

# Transforming Banking in Pakistan

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## Executive Summary

Pakistan undertook ambitious financial reforms in the early 1990s in an effort to establish a more market-based system of monetary management. The reforms were designed primarily to correct the distortion implicit in the administered structure of rates of return on various financial instruments, to do away with the directed credit programs, to enhance competition and efficiency in the financial system, and to strengthen State Bank of Pakistan (SBP) supervision. Accordingly, the Government partially privatized two nationalized commercial banks (NCBs), and introduced an auction system for government securities as steps towards interest rate liberalization and open market operations. The SBP was granted greater autonomy in February 1994. However, since interest rate liberalization preceded fiscal reforms, interest rates shot up, contributing to a further increase in debt servicing costs and the budgetary imbalance. Another important development was the deregulation of resident foreign currency accounts in February 1991.

Further financial liberalization was constrained by a marked deterioration in the financial position of the NCBs, which continued to dominate the banking sector. In fact, the banking sector as a whole experienced declining profitability, increasing inefficiencies, a weakening capital base, and a buildup of nonperforming assets (NPAs).

The stock of nonperforming loans (NPLs) grew from PRs25 billion in 1989 to PRs128 billion in June 1998, or 4 percent of gross domestic product (GDP), while total deposits grew only a little faster than inflation.

Several factors contributed to the disintermediation of deposits, including:

- an increasing dollarization of the economy;
- growing direct borrowing by the Government through attractive tax-advantaged national savings schemes to help finance the deficit;

- a low return on bank deposits due to high reserve requirements and the inefficiency of banks, especially the NCBs; and
- a lack of savers' confidence in the NCBs.

Foreign currency deposits grew rapidly to \$11 billion by July 1997, accounting for half of the country's total bank deposits, compared to less than \$3 billion in the early 1990s. Their rapid increase reflected an erosion of confidence in three factors: the rupee itself, strong tax incentives, and the anonymity regarding the origin of the foreign exchange. With difficulties in mobilizing long-term financing, the widening external current account deficits were financed by nonresidents' foreign currency deposits. Moreover, in accordance with existing policies, foreign currency deposits were exchanged by commercial banks for rupees with the SBP for domestic onlending, while banks purchased forward contracts from the SBP at a cover fee that was consistently 3 to 5 percentage points below the private market forward premium. As a result, banks found it increasingly profitable to intermediate in foreign currency deposits while the SBP suffered large quasi-fiscal losses.

Despite liberalization in the early 1990s, financial markets continued to be segmented into the private and public sectors owing to continuing controls on interest rates paid on government debt and to special credit programs.

Problems in the financial sector are rooted in the following:

- lack of financial discipline encouraged by distorted incentives and weak supervisory capacity of the SBP. In addition, banks are exposed to high risks, since recourse to the legal system is costly and lengthy;
- rising public sector deficits and discriminatory credit rationing. During the mid-1990s, the budget deficit averaged 6.6 percent of GDP, financed by borrowing from the SBP and through the auction of government securities to the banking sector, thus crowding out the private sector from credit;

- mismanagement of short-term capital inflows. Private capital inflows highlighted the inability of the banking system to assess, price, and manage risk, and the inadequacy of the supervisory and regulatory framework to prevent and contain systemic risk. The SBP did not manage foreign exchange resources prudently: by end-May 1998, short-term foreign exchange liabilities of the banking system were \$11.2 billion against official gross reserves of \$1.1 billion; and
- weak resource mobilization. Financial institutions, their industrial clients, and the Government have been unable to mobilize long-term fixed-rate resources for project finance.

Financial sector reforms in 1997/98 were undertaken mainly to promote financial saving, improve the process of financial intermediation, enhance competition, and assure efficient allocation of financial resources. Efforts to achieve these ends, however, have been hampered by political interference, aside from the lack of financial support to carry out banking reforms. Moreover, there are serious structural weaknesses in the banking sector reform strategies adopted. First, there is an overestimation of the capacity of the market to absorb assets that need to be liquidated to recover collateral from bad loans. Second, the development of the capital market has been overlooked. Third, project loans that have contributed significantly to the frequency of loan defaults have not been fully assessed. Fourth, the implementation of reform efforts has been handicapped by the loss of confidence resulting from the freezing of foreign accounts in May 1998.

To overcome these weaknesses, there have been several recommendations, as follows:

- the independence of the judiciary should be reestablished and accountability made impartial to improve governance and end political interference;
- banks' capital requirements should be harmonized, utilizing the standard under the Basle Convention, and a more competitive market structure should be developed. The SBP needs to strengthen its

supervisory capacity so that banks' balance sheets reflect the true position more accurately;

- urgent steps should be taken to develop the capital market, extend the terms of project finance, or reschedule the loans of legitimate cases;
- with regard to the recovery of bad loans, bad assets should be transferred to a separate fund to lengthen the recovery process;
- steps should be taken to deal with market failure in pricing project finance;
- early privatization of the NCBs is a desirable objective, but it must be done through a transparent process with investors who possess integrity, as well as financial and managerial capacity;
- frozen foreign exchange accounts that reached \$7 billion as of September 1998 should be merged with the "new" foreign currency accounts managed by the commercial banks, when a buildup of reserves allows it. Commercial banks could hedge against the exchange rate risk in a developed forward market for foreign exchange; and
- the recent Asian crisis demonstrated the need to proceed with caution in opening the capital account and to undertake liberalization with appropriate macroeconomic, exchange rate, and financial sector policies. In Pakistan's case, while capital inflows were not as large as experienced in Asian economies, there is a need to restore the confidence of foreign investors and domestic depositors in the banking system to revive the economy.

## Introduction

### Overview of the Banking Sector

The financial system of Pakistan consists of the State Bank of Pakistan (SBP), four nationalized commercial banks (NCBs), two partially privatized banks, 3 specialized banks, 21 foreign commercial banks, 12 private domestic banks, 3 provincial commercial banks, 12 development finance institutions (DFIs), 15 investment banks, 33 leasing companies, 51 *modarabas*,<sup>1</sup>

42 mutual funds, 3 stock exchanges, and 68 insurance companies (see Appendix 1). Although in recent years the share of the nonbanking financial sector has increased in terms of lending, the financial system is still dominated by commercial banks.

Between 1993 and 1995, the banking sector as a whole experienced declining profitability, increasing inefficiency, and a weakening capital base, even by Pakistani accounting standards. However, there was a marked difference in performance among the NCBs, partially privatized banks, foreign banks, and private domestic banks.

### STATE BANK OF PAKISTAN

The SBP is the country's central bank. Apart from its traditional central bank functions, it is an important source of financing for the Government and certain State-owned DFIs. To a lesser extent, it channels funds through its refinancing operations to other financial institutions for special purposes such as lending for exports, for small-scale enterprises, and for the purchase of domestically manufactured machinery. It also directs credits by imposing mandatory credit targets on banks for priority sectors. The SBP is the regulatory and supervisory authority for banks, but until the late 1990s shared this role with the Ministry of Finance and the Pakistan Banking Council with respect to the NCBs and DFIs. It had been charged with the supervision of the nonbank financial institutions (NBFIs), but shares this responsibility with the Corporate Law Authority, with respect to nondeposit-taking NBFIs.

Amendments to the State Bank Act in early 1997 enhanced the SBP's autonomy. Recently, the SBP has strengthened its prudential regulations and improved its supervision of the banking system.

### COMMERCIAL BANKS

Commercial banks represent the core of the financial system, holding about 90 percent of deposits and providing more than two thirds of total financing. At present, there are 24 domestic commercial banks

(with 8,718 branches) and 21 branches of foreign banks (with 78 subbranches). Domestic commercial banks include the following:

- 3 large NCBs—the National Bank of Pakistan (NBP), Habib Bank Ltd. (HBL), First Women Bank Ltd., and United Bank Ltd. (UBL);
- 2 banks that were partially privatized—the Muslim Commercial Bank (MCB), with 25 percent government ownership, and Allied Bank Ltd. (ABL), with 49 percent government ownership;
- 4 small specialized State-owned banks;
- 3 provincial banks; and
- 12 private domestic banks.

In 1975, the banking system was nationalized, with a number of private banks merged into fewer larger institutions. Since the early 1990s, the Government has sought private sector participation in the banking system through the privatization of the NCBs and the establishment of new privately owned banks.

In 1990, two NCBs were partially privatized: MCB was sold to a diverse group of investors, and ABL to its employees and management. MCB and ABL were the smallest of the NCBs. They had about one seventh of the assets and deposits of the system, although more than a quarter of the branches. During 1996, the Government attempted to privatize another NCB—UBL—but was unsuccessful, partly because of UBL's large NPL portfolio and overstaffing, and due to militant and corrupt labor unions.

Some progress has been achieved and tangible shifts in market shares are taking place. Up to 1997, the four NCBs lost more than 10 percentage points of market share, with the gain equally shared between private domestic banks and foreign bank branches.

The private domestic banks experienced impressive growth during 1992–1997: their deposit-based market share increased from 5.6 to about 13 percent or by 132 percent, while their loan-based market share increased from 4 to 12 percent or by 200 percent. However, the market share of the four NCBs has

declined from 58 to 46 percent for deposits and from 49 to 39 percent for private sector loans during the same period. In contrast, the market share of branches of foreign banks grew by 35 percent to 22 percent for deposits and 19 percent for loans. The two partially privatized banks, despite improvements in their operations, have not managed to expand their market share during 1992/93–1996/97.

With regard to the market shares for foreign currency deposits, the branches of foreign banks enjoy the highest share: 46 percent for resident deposits and 67 percent for nonresident deposits. Private domestic banks are active mainly in the market for resident foreign currency deposits, with a market share of 25 percent. HBL and NBP together share about 20 percent.

The NCBs' profitability dropped due to an increase in nonperforming loans (NPLs) and declining productivity. If loan losses were adequately provided for, the NCBs would have shown negative returns and net worth, with a negative capital base estimated to be about 6 percent of total assets. Considering the large risks that remain in these institutions, the officially sanctioned capital base of 3 percent of deposit liabilities is inadequate. The cost of recapitalizing these banks in accordance with Bank for International Settlements (BIS) standards could be as high as \$5 billion.

Although still hampered by the low yield on the old stock of loans and an inherited high-cost base, the partially privatized banks have increased their profitability through improved loan recovery and increased efficiency. Still, with a return on assets (ROA) of 0.2 percent and an efficiency ratio of 87 percent, the privatized banks were only marginally profitable in 1995. They have low deposits per branch and high personnel costs due to the recruitment of more qualified staff without a commensurate retrenchment of unqualified personnel.

Although profitability is declining, foreign bank operations in Pakistan are still profitable. The 21 foreign banks make up only 18 percent of the sector but consistently earn about two thirds of its profits. Earn-

ings have come primarily from trade finance and foreign currency deposit collection surrendered to the SBP with good margins. In fact, the dramatic decline in profitability in 1995 was due mainly to reduced arbitrage gains as the SBP began to require banks to pay a forward cover fee for foreign currency deposits, although still subsidized, where there was none before. But with the freezing of the foreign currency accounts, this source of profits for the commercial banks has dried up.

