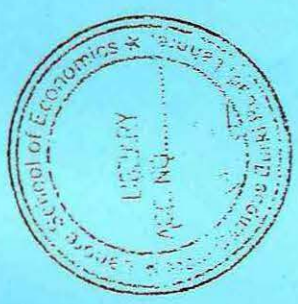
Pakistan: Financial Sector Assessment 1990-2000





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State Bank of Pakistan
Research Department

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State Bank of Pakistan
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The team is especially thankful to the participants of Conference on Financial System held on 18th June 2002 in Karachi. Feedback from the participants enabled the team to add new insights and improve the analytical content of this report. However, the team bears the responsibility for all errors and omissions. As a final point, observations made in this report are entirely those of the working team, these do not necessarily represent the views of the conference participants or those of the SBP management.

Preface

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

With this backdrop, there is a need to take stock of measures undertaken so far; assess their usefulness in terms of development of financial sector; analyze their impact on growth and welfare of the economy; and outline the future direction of reforms. Such a task will be massive and complex; even so a beginning has to be made to trigger this process of assessment. With this objective at the forefront, Dr. Ishrat Husain, Governor, State Bank of Pakistan took the initiative to undertake a comprehensive study, first of its kind by SBP.

The study reviews the process of financial sector reforms since 1990 and focuses on following objectives:

1) To highlight the financial structure at the beginning of reform process;
2) To make an inventory of financial reform measures during 1990s;
3) To evaluate the performance of banking institutions;
4) To evaluate the performance of non-bank financial institutions;
5) To evaluate the performance of financial markets;
6) To analyze the impact of reform measures; and
7) To suggest a direction for future reforms.

Outline of the study closely follows above objectives. These objectives also set the nature of discussion in each chapter: *descriptive* (chapters: 1 and 2); *analytical* (chapters: 3, 4 and 5); and *a combination of analysis and synthesis* (chapters: 6 and 7). Although, various alternatives were possible, the outline of the study was chosen for its simplicity. It also enables the reader to connect various types and stages of reforms, almost automatically.

Draft of this study was discussed in the Conference on Financial System organized by the National Institute of Banking and Finance, Islamabad at the Institute of Bankers, Karachi on 18th June 2002. Feedback from the participants have been incorporated, where possible, in this version. Proceedings of the conference have been released separately by the organizer.

It is hoped that this study will serve as the basis for charting the nature and content of future reforms in the financial sector. In addition, it is likely to promote further research not only in the area of financial sector reforms but also the reforms in economic and social sectors.

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Executive Summary

Pre-reform Structure in 1990

Financial landscape of the country was significantly altered in early 1970s with nationalization of domestic banks and expansion of public sector development finance institutions. By the end of 1980s, it became quite clear that the national socio-economic objectives sought to be achieved by nationalization, were not being met. Instead, the pre-dominance of public sector in banking and non-bank financial institutions, coupled with the instruments of direct monetary control, were becoming increasingly responsible for financial inefficiency, crowding out of the private sector, deteriorating quality of assets and rising vulnerability of financial institutions.

Dominance of public sector financial institutions, at the end of FY90, was apparent with a share of 93.8 percent in total assets. Similarly high shares existed for deposits, advances and investments. Within the banking sector, share of public sector was 92.2 percent in total assets, while the rest belonged to foreign banks as domestic private banks did not exist at that time. Structure of non-bank financial institutions was more skewed with a hefty share of development finance institutions (all in public sector) at 78.6 percent. Share of investment banks, leasing and modaraba companies remained small, despite their inception from early to mid 1980s. With these characteristics, financial structure at the end of FY90 did not provide a level playing field for competition and growth.

Besides the uneven ownership of financial system towards the public sector, a serious distortion was being caused by the presence of National Savings Schemes. Relatively higher returns on these schemes were causing dis-intermediation and worsening the crowding out of the private sector, already squeezed under the system of financial repression exercised largely through direct monetary controls on the banking system. National economy was taking a double hit because of these schemes. First, domestic debt was mounting rapidly, with rising servicing costs and second, the investment potential of the economy was being constrained due to misallocation of credit.

Not only the financial system was becoming more stressful, supervisory system was also losing its effectiveness. SBP's role, as a central bank, had considerably been weakened due to the presence of Pakistan Banking Council (PBC), which acted as a holding company of nationalized commercial banks and also exercised supervisory control over them. Duplication of supervisory role was diluting SBP's enforcement of its regulations over nationalized commercial banks. Not only the supervisory capabilities of SBP were becoming ineffective, it was also not allowed to formulate and implement the monetary policy independently. In addition to this, non-bank financial institutions were practically unsupervised because of lack of autonomy and multiplicity of supervisory agencies over them that included Corporate Law Authority, Monopoly Control Authority and Controller of Capital Issues, all attached directly with the Ministry of Finance.