Private domestic banks, with a few exceptions, are doing well. Profitability is comparatively high, as reflected in an ROA of 0.9 percent and a return on equity (ROE) of 15 percent. But as with the rest of the sector, profitability is declining. Moreover, these banks are still small and are highly vulnerable to any banking crises, as they have been dependent on foreign currency deposits.

#### **DEVELOPMENT FINANCE INSTITUTIONS**

In the early years of Pakistan's development, two banks were given a special mandate to address the long-term financing needs of specific clients of the private and public sectors. These are the Industrial Development Bank of Pakistan (IDBP), which was established to provide term finance to small industries, and the Pakistan Industrial Credit and Investment Corporation (PICIC) which extends term finance to medium and large industries. During the 1960s, while PICIC remained in the private sector and IDBP enjoyed relative managerial autonomy, they were well managed and became major sources of foreign exchange term financing for private industrial investment. In the 1970s, nationalization led to serious problems and in the 1980s both institutions were faced with serious portfolio deficiencies coupled with institutional problems, including loss of experienced staff.

The National Development Finance Corp. (NDFC) and Bankers' Equity Ltd. (BEL) were established in 1973 and 1980, respectively. NDFC was instituted as a bank for public sector enterprises while BEL was originally set up to promote Islamic instruments,

notably providing equity finance to private industry, underwriting equity issues, and arranging consortia finance participation from the NCBs.

Except for BEL, which was recently privatized, all industrial DFIs have boards that are controlled by the public sector. These boards have little autonomy in determining basic lending and recovery policies, staffing levels, and remuneration. The DFIs have been impaired by this lack of operational autonomy. Resources for the DFIs have come mainly from international lines of credit and SBP refinancing facilities. Domestically mobilized deposits are only about one third of the assets. Although DFIs have increased efforts at domestic resource mobilization in recent years, they have had little success, except for short-term deposits. With the drying-up of international credit-line sources and weak collection performance, the DFIs, as a group, have not only become insolvent but are also practically illiquid.

In 1982, three joint venture companies, Pak-Kuwait Investment Company Ltd., Pak-Libya Holding Company, and Pak-Saudi Industrial and Agricultural Investment Company were established to provide loans and venture capital to industry. As PICIC, IDBP, and BEL weakened, and NDFC stagnated, their market shares were taken over by the joint-venture DFIs.

Current ownership and loan disbursements of some DFIs are shown in Tables 1 and 2.

#### INVESTMENT BANKS, MODARABAS, AND LEASING COMPANIES

Since the late 1980s, nine private investment banks have been established in Pakistan. So far they have remained small, accounting for less than 1 percent of financial assets. However, unlike the DFIs, since the investment banks were not created with ready-made funds from international financial institutions, they are better grounded in the domestic capital markets. The bulk of their business is in quasi-deposit-taking and short-term finance for Pakistani blue chip companies. But they are expanding their role in project and corporate finance, advisory services, and under-

**Table 1: Current Ownership of Some DFIs (percent)**

Institution	Public	Private and Foreign
IDBP	100	0
NDFC	100	0
BEL	36	64
PICIC	51	49
Pak-Kuwait	50	50
Pak-Libya	50	50
Pak-Saudi	50	50

BEL = Bankers' Equity Ltd., DFIs = development finance institutions, IDBP= Industrial Development Bank of Pakistan, NDFC = National Development Finance Corp., PICIC = Pakistan Industrial Credit and Investment Corp.  
Source: State Bank of Pakistan.

**Table 2: Loan Disbursements of Some DFIs (PRs million)**

Institution	1989/90	1995/96	1996/97 <sup>a</sup>
NDFC	2,272	2,243	1,302
PICIC	1,230	583	350
BEL	1,461	489	710
IDBP	1,114	275	287
Pak-Kuwait	68	3,267	3,420
Pak-Libya	77	401	122
Pak-Saudi	182	285	337

BEL = Bankers' Equity Ltd., DFIs = development finance institutions, IDBP= Industrial Development Bank of Pakistan, NDFC = National Development Finance Corp., PICIC = Pakistan Industrial Credit and Investment Corp.  
<sup>a</sup> excluding working capital.  
Source: State Bank of Pakistan 1990/91 and 1995/96 Annual Reports.

writing. The larger investment banks are also in stock brokerage and portfolio management. Unlike the DFIs, these investment banks seem to play an important role in Pakistan's capital markets and can become important players in the financial sector in the future, especially since credit lines to DFIs have substantially dried up in recent years. In 1996/1997, the overall financial assistance disbursed by investment banks, *modarabas*, and leasing companies declined by 14.6 percent from the previous period, as a result of a sharp decrease by 26 percent in working capital loans. During the same period, term finance sanctioned by *modarabas* increased by 174 percent and investment banks by 11.9 percent. However, the term finance sanctioned by leasing companies declined by 25 percent, reaching PRs9.5 billion during the same year.

The respective shares of *modarabas*, leasing companies, and investment banks in the total amounts

**Table 3: Credit Indicators of *Modarabas*, Leasing Companies and Investment Banks (PRs billion)**

Type of Assistance	1994/95		1995/96		1996/97	
	Sanctions	Disbursement	Sanctions	Disbursement	Sanctions	Disbursement
Overall Assistance (i+ii)	45.5	42.9	54.5	52.9	46.7	45.2
i. Fixed Industrial Financing	15.3	14.1	21.4	20.1	22.2	20.8
	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)
<i>Modarabas</i>	1.2	1.3	1.9	1.9	5.2	5.2
	(7.8)	(9.2)	(8.9)	(9.5)	(23.4)	(25.0)
Leasing Companies	10.2	7.8	12.7	10.5	9.5	8.3
	(66.7)	(55.3)	(59.6)	(52.2)	(42.8)	(39.9)
Investment Banks	3.9	5.0	6.7	7.7	7.5	7.3
	(25.5)	(35.5)	(31.5)	(38.3)	(33.8)	(35.1)
ii. Working Capital Loans	30.2	28.8	33.1	32.8	24.5	24.4
	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)
<i>Modarabas</i>	3.5	3.6	2.7	2.6	2.5	2.5
	(11.6)	(12.5)	(8.1)	(7.9)	(10.2)	(10.2)
Leasing Companies	1.0	1.1	1.1	1.0	0.4	0.4
	(3.3)	(3.8)	(3.3)	(3.0)	(1.6)	(1.6)
Investment Banks	25.7	24.1	29.4	29.2	21.6	21.5
	(85.1)	(83.7)	(88.6)	(89.0)	(88.2)	(48.1)

Figures in parentheses are percentage shares.  
Source: State Bank of Pakistan.

approved for term finance during 1996/97 stood at 23.4, 42.8, and 33.8 percent, as compared with 8.9, 59.6, and 31.5 percent, respectively, during the previous period (see Table 3).

### FOREIGN CURRENCY ACCOUNTS

Foreign currency accounts for nonresidents were introduced in 1973 (see Appendix 2), while resident foreign currency deposits were deregulated in February 1991. Both types of accounts are protected from disclosure requirements regarding the source of funds. The interest rates payable on these accounts are capped at fractions of a percent above LIBOR (London interbank offered rate), varying with the maturity of deposit. The margins range between 3 and 8 percent for three-month deposits to 5 and 8 percent for three-year deposits. Commercial banks are required to surrender foreign exchange to the SBP in a swap agreement, with the period of the swap corresponding to the initial maturity of these deposits. In June 1992, the SBP phased out its policy of providing free full-forward exchange cover to financial institutions with respect to these deposits and introduced a fee of 3 percent per year. As of end-March 1995, the fee was 4.5 percent and the

stock of foreign currency deposits outstanding was \$6.3 billion, of which about \$3.3 billion was held by residents. In 1993/94, part of foreign currency deposits, especially residents' foreign currency deposits, financed nearly a quarter of the current account deficit (see Table 4).

### Forward Foreign Exchange Cover

The SBP provides forward cover on all foreign currency account deposits to commercial banks that are required to surrender such deposits to the SBP. It previously also extended forward cover on foreign currency loans for trade finance and working capital at a fee of 10 percent. The fiscal cost of the latter cover to the SBP varied with the rate of devaluation of the rupee. Recently, the SBP has discontinued providing forward cover on such short-term foreign currency loans. Several commercial banks are now providing forward cover at varying rates.

Although complete information on the maturity structure of foreign currency accounts and deposits is not available, there is evidence that most deposits had less than one year maturity. However, the maturity structure of foreign currency deposits has been implicitly lengthened by the widespread use of these

**Table 4: Foreign Currency Accounts (\$ million)**

Period (End June)	Foreign Banks (institutional)	Individual Banks	Nonbank Financial Institutions	Total	Resident Foreign Currency Deposits	Total Foreign Currency Accounts	Current Account Deficit
1987	839	654		1,494		1,494	1,682
1988	894	755		1,649		1,649	1,934
1989	913	639		1,552		1,552	1,891
1990	1,088	1,027		2,116		2,116	2,171
1991	951	1,252		2,203	386	2,589	1,346
1992	906	1,084		1,989	1,707	3,696	3,666
1993	864	1,186	177	2,227	2,250	4,478	1,965
1994	1,059	1,404	457	2,920	3,002	5,923	2,484
End March 1995	1,011	1,355	642	3,008	3,255	6,262	na
14 June 1995	na	na	na	3,066	3,260	6,326	na

na = not available.  
Source: State Bank of Pakistan.

deposits as a form of collateral. These deposits, especially those held by residents, demonstrated their stability as they withstood the test of confidence during the balance-of-payments crisis in 1993.

The stability of foreign currency deposits before the recent change of rules depended largely on the motivation to hold a foreign currency asset. Research has confirmed that foreign currency deposits associated with workers' remittances and the informal economy are a more stable form of capital.

## The Early Reforms

Pakistan's financial sector reforms in the early 1990s aimed to establish a more market-based system of monetary management. As part of the reform measures, the Government not only partially privatized NCBs so as to increase competition and efficiency in the banking system, but also, as a step toward interest rate liberalization, it introduced an auction system for government securities. This enabled the SBP to exercise indirect monetary control through open market operations. Subsidy to credit schemes was withdrawn. The SBP was granted autonomy in February 1994.

In order to assure better coordination among the macroeconomic variables, a high-powered statutory body, the Monetary and Fiscal Policies Coordina-

tion Board, was constituted in February 1994, through an amendment to the 1956 State Bank of Pakistan Act. The Board is headed by the Federal Finance Minister. It coordinates fiscal, monetary, and exchange rate policies, and assures consistency among macroeconomic targets for growth, inflation, and fiscal, monetary, and external accounts. It reviews the latest macroeconomic developments on a quarterly basis.

The most obvious outcome of market-oriented reforms in the monetary and banking sector is that there has been a visible shift in the assignment of priority in the credit plan from the government sector to the private sector. This has not only assured a balanced growth of money supply but has taken into account the genuine needs of the private sector. Overall, money supply has declined to the targeted path. Money supply (M2), which grew by an annual average of 20.5 percent in 1990/91–1992/93, contracted to 16.4 percent in 1993/94–1995/96 and further slipped to 12.2 percent in 1996/97 (below the projected target of 13.1 percent for that year). Similarly, annual average growth in domestic credit of 21.1 percent during 1990/91–1992/93 dipped to 14.5 percent in 1993/94–1995/96 and slightly inched up to 15.3 percent in 1996/97. However, since interest rate liberalization preceded fiscal reforms and a

decline in the budget deficit, interest rates shot up. The latter contributed to a further increase in debt service obligations of the Government, thus aggravating the budgetary imbalance.