Structure of financial markets was determined by the type and size of its participants. With the government as the main player in the arena, supported by the passive supervisors and a few large-sized nationalized banks and DFIs, private sector participants were only watching the mobilization of financial savings from the households and consequent diversion to the government and priority sectors. There were hardly any markets in the true sense of the word, i.e., markets where players' interaction resulted in pricing and clearing. Financial markets, after nationalization of commercial banks, were not equating the supply of funds according to their demand, rather a set of distortions was being imposed through the system of financial repression characterized by credit rationing and other controls.

The foreign exchange market was highly regulated by SBP through a system of exchange control over suppliers and users of foreign exchange. Only two of the several financial markets that had

competitive characteristics were call money market and the market for corporate equities. However, the competitiveness of call money market was largely irrelevant for the financial and real sectors as a whole, because of their inability to transmit interest rate signals due to the absence of a proper monetary transmission mechanism. Activities in the equity market were mainly confined to Karachi Stock Exchange with limited turnover of shares and market capitalization. Corporate debt market was almost non-existent except for a few bonds of public sector enterprises. Market of mutual funds was, consequently, also very limited.

In short, the financial structure at the end of 1980s was hardly conducive for meeting the growing financial needs of the economy. Although the nationalization of banks in early 1970s resulted in a rapid expansion of branch network within the country, the system of credit ceilings, interest rate controls, subsidized loans, directed credits and high government borrowing both from banks and non-banks (through national savings schemes) were adversely affecting the banking system.

Weaknesses in the supervisory system and lack of governance in state-owned institutions were worsening the quality of services being delivered. Inefficiencies due to over-staffing and over-branching were continuously adding to the administrative cost of public sector institutions. Spread between lending and deposit rates was concealing the intermediation inefficiencies due to the system of caps and ceilings on interest rates. Data disclosure standards were not resulting in conveying full picture of financial health of institutions. In short, the financial health was deteriorating fast, but largely concealed in opaque balance sheets of banks and NBFIs.

Financial Sector Reforms During 1990s

Realizing the inherent weaknesses of the financial structure that emerged after nationalization, government initiated a broad based program of reforms in the financial sector. Objectives of reforms were to create a level playing field for financial institutions and markets for instilling competition, strengthening their governance and supervision, and adopting a market-based indirect system of monetary, exchange and credit management for better allocation of financial resources. Reforms covered seven important areas: financial liberalization, institutional strengthening, domestic debt, monetary management, banking law, foreign exchange and capital market.

Banking sector was liberalized by permitting private banks to operate and compete with nationalized commercial banks. Competition was promoted by privatization of MCB and ABL. Initially at the start of 1990s, ten new banks were permitted to operate, of which eight started functioning. A couple of new banks joined later in the private sector. Governance of financial institutions was strengthened by insertion of new sections in Banking Companies Ordinance, 1962. Loan recovery process was streamlined by issuing clear guidelines for loan classification and requiring banks to submit regular reports on recoveries. A number of state-owned banks and DFIs were downsized and restructured through golden handshake and branch closure programs in later half of 1990s. Prudential measures were strengthened at the same time to ensure capital adequacy and disclosure of financial data reflecting true conditions of banks.

Several steps were taken to enhance effectiveness of SBP: a Credit Information Bureau (CIB) was established to keep credit records; an NBFIs Regulation and Supervision Department was established that subsequently issued 'Rules of Business' to supervise them; autonomy was granted to SBP in matters related to administration and conduct of business, that was later expanded to include formulation and implementation of monetary policy; regulatory function of SBP was consolidated through dissolution of Pakistan Banking Council; and supervisory role was further enhanced by placement of CAMELS and CAELS frameworks and extensive training of SBP officers on off-site surveillance and on-site inspection.

Domestic debt management underwent one of the most significant reform processes during 1990s. A primary market of treasury bills was established through auctions that replaced earlier tap system. Secondary market activities were promoted by replacing the discount window with SBP 3-Day repo facility. A system of approved dealers was established to widen the participation in auctions. A long-term auctionable government paper was also introduced in 3, 5 and 10-year maturities. Establishment of a book-based system of government securities settlement greatly enhanced the volumes of repo transactions in the secondary market. An important step was also taken with regard to national savings schemes; Khas Deposit Certificates, with very high returns, were discontinued.

Various monetary management measures were initiated to dismantle the system of financial repression and establish a market-based mechanism of monetary control. Bank-by-bank credit ceilings were abolished and replaced with credit deposit ratio that too, was subsequently removed. In addition to this, caps on lending rates of banks and NBFIs were eliminated to pave the way for implementation of monetary policy indirectly through signals of liquidity and short-term interest rate changes.

Banking laws also underwent significant changes during 1990s in order to provide a supportive legislative framework for the reform process. Important amendments were made in all the relevant banking laws including SBP Act, 1956; Banking Companies Ordinance, 1962; Banks (Nationalization) Act, 1974; and Banking Companies (Recovery of Loans, Advances, Credits and Finances) Act, 1997. The most important of these were the amendment in SBP Act, 1956 that provided for its full operational autonomy in conjunction with the dissolution of PBC in 1997.