### Constraints to Further Liberalization

One of the main constraints to moving further with financial liberalization and reliance on market mechanisms of monetary control has been the marked deterioration in the financial position of the banking system, in particular of the NCBs, which continue to dominate the banking sector. In recent years, the sector has experienced declining profitability, increasing inefficiencies, a weakening capital base, and a buildup of nonperforming assets (NPAs). Loan defaults of banks and DFIs reached a level of PRs121 billion at the end of December 1996—nearly 21 percent of total advances, and close to 5 percent of gross domestic product (GDP). Of the total amount of PRs102 billion owed to banks at the end of December 1996, PRs83 billion have been loaned to the NCBs and to four small State-owned specialized banks. The bulk of “stuck-up” loans has been used mostly for project financing to large-scale textile industries. The largest 250 defaulters accounted for about 70 percent of the total loan defaults.

The declining profitability and increasing inefficiencies in NCBs were due to weakening government leadership and the burden placed on banks to fulfill several social objectives—creating employment, servicing remote areas at high cost, and providing subsidized and mandatory credit under an array of government-sponsored credit schemes. Analysis based on 1995 data found that the negative net worth of the NCBs was PRs60 billion (the equivalent of 2 percent of GDP), and that the cost of recapitalizing these banks according to BIS standards could be as high as \$5 billion (equivalent to 7 percent of GDP). Moreover, the profitability of all banks continues to suffer from remaining forms of financial repression such as indicative credit ceilings and high liquidity requirements.

## 1997–1998 Banking Reforms and Issues

### Major Problems of the Banking Sector on the Eve of the 1997–1998 Reforms

While Pakistan took great strides in deregulating the banking sector in the early 1990s, Government loss of control coupled with lack of credit discipline especially in the State-owned banking sector have aggravated structural problems, as evidenced by a rising level of NPLs and increasing disintermediation. Worsening macroeconomic imbalances led to a growing dependence on foreign currency deposits and increasing market intervention to contain the cost of financing a large fiscal deficit. Consequently, the insolvency of the banking sector rose, two large NCBs and the older DFIs experienced liquidity problems, foreign exchange reserves were boosted by potentially volatile and expensive foreign currency deposits, and access to credit by the private sector was increasingly curtailed.

#### **DETERIORATION OF THE LOAN PORTFOLIO**

Resource allocation, a key function of the financial sector, has been vitiated by political interference in lending and loan recovery decisions. As a result, the stock of NPLs has grown from PRs25 billion in 1989 to PRs128 billion as of June 1998, or 4 percent of GDP. On the other hand, total deposits were growing only at a little above inflation, with growth accounted for mainly by foreign currency deposits (before May 1998). So while the banking sector is still liquid, in terms of stock, there is an emerging liquidity problem, owing to the conservative reserve policies of the past (i.e., credit/deposit ratio not exceeding 65 percent). New deposits may become insufficient to cover the outflow from bad loans and operational losses.

#### **SLOWDOWN IN DOMESTIC DEPOSIT GROWTH**

Disintermediation of domestic deposits is caused by several factors, as follows:

- increasing dollarization of the economy as confidence in the rupee weakens,
- growing direct borrowing by the Government through attractive tax-advantaged national savings schemes to help finance the deficit,
- low return on bank deposits vis-a-vis inflation and overcompeting financial and real assets due to heavy taxation on financial intermediation (through high reserve requirements) and the inefficiency of banks—especially the NCBs, and
- increasing lack of confidence of savers in the NCBs (the traditional domestic deposit mobilizers) in the face of publicity about their large NPLs and poor service in comparison with the new private banks.

### FOREIGN CURRENCY DEPOSITS

Foreign currency deposits had grown rapidly to \$11 billion by July 1997, already accounting for half of bank deposits in Pakistan compared with less than \$3 billion in the early 1990s. The rapid increase in resident foreign currency deposits reflected the tendency in recent years towards more external private transfers (mainly workers' remittances) being kept in foreign exchange rather than being surrendered to the SBP. This was caused by an erosion of confidence in the rupee, strong tax and other incentives to these deposits, and the "no questions asked" policy concerning the origin of the foreign exchange. Widening current account deficits and difficulties in mobilizing long-term financing has, on the other hand, led to increased reliance on mobilization of nonresidents' foreign currency deposits as a form of external short-term financing.

In so far as regulations prohibited banks from lending in foreign currency and permitted them to maintain only small uncovered positions in foreign exchange, foreign currency deposits were exchanged for rupees with the SBP for on-lending in Pakistan. The banks then closed their open position by purchasing a forward contract from the SBP. Despite several adjustments in the forward cover fee (one

implemented in late March 1997 increased the fee to 5 percent for dollar deposits), they have proven inadequate to compensate for actual exchange rate depreciation, resulting in large losses (PRs11 billion in 1995/96 and PRs24.3 billion in 1996/97) for the SBP.

The level of the forward cover fee has also been consistently 3 to 5 percentage points below the private market forward premium.<sup>2</sup> The below-market level of this fee has served, in part, to lower lending interest rates—i.e., to provide a subsidy to the private sector that has access to bank credit and to mask the real cost of borrowing by the Government. On the other hand, it has afforded banks a comfortable intermediation margin estimated at 5 percent. As a result, banks have found it increasingly profitable to intermediate in foreign currency deposits, and thus they have increasingly relied on them as the principal source of funds. This has also contributed significantly to the rise in the share of foreign currency deposits in total bank deposits. In particular, banks and NBFIs increased their short-term foreign borrowings, the proceeds of which were "deposited" with the SBP, with the corresponding rupees loaned out to local clients. The foreign exchange cover scheme has also given banks and financial institutions attractive fee business when they bring in foreign currency deposits that are prearranged by "depositors" as loans to third parties in Pakistan. In all these transactions, bank depositors and borrowers arbitrage between foreign and domestic interest rates, with the SBP providing the hedge at a subsidized rate, thus creating large quasi-fiscal deficits. In 1996–1997, the annual losses of the SBP due to this scheme were 0.8 percent of GDP.

### MARKET SEGMENTATION

Despite liberalization, the financial markets continue to be segmented, principally into private and public sectors due to continuing controls on interest rates paid on government debt. Yields on Treasury bills (T-bills) were artificially expressed by predetermining cutoff rates at the primary auctions, and requiring banks to hold large reserve requirements in

T-bills and other government paper. (For these reasons too, there was hardly any secondary market for government paper.) On the other hand, because of its appetite for funds, the Government borrows at much higher rates from the public through national savings schemes that offer higher yields and are tax advantaged. The spread between the yield on government securities (sovereign risk) and private sector debt (commercial risk) is large.

The other sources of market segmentation are the special credit programs. Although declining, these programs are still sizable. In 1995/96, the total cost of interest subsidies amounted to about PRs7 billion or 0.3 percent of GDP. The Government implements two types of special credit programs: mandatory credit programs and concessional credit programs. Under mandatory credit programs, the SBP prescribes minimum annual targets for Pakistani commercial banks to lend to certain priority sectors, such as agriculture, industry, and business. Concessional credit programs require banks and NBFIs to charge below-market interest rates on their loans for exports, local sale and export of locally manufactured machinery, tourism projects in specified geographic areas, and production loans to small farmers. Loans to the Government for financing commodity operations are also at concessional rates.

Mandatory credit targets and concessional credit schemes have been justified on grounds of market failure, which has constrained access to credit by certain sectors or classes of borrowers, and for social reasons—to provide relief to the disadvantaged. But contrary to expectations, interest repression has constrained the supply of credit and political clout has influenced the allocation of limited funds. Thus, these schemes have not only been costly for the budget, but have also become unsustainable and, to a large extent, ineffective in achieving their objectives. Besides, these schemes have had poor repayment records. The default risks have been so high that banks have preferred to pay the penalty of not meeting targets, rather than lose the principals of such loans.

## Root Causes of the Problems

### **FAILURE OF GOVERNANCE AND LACK OF FINANCIAL DISCIPLINE**

The financial sector leadership, including bank owners, bank regulators, market competitors, and the courts, either adopted distorted incentives or are too weak to provide proper executive ability or impose credit discipline. The Government, which owns most of the banking sector through its ownership of the NCBs and larger DFIs, has allowed political interference to twist credit allocation and loan recovery decisions of the NCBs and DFIs. Together they have accounted for 90 percent of the bad loans of the entire system. Similarly, loan recovery by the NCB and DFI officers and staff has been thwarted by fear of politically motivated retribution.

Because of the frustration over the devastation of the banking sector, there is consensus in Pakistan that the key solution lies in the privatization of State-owned banks. However, market conditions, slow restructuring of banks, bureaucratic inertia, and the political agenda have slowed down the privatization program since the initial spurt in the early 1990s.

Banking regulation and supervision over the NCBs and DFIs used to be shared by three agencies—the Ministry of Finance, the Pakistan Banking Council, and the SBP—whose authority had been weakened by conflicts of interest and questionable incentives. The SBP did not have the autonomy to exercise its supervisory powers over most of the banking sector, i.e., the NCBs and DFIs. Because of a conflict between the Banking Companies Ordinance and the Bank Nationalization Act (which set up the NCBs) the SBP could not exercise its powers to discipline the NCBs through various enforcement measures, especially the removal of management or withdrawal of banking licenses. Only the Government, through the Ministry of Finance and the Pakistan Banking Council, had the authority to appoint or remove NCB and DFI management. The Government, not the central bank, was the authority that granted banking licenses and permission to open branches.

The SBP's supervisory capacity is itself weak. Although it is trying to improve the quality of bank supervision, it will take time before the SBP can acquire the expertise to manage banking risks and anticipate bank failures, considering the years of neglect during the period of nationalized banking. Moreover, there are major organizational and systemic problems that work against the SBP's efforts to modernize, including a powerful labor union that resists personnel changes.

Although growing, competition in financial markets is still limited. The NCBs continue to dominate the market, also rendering market discipline weak. Among the NCBs, HBL and NBP account for half the market. Credit ceilings, although removed in principle, are still applied in practice, and prevent more dramatic shifts in market shares among the NCBs, the privatized banks, the private domestic banks, and foreign banks. Moreover, the playing field is not level. NCBs and privatized banks are allowed to operate *de jure* with less capital (although the situation is worse, *de facto*, since they have negative capital), enjoy lower tax rates, and have a preferred position to receive public sector deposits. A reduction in market concentration must be an important objective to aim for in the privatization of the NCBs. The sale of the NCBs, especially of HBL, in parts, rather than as wholes, must be a serious consideration.

Finally, the legal risks for banks in Pakistan are high. When a loan becomes nonperforming for any reason, legal recourse is costly because of the time it takes not only for decisions to be made but also to get the decisions executed. Lenders cannot foreclose on collateral without lengthy court procedures. The legal and judicial system in Pakistan has become a haven for defaulters rather than a deterrent to defaulting. Under Islamic banking practices, interest has to stop accruing 210 days after a case is filed in court, on the assumption that court decrees could be made and executed in 90 days and because of the Islamic principle that interest cannot accrue on interest. Since the experience shows that it takes years

to get court cases resolved, a defaulter can enjoy an interest free loan beyond the initial 210 days allowed for accruing interest under Islamic banking practices.

## **PUBLIC SECTOR DEFICITS AND CREDIT RATIONING**

During the five-year period, 1992/93–1996/97, the Federal Government budget deficit averaged 6.6 percent of GDP, contributing to inflationary pressures and imbalances in the external accounts, and resulting in a large buildup of public debt. The deficit was financed by borrowing from the SBP and through the auction of government securities to the banking sector, thus crowding out the private sector from credit. Following the introduction of market-based auction procedures, the interest rates on T-bills were liberalized, although initial auction procedures were far from ideal. Consequently, interest rates rose due to the poor sequencing of reforms, i.e., interest rate liberalization preceded fiscal adjustment.

Apart from crowding out the private sector, credit was allocated between banks and targeted sectors of the economy by the SBP on grounds of market failure.

## **MISMANAGEMENT OF SHORT-TERM CAPITAL INFLOWS**

Pakistan experienced considerable private capital inflows throughout the 1980s in the form of workers' remittances and, to a lesser extent, private short- and medium-term capital inflows. These flows have financed most of the trade deficit since that period. However, it was only in 1993/94, that private capital inflows grew substantially, contributing to a rapid accumulation of reserves.

The initial expectation was that capital inflows would have positive impact, by easing external financing constraints and holding the potential for higher investment and growth. However, if capital inflows become large, they could threaten macroeconomic stability by contributing to an acceleration in domestic demand, feeding inflationary pressures. There

were significant variations in experiences of other developing countries that received capital inflows, due to the nature of the inflows and the policy responses adopted by governments. Nevertheless, policymakers have similarly sought to accommodate higher investment and growth afforded by the inflows while trying to insulate their economies from destabilizing effects. This was the challenge policymakers in Pakistan also faced.

The growing volume of capital inflows into Pakistan in recent years raised some important issues, such as: what are the effects of capital inflows on the banking system and capital market? Have financial risks in Pakistan's banking system increased? Are the existing regulatory, supervisory, and accounting arrangements capable of fostering adequate management of these risks?

While there is evidence that workers' remittances and resident foreign currency deposits are relatively stable forms of inflows, the growing practice of using these deposits as a form of collateral has further enhanced their stability. On the other hand, portfolio investment, some nonresident foreign currency deposits, and other short-term capital present a potential risk of a reversal of flows in a very short time. It was feared this could create a banking crisis, and result in exchange-rate and interest-rate volatility. In view of this, two major areas of concern were addressed:

- the ability of the banking system to assess, price, and manage risk; and
- the adequacy of the supervisory and regulatory framework, e.g., of the SBP, to prevent and contain systemic risk, particularly in the presence of the problem of moral hazard.

To meet this risk, policymakers were required to ensure adequate gross official reserves and quality of domestic credit expansion. When the banking system is sound and efficient, in the process of extending credit, banks are able to anticipate the effect of a reversal of capital flows on the revenues of their borrowers (interest rate and exchange rate risks) by

pricing loans accordingly, accumulating reserves against such loans, and reducing the concentration of their loan portfolios to sectors that may be affected by capital flow reversals.

On the other hand, when credit institutions operate in a regulatory environment that allows them to misallocate credit and mismanage their balance sheets, an expansion of bank credit induced by capital inflows will create further opportunities for banks to expose the financial system to a larger risk of financial loss. As a preventive measure, the authorities in Pakistan decided to collect foreign exchange reserves in the SBP instead of the commercial banks, thus asking commercial banks to surrender foreign exchange to the SBP. Unfortunately, the SBP and the Government did not manage foreign exchange resources from potentially volatile sources in a manner that was prudent and responsible. By the end of May 1998, the short-term foreign exchange liabilities of the banking system were \$11.2 billion against official gross reserves of \$1.1 billion.

#### **TERM LENDING/RESOURCE MOBILIZATION**

Financial institutions, their industrial clients, and the Government have been unable to mobilize long-term fixed-rate resources for project financing. As a result, most projects financed are repayable in five to ten years, implying a repayment of 10–20 percent of the principal every year, starting with the first year of operation. During the years of import substitution policies when ROEs were high, loans of five to ten years on projects were serviceable. Following the start of trade liberalization in 1988, and especially after tariffs were reduced sharply in 1993, ROEs have fallen sharply in Pakistan, and in line with returns in competitive international markets. This has adversely affected the debt servicing ability of businesses in the country due to the short repayment period.

Domestic investors have been locked into large equal repayments (in nominal terms) of principal, which implies heavily front-loaded real amortization patterns. This is not helpful to new projects, which

typically do not reach full capacity production or profits in the early years of operation. The outcome is loan default. The problem is aggravated by new prudential regulations that force banks to cut off working capital loans to such borrowers, thus resulting in a typical “sick industry.”

## 1997–1998 Banking Reforms

The problems of the financial sector had their origin in the nationalization of banking institutions, weakening of appropriate regulations, undue outside interference, and the erosion of an accountability mechanism. The thrust of the 1997/98 reform program is to improve the environment for, and ability of, bank owners, bank management, bank regulators, the markets, and the courts to provide better governance and regulation in order to promote efficient financial intermediation. The reform program focuses on:

- speeding up the privatization of State-owned institutions, and assuring necessary restructuring and improved management;
- improving the legal and judicial process for enforcement of financial contracts;
- centralizing the regulatory authority in the SBP;
- strengthening the SBP’s capabilities to perform its enhanced responsibilities; and
- improving prudential regulations and the supervision of financial institutions.

### **AUTONOMY OF THE STATE BANK OF PAKISTAN**

To address structural weaknesses in the financial sector, the State Bank of Pakistan Act was amended to grant the SBP full autonomy in the conduct of monetary policy. Amendments were also made in banking laws to strengthen the SBP’s authority in bank supervision and regulation.

### **PRUDENTIAL REGULATIONS AND BANK SUPERVISION**

The enactment of the amendments to the Banking Companies Law and to the Banks’ Nationalization Act made the SBP the exclusive regulatory and su-

pervisory authority for the banking system, and insulated State-owned banks from political interference. The Pakistan Banking Council was abolished, and all its former responsibilities transferred to the SBP. Private sector bankers replaced the managers of HBL and NBP and their boards were reconstituted. Moreover, the SBP has developed a comprehensive plan to modernize and strengthen its banking supervision department, reorient its policy objectives, and adopt new supervisory techniques and data-collection methods.

### **LEGAL ENVIRONMENT AND INCENTIVES FOR LOAN RECOVERY**

To improve the legal environment for loan recovery, Parliament passed in May 1997 the Banking Companies (Recovery of Loans, Advances, Credits, and Finances) Act of 1997. This law is expected to sharply reduce the legal and judicial costs to recover loans as it provides that default cases must be disposed of in 90 days, after which the defaulter is required to furnish security. Attachment of collateral is permitted before judgment and appointment of a receiver. In cases where a bank is authorized to recover or take possession of the collateral without filing a suit, the bank may, at its discretion, recover its loan by selling the collateral.

An incentive package was offered to defaulters vis-a-vis State-owned banks and financial institutions to voluntarily repay their overdue loans without facing legal action under the new law. The package provides incentives to all loan defaulters to settle their overdue obligations to NCBs and DFIs, offering some exemptions on payment of overdue interest. The defaulters would have to make an agreement with the respective financial institutions within one month and repayment would have to be made within six months.

### **ARRESTING THE FLOW OF BAD LOANS**

Considering the deep-seated nature of the problems in the country’s banking sector, it will require persistent and constant efforts over the medium term to

remove them. However, in the immediate term, the Government and the SBP have taken measures to prevent the situation from getting out of hand. Based on an analysis of the 250 largest defaulters, the main source of default has been project lending by the NCBs. In December 1996, the Government, as owner, instructed the NCBs to refrain from making new project loans until June 1997. This was an emergency measure justified on grounds of stopping the hemorrhage. It also helped to restructure the market shares of the NCBs, partially privatized banks, private domestic banks, and foreign banks, which had remained static due to the previous credit ceilings. The SBP has stopped using informal credit ceilings to control liquidity, and is using more indirect means of monetary control.

In January 1997, the SBP required the new management of the NCBs and DFIs to submit for its clearance well-defined lending policies, including loan approval procedures and powers of various levels of management. It issued directives to tighten lending practices and increase transparency in lending. With its new powers over the NCBs and DFIs, the SBP has been closely monitoring compliance with the new lending policies.

#### **PREVENTING FURTHER DETERIORATION OF THE NCBs AND DFIs**

The management and boards of the NCBs and DFIs have been replaced. More important, the process of their appointment and removal has been changed through an amendment to the law. Appointment of presidents and board chairpersons are based on a list of qualified professionals, maintained and updated by the SBP. They serve for a fixed term of three years and have security of tenure. Similarly, the Government has appointed board directors in consultation with the SBP. Moreover, all selections, promotions, and transfers of NCB and DFI staff, and decisions on remuneration and benefits, are being made by the concerned bank presidents in accordance with personnel policies approved by their

boards, under the guidelines of the SBP. Amendments to the law prohibit government departments from issuing directives to NCBs and DFIs that are inconsistent with those of the SBP. The Pakistan Banking Council has been abolished, making the SBP the sole regulatory and supervisory agency for the banking sector.

Acting as caretaker management until these institutions are privatized, the new managements of the NCBs and DFIs are implementing action programs approved by the SBP, aimed at conserving assets, reducing costs, downsizing staff and branches, increasing loan recovery, and limiting lending to borrowers that have no defaults with any other bank.

#### **REDUCING THE STOCK OF NONPERFORMING LOANS**

Efforts to reduce the stock of bad loans through vigorous recovery have also started. The Government and the SBP have launched a loan recovery program consisting of two phases. The first phase, from 5 June to 5 September 1997, was an amnesty program under which defaulters and "sick units" were given incentives to settle their overdue amounts. Cash settlement is typically 10 percent downpayment, with the 90 percent balance due by 5 December 1997. Under this program, some 34,000 defaulters and 770 sick units with loans amounting to PRs28.5 billion and PRs34.4 billion, respectively, were covered.

The second phase was the mandatory filing with the banking courts of default cases of borrowers who did not take advantage of the amnesty program by 30 September 1997. These defaulters will be pursued vigorously under the new loan recovery law. This law has strengthened the hand of the banks and DFIs to expedite loan recovery. Outside of the amnesty program, the new managements of the NCBs and DFIs have also pursued loan recovery more aggressively. Asset recovery departments under new management have been established. As of 30 June 1998, PRs16.3 billion had been recovered in cash,

while PRs 14.7 billion in loans had been restructured or rescheduled, together constituting about 21 percent of total loan default at the time.

### REFORMING GOVERNANCE THROUGH PRIVATIZATION

The overriding goal of privatization is to achieve good governance by selling the NCBs and DFIs (see Table 5) to private investors who possess the integrity, capital, banking expertise, management, and technology to run these institutions prudently and efficiently. The privatization plan consists of the following:

- complete divestiture of the Government's remaining ownership interests in MCB, ABL, PICIC, and BEL, and the sale of Habib Credit and Exchange Bank;
- full privatization of HBL, UBL, NBP, NDFC, and IDBP; and
- orderly liquidation of the bad assets that will be removed by the Government from HBL, UBL, NBP, NDFC, and IDBP when they are sold.

#### Reducing Political and Social Costs

Until the end of 1996, all the five large institutions to be sold were heavily overstaffed, while three NCBs, namely, National Bank of Pakistan, Habib Bank and United Bank had by far too many branches to achieve reasonable profitability. Overstaffing and overbranching were caused by political interference and by militant labor unions that resisted downsizing, making it difficult to attract bona fide investors. Thus,

before privatization, the staffs and branches of these institutions are rationalized in accordance with the plans agreed with the SBP, through voluntary separation with the help of an attractive severance payment program. Through this program, 20,000 employees, or 25 percent of total staff, were shed from the NCBs and DFIs. The cost of the severance payment program is expected to be about \$350 million on an after-tax basis.

#### Removal of Bad Assets

To attract bona fide investors and enhance the transparency of the privatization process, the Government will remove the bad assets in HBL, UBL, NBP, NDFC, and IDBP that remain after vigorous recovery efforts. However, to assure that financial restructuring is not carried out before there is a structural change in governance, the removal of bad assets will be undertaken only upon privatization.

#### Transparency of the Privatization Process

The Privatization Commission, the agency responsible for privatization, is contracting fully qualified investment advisers to assist in the structuring of the sales transactions and in developing related marketing plans. The Commission, in close collaboration with the SBP, is preparing a complete information package on each institution that would provide prospective bidders with sufficient information to undertake informed analyses of the transactions and perform their own thorough due diligence.

**Table 5: Status of NCBs and DFIs, as of 31 December 1995**

Item	Total	HBL	UBL	NBP	NDFC	IDBP
Number of Employees	77,492	31,761	22,102	21,549	1,200	880
Number of Branches	5,280	1,978	1,706	1,537	40	19
Total Assets (PRs billion)	893.0	336.6	182.2	320.2	33.0	21.0
Classified Loans (PRs billion)	121.4	52.0	32.0	17.4	8.0	12.0
Provisions (PRs billion)	42.0	18.7	4.5	10.9	2.9	5.0
Paid-up Capital (PRs billion)	6.1	2.5	1.5	1.5	0.4	0.2
Reserve Funds (PRs billion)	15.8	4.8	2.1	6.4	2.1	0.4

DFIs = development finance institutions, HBL = Habib Bank Ltd., IDBP = Industrial Development Bank of Pakistan, NBP = National Bank of Pakistan, NCBs = nationalized commercial banks, NDFC = National Development Finance Corp., UBL = United Bank Ltd.  
Source: State Bank of Pakistan.

## **STRENGTHENING PRUDENTIAL REGULATIONS AND BANKING SUPERVISION**

The general objective of banking reforms is to develop a regulatory and supervisory system that will accurately assess the conditions of banks and deposit-taking NBFIs and, where problems exist, take action to rectify them. The system will prescribe capital standards, loan concentration limits, provisioning norms, and reporting requirements consistent with international standards, and assure that such policies are pursued by NCBs and DFIs.

### **Reporting Disclosure for Off-site Supervision**

At present, reports submitted by the banks to the SBP include substantial detail in some areas, but omit important information that is necessary to assess their condition. Banks are not required to submit an income report according to any format prescribed by the SBP. At present, annual audited financial statements are made available to the public once a year, three or four months after the end of the year. Apart from the time lag, the accuracy of these reports is questionable. Income and net worth do not reflect required provisioning for many banks.

The SBP has announced revised reporting requirements based on accounting standards that are consistent with international norms. Revised reporting began in 1997 along with initial efforts at off-site monitoring. The SBP required banks to report provisioning requirements and appropriately adjust net income and net worth in 1998, based on 1997 reports.

In due course, on-site examinations will help assure the accuracy of the reports. Once the quality of reporting reaches satisfactory levels, the information from individual banks will be available to the public, in an effort to make the overall financial system transparent and subject to greater market discipline.

### **Role of Bank Examiner**

In the past, on-site examinations have focused, to a considerable extent, on determining whether banks were complying with certain legal requirements.

Examiners paid little attention to such factors as determination of overall performance, risk profile, and the quality of management at the banks.

The SBP has hired the services of an international consulting firm, in consultation with the World Bank, whose mission includes, among other things, modernizing and reorienting on-site bank examinations in Pakistan. This will involve participating in on-site examination, developing a satisfactory examination manual that focuses on bank risk and performance, an appropriate examination report, and initiating training to enable supervisory staff to act effectively in the future.

### **Quality of Examination Staff**

As a part of its plan to revamp its supervisory and regulatory side, the SBP has started a crash recruitment and training program to improve its long- and short-term staffing and skill requirements. In the short run, it has recruited several qualified and experienced middle-level staff in the banking supervision departments. In the long run, it is necessary to continually recruit qualified young professionals to keep up with growing staffing needs. The pay and quality of supervisory staff must be sufficient so that they eventually command the respect of the financial institutions. The SBP has developed a plan for staff compensation in 1997/98.

### **Capital Requirements**

Currently, capital requirements are based on total callable liabilities. They are 7.5 percent for foreign banks, 8 percent for private domestic banks, and 3 percent for the NCBs and partially privatized banks. The Pakistani liability-based system does not raise the capital requirement for off-balance sheet exposure, nor lower it for holdings of cash and government securities, nor take account of borrowings. To strengthen the system's capital base and achieve international consistency, Pakistan will move to the Basle system of defining minimum capital requirements. These requirements will apply to consolidated bank balance sheets for all Pakistani banks.

### **Provisions for Loan Losses**

Loan classifications and provisioning requirements are based principally upon the length of time that either or both interest and principal payments are in arrears on a particular loan. In calculating required provisioning, only liquid collateral is netted out. Some provisioning requirements may appear substantial in view of the value of nonliquid collateral. However, recovery experience from nonliquid collateral on NPLs has been bad.

Time-based provisioning will continue until satisfactory court reforms occur and loan collection experience shows improvement. In the immediate future, the best practice will be to continue time-based provisioning, supplemented by increased classification and provisioning in those situations where time-based rules understate likely present value loss. Required provisions as determined by the SBP will be made, regardless of their impact on net income and on a bank's net worth.

### **Loan Concentration**

Single-borrower limits for commercial banks are reasonable and consistent with international standards. However, a single borrower, if a listed company, was allowed to borrow up to 20 percent of the assets of an NBFIs. This is excessive and could lead to insolvency. Accordingly, the SBP has revised the relevant regulations to make the single-borrower limits of deposit-taking NBFIs consistent with those of commercial banks.

### **Large Credits**

Large business groups account for a major share of bank borrowing in Pakistan and the performance and creditworthiness of these groups are important for bank performance. The SBP will establish a staff team within its departments that will analyze financial performance of major Pakistani groups and their affiliates and its findings will be available to those engaged in on-site examinations.

### **Problem Banks, Enforcement, and Bank Closing Procedure**

The laws have been changed to make it possible for the SBP to identify problem banks, take measures to enforce prudential requirements, and initiate closing procedures if a banking company does not show improvement.

### **Deposit Insurance**

The Government guarantees deposits with nationalized banks, but this is not the case with deposits with private domestic banks, which account for about 7 percent of total bank deposits. During the next several years, a deposit insurance system will be developed. Such a system will provide limited deposit insurance coverage when a bank fails, making it more feasible to close banks and lessening the potential exposure of the Government or the SBP in the event of bank failure.

### **Bank Audit**

The SBP has the authority to prescribe standards for external audit. Apparently, many bank audits do not meet rigorous standards. The authority to prescribe audit contents and to maintain an approved list of auditors will be pursued more vigorously and made to complement and strengthen the SBP's supervisory activities.

### **PROMOTING MARKET INTEGRATION**

Market integration reforms should remove the major causes of segmentation of the credit market. Significant progress has already been made in this direction. For instance, control on yields on government securities through a restriction on the volume at auction has already been abolished, statutory reserve requirements for banks and DFIs have been lowered, and interest rate subsidies on special credit programs have been virtually eliminated. The forward foreign exchange cover program for foreign currency deposits by the SBP has been removed. However,

the administered rates on national savings schemes continue, but the interest rate structure is in the process of rationalization.

#### **STATUTORY LIQUIDITY REQUIREMENT (SLR) AND AUCTIONS OF GOVERNMENT SECURITIES**

Previously, banks and NBFIs were required to invest 25 and 19 percent, respectively, of their demand and time liabilities in approved securities. Effective June 1997, the SLR was reduced by 5 percentage points, thereby reducing SLR of banks and NBFIs to 20 percent and 14 percent, respectively. This is expected to improve banks' profitability, provide higher returns for depositors, increase financial savings, and, eventually, lead to better resource allocation.

At the same time, the SBP has started the practice of preannouncing the volume of securities to be auctioned each time and allowing the bidding process to determine the yield on T-bills. These measures probably contributed to the rise in interest rates on public debt instruments to about 17.5 percent, a rate considered in line with the budget deficit, the inflation rate, and prevailing market conditions. By early 1998, as loan demand from the private sector slackened, the T-bill rates fell back to about 15.5 percent.

#### **SPECIAL CREDIT PROGRAM**

The authorities have reduced mandatory and concessionary credit schemes and are committed to substantially phasing them out, in line with the gradual removal of excess burden of stuck-up loans and the high administrative costs on the rates of interest.

The only significant program for which concessionary SBP refinancing is being provided is export financing. Although recent changes have made the scheme less attractive to lenders (e.g., the lender's spread has been lowered from 3 to 2 percent), the lending rate itself has been reduced, and the amount disbursed has increased in line with

other private sector financing. Due to the need to boost exports, the SBP does not consider it timely to phase out this scheme until other alternatives can be found.

#### **COLLATERAL AND FORECLOSURE LAW REFORMS**

As part of the Banking Sector Reform Program, the following laws have been passed:

- Banking Companies (Recovery of Loans, Advances, Credits, and Finances) Act, 1997;
- Banks (Nationalization) Act, 1997 (Amendment);
- Banking Companies Act, 1997 (Amendment); and
- State Bank of Pakistan Act, 1997 (Amendment).

Various amendments have also been made to the Banking Companies Ordinance of 1962 to enhance the effectiveness of the SBP as a supervisory and regulatory body and to safeguard the interests of banks and depositors (see Appendix 3).

Until 1997, there were two parallel systems of bank loan recovery courts: special banking courts, with jurisdiction over interest-based transactions; and banking tribunals, with jurisdiction over noninterest-based (or so-called Islamic) transactions.

With the enactment of the Banking Companies Act of 1997, the previous parallel systems were replaced by a new unified system of banking courts. Under the new system, one unified court system deals with the recovery of all loans, whether interest- or noninterest based. The Act also creates a more effective two-tier system, in which cases of up to PRs30 million are to be tried by the banking courts, and cases above this amount by the high courts. This division of work will enable the courts to expedite the disposal of the heavy load of pending recovery cases, and help the financial institutions recover their debt quickly. To increase effective court capacity, the Government has established 34 banking courts, pursuant to the new law.

### **FREEZING OF FOREIGN CURRENCY ACCOUNTS**

At the end of May 1998, amid threats of economic sanctions from the United States and other countries for testing nuclear devices, and fearing capital outflows, the Government froze all foreign currency accounts.

## **Remaining Issues and Recommendations on Banking Sector Reform**

The importance of banking sector reform cannot be overemphasized. Apart from reducing the cost of financial intermediation, it could result in the restructuring of existing sick industrial units and lay the foundation for better credit decisions. This will contribute greatly to higher GDP growth and improve the balance of payment position through better resource allocation.

Despite reforms, the banking sector still suffers from serious structural weaknesses rooted in governance failure, lack of financial discipline, and macroeconomic imbalances. These difficulties are further aggravated by the country's weak external position, stagnant economy, and loss of confidence in the financial system. The measures already taken by the Government and the continuing efforts to improve the banking system represent a fairly wide-ranging set of reforms. However, the Government's commitment to the reforms is beginning to be in question and there are some doubts about its capacity to carry them through fully. Moreover, there are other issues that need to be addressed to make the reforms successful.

### **Issues and Recommendations**

#### **FAILURE OF GOVERNANCE**

The failure of governance that afflicts the NCBs and the SBP is a reflection of the general weakness in governance across the various development sectors. There has been a disrespect for the law and the judiciary has been subjugated to political power. Harassment of the private sector is frequent through mis-

use of law enforcement powers and abuse of tax authorities, while others are rewarded through selective application of the law. Even the accountability mechanism set in place is biased and lacks credibility. The SBP's autonomy is an example. While the SBP has been granted greater autonomy in the conduct of monetary policy through a legal enactment, in effect this autonomy has not been exercised. The main reason is that the overall balance of power is heavily tilted in favor of the Prime Minister. Parliament and the Cabinet are circumvented in policy making so that the Governor of the SBP can hardly challenge the direction of the Prime Minister in any matter. This was visibly demonstrated during the foreign exchange crisis in the post-May 1998 period, when SBP circulars were issued but were contradicted by the Prime Minister.

Similarly, the independent management of the NCBs is most often countered by government announcements. Political interference in banks' management decisions was publicly demonstrated when some private sector loan defaulters advertised in the free press that they were willing to reschedule their outstanding loans on the same conditions as those provided to the Prime Minister's family businesses by some banks. This shows that there are different criteria applied for evaluating loan decisions of the influential.

Prospects of political change to rectify the underlying causes of poor governance are slim. In fact, recent constitutional changes have further concentrated power in the hands of the Prime Minister, stifled dissent in Parliament through mandatory party consensus on all issues, and given law enforcement agencies unquestioned powers through emergency and antiterrorist laws.

The independence of the judiciary should be reestablished and accountability made impartial.

#### **LACK OF FINANCIAL DISCIPLINE**

The appointment of independent and professional management of the NCBs, and new SBP prudential

regulations have contributed toward the improvement in financial discipline of banks. However, there is still much to be achieved. Apart from stopping political interference, it is recommended that capital requirements of publicly and privately owned banks be harmonized with the standards set under the Basle Convention. Moreover, factors that hinder a more competitive market structure should be removed, such as lower tax rates applied to NCBs, better access of NCBs to public sector deposits and, most important, implicit credit ceilings for each individual bank that assure the NCBs a larger share of the market.

The SBP needs to strengthen its supervisory capacity so that banks' balance sheets reflect the true position more accurately.

#### **DETERIORATION OF LOAN PORTFOLIO**

Commercial banks' loan portfolios are deteriorating for a number of reasons. First, better accounting procedures have led to a reclassification of loans into the nonoperating and bad loan categories. Second, poor economic conditions and changing domestic prices have eroded the operating margins of many businesses, forcing them to default. The matter has been further complicated by the stricter enforcement of SBP prudential regulations that cut off working capital to businesses that are behind their project loans, which virtually guarantees their total collapse. With an underdeveloped capital market, and five-year terms on most project loans, firms are increasingly unable to service project loans that require an annual repayment of 20 percent of the principal, especially since the economy is in a slump and tariff liberalization has reduced profit margins. Mergers or bank takeovers of the management of failing businesses are practically unheard of in Pakistan. In this kind of environment, it is not surprising that banks have become even more conservative in their lending policies, cutting off possibilities of rescheduling loans or encouraging financial restructuring among their borrowers.

There is a wave of sentiment against all defaulters due to the criminal and deliberate default by a

corrupt political elite. Genuine businesses are equally maligned and unable to negotiate on fair terms. Ironically, the class of defaulters that has provoked the ire of the country due to its criminal defaults is still able to reschedule its loans due to misuse of political power.

Urgent steps should be taken to develop the capital market, extend the terms of project finance, or reschedule the loans of genuine cases. This will require a case-by-case analysis. Rescheduling must be associated with some or total management takeover by the commercial banks or their chosen management consultants who would help turn the businesses around. Prudential regulations also need to be revisited to find ways to avoid precipitating the financial collapse of firms that are beginning to have problems. In addition, some financial institutions such as the DFIs could develop longer-term debt instruments and explore the use of other instruments.

#### **RECOVERY OF BAD LOANS**

Legislative and administrative support is in place to promote the speedy foreclosure of collaterals. However, little progress has been made regarding this matter due to several reasons. First, press statements by government functionaries regarding decisions taken by the newly appointed professional managements with respect to downsizing cast doubt about the autonomy of banks in making decisions and delay and jeopardize the restructuring process. Second, by introducing a distorted incentive scheme to loan defaulters and then by extending the deadline to avail of the same, the SBP has sent the wrong signal to the market about its commitment to recover loans. The loan recovery process is also marked by perceptions among defaulters of unequal treatment by the Government, and the banking courts have yet to prove that the new law is adequate for speedy recovery. Third, notwithstanding the above, the reforms overestimate the speed at which loans can be recovered. For instance, even if the total current defaults of PRs120 billion were properly collateralized, and

courts were able to give early verdicts in favor of liquidation, it is highly unlikely that such a large portfolio could be sold in such a depressed market, especially since these would be all cash transactions without bank credit support. It would be better to transfer these bad assets to a separate fund for the lengthy process of recovery, and as a result lower the burden of the bad portfolio on banks so that they could reduce the spread between the deposit and lending rates. The latter is the ultimate objective of the reform to enhance financial intermediation and stimulate economic activity. Another important advantage would be that banks could, as a consequence, improve their balance sheets so that when these are eventually privatized, they could fetch a good price and help pay back some of the public debt. The current hurry to sell all NCBs is purposeless since they will not get a good price. Rather, by appointing professional autonomous managers, much of the gains to the financial system can be attained.

### **MARKET FAILURE IN PRICING PROJECT FINANCE**

While efforts have been made to professionalize the process of loan provision, a concern has been raised that most commercial banks and even the DFIs have sharply curtailed project finance. Part of the reason is that a large segment of existing bad debt is related to projects, and since project finance by its nature is more risk-prone, banks shy away from lending in this area. Until July 1997, the SBP imposed a moratorium on project finance lending by the banks that has subsequently been relaxed only sparingly. The consequences of such a policy for industrial investment and growth can be significantly adverse. The issue has become more acute since prospects of opening new international lines of credit for project investment through DFIs are low and DFIs may also not be keen to take project risks, especially when they are privatized as well. This is a clear case of “market failure” or a divergence between the private and social benefits of project finance. One way to re-

solve this would be to allow banks to charge high rates of interest on project finance, but that would choke off industrial investment altogether. A second option is to adopt a cautious speed in privatizing the remaining DFIs and assure through their charters a significant share in their portfolios for project finance. The last option is to guarantee independent, private, and professional management. Similarly, banking reform, in its drive to make everything market-based, should not overlook “market failure” in the case of the unwillingness of banks to lend to the agriculture sector.

Another issue related to project finance is that banks in general require investors to undertake projects with a debt to equity ratio of 60:40 and, in some cases, 70:30. The required ratios are the result of banks’ own perceptions of risk and in consideration of existing prudential requirements. Since capital market development is at an early stage in Pakistan, such equity requirements often lead to circumvention of debt/equity requirements through selective waivers on a discretionary basis (presenting an opportunity for corruption) or to overinvoicing of machinery to generate “equity”. In light of this, it will be advisable to standardize equity requirements consistent with a debt to equity ratio of 70:30, strengthen collateral requirements, and lengthen the term of the loans. Currently, most local-currency project loans are of five to seven years duration, thus squeezing investors of not only a high debt service burden of 20 percent of principal alone but also the lack of equity. By extending the terms of project finance to 15–20 years, the burden would be drastically reduced even if debt to equity ratio was 60:40.

### **PRIVATIZATION**

Early privatization of NCBs is desirable. In the interim, the establishment of professional, honest, and independent management will achieve all the economic gains that privatization ultimately will. The sale of public assets has the added advantage that the proceeds could go towards retirement of public debt.

However, privatization should not be rushed at the cost of jeopardizing the restructuring process or recovering bad loans. An attempt was made to privatize UBL in 1997, but obscure procedures brought about by conflicting interests doomed the sale from the start. The failed privatization of UBL has underscored the lesson that the main goal must be to sell the banks through a transparent selection process to private investors who possess the integrity, financial and managerial capacity, and the expertise to run these banks.

To a large extent, the SBP has shifted to indirect instruments (especially open market operations) in the conduct of monetary policy. The use of market-based methods to control monetary aggregates is commendable since it encourages the efficient use of resources. However, there are indications that the shift to the use of indirect instruments is not yet complete. Due to the Government's continuing practice of borrowing directly from the SBP, the expansion of reserve money is sometimes not commensurate with the targets for growth in overall liquidity, leading the SBP to suggest "notional" credit targets to various commercial banks. Adoption of notional credit targets does not contribute to the efficient allocation of credit, prevents the restructuring of the banking sector, and impinges on the profitability of individual banks by forcing them to be more liquid than desired. The SBP should try to adhere to targets of reserve money and refrain from suggesting notional credit targets to banks. In a related issue, the procedures of open market operations should be made transparent. The size of T-bill auctions, once announced, should not be exceeded if they are oversubscribed.

### FOREIGN CURRENCY ACCOUNTS

The freezing of foreign exchange accounts is the largest failure of the banking system in Pakistan's history, affecting accounts worth \$11 billion (PRs533 billion), causing a loss to depositors of at least PRs100 billion at the kerb<sup>3</sup> exchange rate of PRs55 per dollar. The loss could be more as the kerb

rate inevitably rises. Significantly this is not a commercial bank failure, but a reflection of the lack of prudential management by the SBP and the Government, which are the supervisors and regulators of prudential behavior in the banking system. The affected depositors are ordinary citizens of Pakistan, whose \$11 billion deposits financed a large portion of the country's current account deficit since 1991. This resulted in a loss of annual inflow of \$2.5 billion into the Government's reserves at a time of uncertain official aid commitments and poor export prospects.

In view of Pakistan's limited success in tapping international financial markets with other instruments, the significance of foreign currency accounts in financing the balance-of-payments deficits cannot be overemphasized.

Foreign currency deposits, because of the anonymity of source of funds, to some extent also represent the earnings in the informal sector. For example, deposits of Pakistanis in international banking centers declined after the deregulation of resident foreign currency deposits in 1991. Now that the rules governing these accounts have changed, most of this money will flow back to overseas accounts. Already nearly \$4 billion has been withdrawn at the official rate of PRs46/\$, and according to secondary data, it has left the country through the black market for foreign exchange. There are three reasons for this: first, domestic financial assets do not provide the inflation and exchange rate hedge that can be derived from foreign currency accounts, while domestic real estate does not provide the liquidity ensured by foreign currency accounts. Second, a loss of confidence due to freezing foreign currency accounts has spilled over to all Government and banking financial instruments. Third, the bizarre manner in which the Government handled its differences with the foreign investors in the power sector led to a crash in the stock exchange market, thus discouraging depositors shifting their resources in the capital market.

The growth of foreign currency deposits constitutes dollarization, which is measured by the ratio of

resident foreign currency deposits to total domestic liquidity. The ratio increased from 2.6 percent in 1991 to about 33 percent in 1998. Its rapid growth was a reflection of the lack of confidence in the state of economy by the depositors. This was the response of people to poor economic management and expectations of inflation and devaluation.

The recent Government decision to freeze foreign currency deposits cannot eliminate dollarization or the desire of economic entities to hold a safe, reliable currency. By forcing the conversion of foreign accounts into rupees, people will either hold dollar balances outside the banking system or transfer their foreign exchange funds abroad to offshore banks as they were doing before 1991. In either case, the open market exchange rate will result in sharp devaluation, inflation, and further outflows. No emergency law can stifle market forces. Industrial countries' central banks together have failed to counter foreign exchange market forces. It would be suicidal for the SBP to try to manipulate the market. All these actions will result in large-scale financial disintermediation and an inevitable financial crash. The worst aspect is that the freeze on foreign exchange accounts has cost Pakistan about \$2.5 billion in annual inflows in the balance of payments.

About \$7 billion remain frozen in foreign currency accounts while the country's gross foreign exchange reserves are a little less than \$600 million. Depositors await the Government's final decision amid conflicting reports. Since the freezing of the accounts, the Government has taken several other steps that have further shaken foreign investor confidence in the credibility of its commitment to direct investors, participants in privatization, and depositors in the banking system. There has been little success in converting these deposits into long-term bonds. The question is: what should the Government do with these deposits? And what kind of foreign currency account scheme should be operated?

A significant portion of the \$7 billion remaining in foreign currency accounts has been collateralized

against rupee-denominated advances over the last few years, and to some extent these deposits are unlikely to be withdrawn even if the restrictions are removed. Yet these could be settled against the advances at the market exchange rate. The rest of the deposits should be merged eventually with the "new" foreign currency accounts managed by the commercial banks. To carry this out, the following measures should be undertaken. First, it will be necessary for the SBP to transfer adequate foreign exchange to the commercial banks when a buildup of reserves allows it. The new foreign currency accounts should be operated by the commercial banks, which could either or both hedge against the exchange rate risk in a developed forward market for foreign exchange and invest abroad under relaxed capital account regulations of the SBP. In this regard, it is necessary to immediately develop a forward foreign exchange market, and the SBP should completely withdraw from its operations to provide exchange rate cover. Second, the SBP regulations regarding capital flows should allow commercial banks to participate in the international markets while managing deposits in new foreign currency accounts. Third, as the official gross reserves improve, a portion of the frozen foreign currency accounts could be gradually unfrozen in phases, as equivalent foreign exchange is transferred back to the commercial banks for management. The merit of the latter proposal will be that the confidence (though tenuous) that can be developed in the new foreign currency accounts will also transfer to the gradually unfrozen foreign currency accounts.

## The Issue of Capital Mobility

The Mexican and Asian crises took most policymakers by surprise since both were preceded by buoyant financial markets for assets and major inflows of capital. In both cases, investors abruptly changed their perceptions about the economy, leading to massive outflows of capital, unleashing profound crises in domestic financial systems, and threatening the productive sectors.

One lesson from the crises is that financial globalization quickly exposes and punishes countries' economic weaknesses and facilitates the worldwide transmission of financial turmoil. It is essential for countries to maintain appropriate policies and measures that reduce the risks of capital outflows, e.g., sound macroeconomic fundamentals, strong fiscal position, external viability, improved supervision and regulation, and transparency of financial systems.

Some of the conclusions drawn by commentators on the Asian crisis are worth closer examination.

- The economic and financial damage resulting from the crisis was not inevitable and was exacerbated by policy errors that further reduced investor confidence.
- The role of a fixed or pegged exchange rate policy in precipitating the currency crisis has been exaggerated. The crisis was brought about by inconsistent policies that finally lost credibility.
- The role of capital outflows in triggering the crisis has been overestimated, in essence, treating symptoms of deeper problems as if they were the problems themselves.
- Halting and eventually reversing capital flight is a difficult task even in the best of circumstances. Unless the underlying problem is recognized, there is little chance that the injection of new external capital alone—even in large doses—can prove effective in ending a financial crisis that is essentially a crisis of confidence.
- Any solution to the crisis will necessarily rely on private funding. Thus, restoring investor confidence is the main challenge. Large-scale public funding is not a practical alternative to capital market stabilization. Strengthening the financial markets will contribute substantially to rebuilding confidence.
- A long tradition of regional exchange rate stability had encouraged domestic investors to assume significant currency risk. These investors incurred large losses on unhedged positions when

central banks abruptly withdrew from the foreign exchange market without providing a clear rationale for their decision to float their currencies.

The long-running debate about the desirability of unrestrained capital movements has intensified in the wake of the Asian financial crisis. Do capital controls have a role in today's world economy? This question needs to be addressed in the context of the economic role of government and the limits of economic policy as viewed today.

There is a widely held view that the role of government is to allow and support, not to restrain or compete with, private initiative. Government responsibilities for economic performance do not include direct management of the economy but, rather, involve maintaining a stable macroeconomic framework, supporting the economic infrastructure, and developing an institutional infrastructure (legal, regulatory, social, economic, as well as a competitive open economy).

Regarding the limits of macroeconomic policy, the empirical evidence suggests that most countries have moved in the direction of using economic policy as a means for encouraging market forces rather than competing with them. The main issue that emerges is whether the case for market forces has been stretched to the point that it conflicts with a sustainable balance between national and international interests.

The experience of the Asian economies demonstrated the need to proceed with caution in opening the capital account. Liberalization needs to be undertaken with appropriate macroeconomic, exchange rate, and financial sector policies. The issue relates more to the sequence of reforms than to their speed. It is also critical to recognize that a country's economic policies will be constrained by its choice of exchange rate arrangements. Therefore, attention has to be given to the maintenance of an appropriate, sustained, and consistent policy mix to prevent a

country from attracting short-term inflows on a scale that it cannot absorb.

Capital inflows in Pakistan were not as large as those in Asian economies. Nevertheless, the country also experienced the instability of these inflows, particularly of short-term deposits. Weak economy, a financial system overburdened with debts, and threats of sanctions by donor institutions on political grounds contributed largely to this instability. Government policies, particularly the freezing of foreign currency accounts, have triggered the loss of confidence of foreign investors and domestic depositors in the banking system. Economic revival depends on

bringing back this confidence to solidify the country's financial system.

## Notes

<sup>1</sup>*Modaraba* refers to term financing devised in 1980 to comply with Islamic mode of financing. It is an agreement between two parties whereby one provides 100 percent of the capital for a project and the other party manages it.

<sup>2</sup>A private market in forward cover related to trade transactions, although still thin, has developed in recent years.

<sup>3</sup>Open market.

## Appendix 1

## Domestic and Foreign Financial Institutions, as of 31 March 1998

**A. Nationalized Scheduled Banks**

1. First Women Bank Ltd.
2. National Bank of Pakistan
3. Habib Bank Ltd.
4. United Bank Ltd.

**B. Denationalized Scheduled Banks**

1. Allied Bank of Pakistan Ltd.
2. Muslim Commercial Bank Ltd.

**C. Specialized Banks**

1. Agricultural Development Bank of Pakistan
2. Federal Bank for Cooperatives
3. Punjab Provincial Cooperative Bank

**D. Private Scheduled Banks**

1. Askari Commercial Bank Ltd.
2. Bank Al-Habib Ltd.
3. Bolan Bank Ltd.
4. Faysal Bank Ltd.
5. Habib Credit & Exchange Bank
6. Indus Bank Ltd.
7. Metropolitan Bank Ltd.
8. Platinum Bank Ltd.
9. Prime Commercial Bank Ltd.
10. Prudential Bank Ltd.
11. Schon Bank Ltd.
12. Soneri Bank Ltd.

**E. Provincial Commercial Banks**

1. The Bank of Khyber
2. The Bank of Punjab
3. Union Bank Ltd.

**F. Foreign Banks**

1. ABN AMRO Bank N.V.
2. Albaraka Islamic Bank BSC (EC)
3. American Express Bank Ltd.
4. ANZ Grindlays Bank Ltd.
5. Bank of America (NT & SA)
6. Bank of Tokyo Mitsubishi Ltd.
7. Bank of Ceylon
8. Banque Indosuez
9. Citibank N.A.
10. Deutsche Bank A.G.
11. Doha Bank Ltd.

12. Emirates Bank International Ltd. PJSC
13. Habib Bank A.G. Zurich
14. Hongkong and Shanghai Banking Corp. Ltd.
15. International Finance Investment and Commerce Bank Ltd.
16. Mashreq Bank PSC
17. Oman International Bank SOAG
18. Rupali Bank Ltd.
19. Société Générale the French Int. Bank Ltd.
20. Standard Chartered Bank
21. Trust Bank Ltd.

**G. Development Financial Institutions**

1. Bankers' Equity Ltd.
2. Housing Building Finance Corp.
3. Industrial Development Bank of Pakistan
4. Investment Corp. of Pakistan
5. National Development Finance Corp.
6. National Investment Trust
7. Pakistan Industrial Credit and Investment Corp.
8. Pak Kuwait Investment Company
9. Pak Libya Holding Company
10. Regional Development Finance Corp.
11. Saudi Pak Industrial and Agricultural Investment Corp.
12. Small Business Finance Corp.

**H. Investment Banks**

1. Al-Faysal Investment Bank
2. Al-Towfeek Investment Bank
3. Asset Investment Bank
4. Atlas BOT Investment Bank
5. City Corporation Investment Bank (Pak) Ltd.
6. Crescent Investment Bank
7. Escort Investment Bank
8. Fidelity Investment Bank
9. First International Investment Bank
10. Franklin Investment Bank Ltd.
11. Islamic Investment Bank
12. Orix Investment Bank (Pak) Ltd.
13. Prudential Investment Bank
14. Security Investment Bank
15. Trust Investment Bank Ltd.

## Appendix 2

### Foreign Currency Accounts Scheme in Pakistan

The foreign currency accounts scheme, which was introduced in January 1973, was initially meant for Pakistani nationals residing abroad. The scope of the scheme was gradually widened. Permission for Pakistani residents to open and maintain these accounts was granted as part of the overall package of foreign exchange reforms announced in February 1991. At present, banks may, without the approval of the SBP, allow Pakistani nationals residing in or outside the country, including those having dual nationality to open and maintain foreign currency accounts in Pakistan. Resident companies, including investment banks and companies incorporated in Pakistan with

foreign shareholdings, are also eligible. The facility is also available to diplomatic missions and their officers, international organizations in Pakistan, and foreign firms/corporations other than banks incorporated and operating abroad, provided that they are owned by persons who are eligible to open foreign currency accounts.

The balances held in foreign currency accounts and income therefrom are exempt from the wealth and income taxes, and compulsory deduction of *zakat* (Islamic tax of 2.5 percent for welfare use) at source. Banks can also grant rupee loans to account holders up to a certain limit of their balances and can also issue guarantees on their behalf in favor of residents or nonresidents. The SBP covers exchange risk of all such deposits against payment of prescribed fee.

## Appendix 3

### Amendments to Banking Legislation

In January 1997, the caretaker Government promulgated three ordinances amending the SBP Act, the Banks Nationalization Act, and the Banking Companies Law. In May, these ordinances were approved by Parliament. The amendments aimed to give the SBP full autonomy in the conduct of monetary policy, to strengthen its regulatory and supervisory powers, to insulate it and State-owned banks from government interference, and to promote good governance of State-owned banks.

#### AMENDMENT TO THE SBP ACT

To give the SBP full autonomy in the conduct of monetary policy, its board of directors has been given the authority to determine and enforce a limit on the credit to be extended by the SBP to the Government and its agencies. The Government will have to meet its additional requirements directly from commercial

banks through market-based auctioning system to be conducted by the SBP. Moreover, no government agency has the right to issue directives to any banking company that is inconsistent with SBP directives.

#### AMENDMENT TO THE BANKING COMPANIES LAW

The amendment gives the SBP the sole authority for supervising banks and NBFIs. All previous rights for the federal Government to interfere in the activities of the banks have been transferred to the SBP. Penalty rates on various violations have been raised. The period of takeover of the management of a bank by the SBP has been increased from two to three years.

#### AMENDMENTS TO THE BANKS NATIONALIZATION ACT

The aim of the amendment was to insulate the NCBs and NBFIs from government interference, giving them autonomy to operate as commercial institutions. The Pakistan Banking Council, which used to have great power in overseeing the activities of all NCBs, has been dissolved. All its assets and liabilities were

transferred to the SBP. Each bank will have a board of directors consisting of a chairman, a president, who is also the chief executive, and between five and seven other members. All board members shall be appointed by the federal Government in consultation with the SBP. The chairman and the president

will be chosen among a panel of bankers maintained and updated by the SBP. The term of all board members is three years. The board of directors is solely responsible for determining all bank policies. No person with a political appointment can serve in the board of directors of any bank.

## Appendix 4

## Selected Bank Indicators

Table A4.1: Market Share of Banks, 1992/93–1996/97 (percent)<sup>a</sup>

Item	1992/93	1993/94	1995/96	1996/97	Percentage Change 1992/93 and 1996/97
<b>Deposit Market Share<sup>b</sup></b>					
Nationalized Commercial Banks	58.3	53.6	49.7	45.6	(21.8)
Habib Bank Ltd.	25.0	21.9	19.7	18.3	(26.8)
National Bank of Pakistan	20.4	19.3	20.9	18.3	(10.3)
United Bank Ltd.	12.7	12.2	8.8	8.7	(31.5)
First Women Bank	0.2	0.2	0.3	0.3	50.0
Partially Privatized Banks	20.1	18.2	19.6	18.0	(10.4)
Muslim Commercial Bank	13.4	11.8	12.9	11.9	(11.2)
Allied Bank Ltd.	6.7	6.4	6.7	6.1	(9.0)
Specialized Banks	1.4	1.4	1.5	1.5	7.1
Private Domestic Banks	5.6	8.1	10.5	12.7	126.8
Branches of Foreign Banks	16.6	18.7	18.7	22.3	34.3
<b>Loan market share<sup>c</sup></b>					
Nationalized Commercial Banks	49.4	46.9	41.8	39.0	(21.1)
Habib Bank Ltd.	23.2	20.5	17.7	16.8	(27.6)
National Bank of Pakistan	15.4	15.8	14.9	14.0	(9.1)
United Bank Ltd.	10.7	10.5	9.1	8.1	(24.3)
First Women Bank	0.1	0.1	0.1	0.1	0.0
Partially Privatized Banks	12.6	12.8	14.1	14.5	14.3
Muslim Commercial Bank	8.3	4.3	9.2	5.2	(37.3)
Allied Bank Ltd.	4.3	8.5	4.9	9.3	116.3
Specialized Banks	20.2	18.1	17.0	15.6	(22.8)
Private Domestic Banks	4.0	7.4	10.4	12.3	207.5
Branches of Foreign Banks	13.8	14.8	16.8	18.7	35.5

( ) = negative values are enclosed in parentheses.

<sup>a</sup> Based on end-of-period data. Data for 1994/95 are not available.

<sup>b</sup> Deposits include banks' liabilities to the nongovernment sector plus deposits of the federal and provincial governments.

<sup>c</sup> Includes lending to the private sector, public enterprises, and autonomous bodies.

**Table A4.2: Foreign Currency Deposits, 1992/93–1996/97 (\$ million)**

Item	1992/93	1993/94	1994/95	1995/96	1996/97 <sup>a</sup>
<b>By Source</b>					
Residents' Deposits	2,250	3,002	3,384	4,147	5,495
Nonresidents' Deposits	2,227	2,933	3,192	4,158	4,352
With Domestic Banks	2,050	2,476	2,524	3,050	2,657
Institutional Deposits	864	1,059	1,199	1,592	1,533
Individual Accounts	1,186	1,417	1,325	1,458	1,134
With Domestic Nonbank Financial Institutions	177	457	668	1,108	1,685
<b>Total</b>	<b>4,477</b>	<b>5,935</b>	<b>6,576</b>	<b>8,305</b>	<b>9,846</b>
<b>By Type</b>					
Demand Deposits	2,115	2,687	2,723	3,413	3,748
Current	158	153	160	217	203
Call	43	103	49	68	120
Savings	1,914	2,431	2,514	3,127	3,425
Time Deposits	2,362	3,248	3,853	4,892	6,099
1 month	92	173	99	266	407
3 months	992	1,342	1,409	1,720	1,773
6 months	314	882	1,039	1,160	1,347
1 year	781	678	1,001	1,396	1,419
Above 1 year	183	173	305	351	1,153
<b>Total</b>	<b>4,477</b>	<b>5,935</b>	<b>6,576</b>	<b>8,305</b>	<b>9,847</b>
<b>In percent</b>					
Demand Deposits to Total	47.2	45.3	41.4	41.1	38.1
Of which: 6 months and less	31.2	40.4	38.7	37.9	35.8
<b>Memorandum Items:</b>					
Share of Foreign Currency Deposits in Total Deposits	24.2	28.3	26.7	31.2	36.8
Share of Resident Foreign Currency Deposits in M2 Deposits	14.3	17.8	17.2	20.7	28.1
Share of Resident Foreign Currency Deposits in M2	10.3	13.1	12.7	15.6	21.4

<sup>a</sup> Preliminary.

Source: State Bank of Pakistan and author's estimates.

**Table A4.3: Classification of Scheduled Banks' Advances by Type of Borrower—All Banks (PRs million)**

Borrower	End June			
	1990	1995	1996	1997
Foreign Constituents	77.4	246.2	3.7	na
Business	77.3	241.7	3.2	na
Individual	0.1	4.5	0.4	na
Local	216,912.5	453,666.9	502,641.2	577,917.6
Government	23,990.0	44,336.9	50,615.9	55,598.7
Public Sector Enterprises	15,980.7	26,426.2	31,779.5	44,708.7
Agriculture, Forestry, Hunting & Fishing	42.0	127.8	203.3	364.2
Mining & Quarrying	552.7	1,731.2	2,003.4	3,598.7
Manufacturing	8,884.2	10,519.1	11,865.3	17,214.6
Construction	805.0	125.8	333.2	746.8
Electricity, Gas, Water & Sanitary Services	3,492.0	4,509.2	6,031.6	6,085.4
Commerce	450.9	2,800.6	3,645.6	5,608.1
Transport, Storage & Communication	207.1	2,721.5	4,292.5	7,566.6
Services	44.5	1,425.2	745.6	133.2
Private Sector (Business)	155,794.1	332,019.0	358,503.4	404,445.8
Agriculture, Forestry, Hunting & Fishing	39,915.9	59,139.1	55,012.4	59,726.8
Mining & Quarrying	850.8	2,797.9	4,087.7	3,642.1
Manufacturing	63,977.8	149,812.0	174,917.5	203,506.3
Construction	4,313.9	7,976.3	6,856.6	8,835.9
Electricity, Gas, Water & Sanitary Services	624.9	4,346.1	5,263.5	4,669.6
Commerce	35,375.9	61,517.2	64,493.8	69,593.8
Transport, Storage & Communications	1,220.3	13,991.6	13,380.1	14,311.3
Services	2,207.9	3,111.4	4,550.6	5,578.4
Other Private Business	7,306.7	29,327.4	29,941.2	34,581.6
Trust Funds & Nonprofit Organizations	441.1	446.1	506.6	1,603.2
Individual	20,545.0	49,323.2	60,489.7	70,151.9
Others	161.6	1,115.5	746.1	1,409.3
<b>Total</b>	<b>216,989.9</b>	<b>453,913.1</b>	<b>502,694.8</b>	<b>577,917.6</b>

na = not available.

Source: State Bank of Pakistan, Annual Report (various issues).

## Appendix 5

## Chronology of Banking Sector Events

**1973.** Nonresident foreign currency accounts (FCAs) introduced.

**1973.** National Development Finance Corporation established.

**1975.** Nationalization of all commercial banks.

**1980.** Bankers Equity Ltd. established.

**1982.** Joint venture companies established:

- Pak-Kuwait Investment Company Ltd.;
- Pak-Libya Holding Company; and
- Pak-Saudi Industrial and Agricultural Investment Company.

**1990.** Two nationalized commercial banks partially privatized (Muslim Commercial Bank and Allied Bank Ltd.).

**1991.** Resident FCAs deregulated. Auction of government securities started.

**June 1992.** State Bank of Pakistan (SBP) introduces a fee of 3 percent to replace its free full forward exchange cover.

**July 1992.** SBP adopts use of credit/deposit ratio to regulate credit and phase out direct credit controls.

**1993.** Amendment in State Bank Act towards greater autonomy.

**1995.** Credit/deposit ratio established as instrument of credit control.

**1996.** Unsuccessful attempt to partially privatize United Bank Ltd., the largest of NCBs.

**1997.** Further Amendment in State Bank Act to grant autonomy.

**1997.** The SBP stopped providing forward cover for foreign exchange to bankers.

**1997.** T-bills of three, six, and 12 months maturities introduced.

**1997.** Banking Council established, making the SBP the sole regulatory authority.

**1997.** Government and the SBP launch loan recovery program.

**1997.** As part of banking sector reform program, the following laws were enacted:

- Banking Companies (Recovery of Loans, Advances, Credits, and Finances) Act, 1997;
- Banks Nationalization (Amendment) Act, 1997;
- Banking Companies (Amendment) Act, 1997; and
- State Bank of Pakistan (Amendment) Act, 1997.

**May 1998.** Freezing of FCAs.

**July 1998.** New FCAs permitted with fresh foreign exchange inflows.