Another important set of reforms, related to exchange and payments, was initiated in early 1990s, and quickly resulted in promotion of bank intermediation, encouragement of foreign investment, facilitation of forex transactions and enhancement of international trade. These steps in conjunction with capital market reforms helped in attracting foreign portfolio investment. Capital market saw an establishment of a central depository for automated trading of corporate equities and bonds. Further measures included establishment of credit rating agencies and transformation of Corporate Law Authority into an independent Securities and Exchange Commission of Pakistan, with full supervisory powers over capital market and non-bank financial companies.

Performance of Commercial Banks During 1990s

Growth trend of commercial banks during the decade seemed to indicate a structural break at the end of 1997. Assets of banks grew from Rs 426 billion in 1990, at a compound average growth rate of 17.8 percent per annum, to Rs 1,339 billion in 1997. Later on, compound average growth slowed down to 7.0 percent per annum, with assets reaching Rs 1,641 billion at the end of decade. Deposits of commercial banks showed a similar trend during this period. Up to 1997, average annual growth rate was in double digit (17.9 percent), decelerating to a low single digit (5.6 percent) in the later period of the decade. Deposits in terms of GDP increased from 41.4 percent in 1990 to 45.7 percent in 1997, later eroding to 41.6 percent in 2000.

Evaluation of banks under the CAMELS framework revealed important insights about their soundness and vulnerabilities. Commercial banks, for analytical purpose, were grouped into three categories: state-owned banks, private banks and foreign banks. Performance of overall banking sector mirrored that of the state-owned banks due to their large share in total assets. Nevertheless, the assets share of state-owned banks declined drastically from 92.2 percent in 1990 to 54.0 percent in 2000 (if MCB and ABL are excluded). This development is a firm reflection of growing competition in the banking sector from new private banks that did not exist in 1990.

Capital erosion was witnessed in the state-owned banks, in terms of capital to liability ratio, for the first seven years of the decade. Capital to liability ratio was at the lowest level in 1997 when two

large banks suffered huge losses for two consecutive years. However, injection of capital by SBP in these banks improved their capital adequacy. Capital to risk-weighted assets ratio (CRWA) also increased from only 0.6 percent in 1997 to 9.5 percent in 2000, well above the minimum benchmark of 8 percent set by the Basel Committee. For the foreign banks, capital adequacy ratio remained very strong throughout the decade indicating their soundness; their CRWA ratio was 18.0 percent in 2000. Private banks, which commenced their operations in early 1990s, naturally experienced a decline in their capital to liability ratio because of expansion of their deposits from nil position. Their CRWA ratio also declined from 15.5 percent in 1997 to 11.1 percent in 2000, but remained comfortably above the minimum required, indicating much better health than that of state-owned banks. Banking industry, as a whole had a CRWA ratio at 11.4 percent in 2000.

Asset quality of state-owned banks had declined, both in terms of earning assets to total assets and NPLs to gross advances during the decade. However, the deterioration was mostly observed up to 1997.[1] This is because of the reason that the most important set of banking reforms were undertaken late in the reform process -- mostly towards the end of 1997. Enhanced disclosure requirements by SBP, with consolidated supervisory powers after the dissolution of PBC in May 1997, forced the banks to reveal true pictures of their balance sheets by incorporating full provisioning. That alone resulted in 'reported' increase in non-performing loans that already existed but seldom declared as such. Furthermore, after the freezing of FCAs in May 1998, all banks faced deposit erosion, liquidity squeeze, liquidation of investment and consequent erosion of earning assets.

Foreign banks again stand out as the best performers in terms of asset quality. Although they had experienced a sharp decline in the ratio of earning assets to total assets in 1999 in the aftermath of FCA freeze, they were successful in turning it around in 2000. Their NPLs to gross advances had not only remained stable since mid 1990s, these had actually declined from early 1990s. Private banks also remained in comparatively better position than state-owned banks, although their NPLs to gross advances had been rising since 1997 and compared poorly with those of foreign banks.

Management soundness indicators revealed a mixed picture for state-owned as well as private banks. Expenditure to income ratio remained stubbornly high for state-owned banks during 1990s, even if the value for 1997 was ignored due to extraordinary expenditure on golden handshake schemes. As discussed earlier, higher provisioning in these years was the prime reason behind this. This higher cost is also depicted in rising trend of their interest rate spread. Private banks displayed a sharper rising trend in expenditure to income ratio than those of state-owned banks. With the better quality assets, lower expenditure to income ratio for foreign banks was expected. Surprisingly, their interest rate spread had been higher than that of state-owned banks. However, this was due more to the inefficiencies of state-owned banks, than of foreign banks.[2] Higher spread helped foreign banks in earning above normal profits, while state-owned banks were primarily maintaining this to cover their inefficiency cost.

Earnings and profitability indicators of state-owned banks showed steep decline in 1996, 1997 and 1999, due to losses suffered mainly by two of the large state-owned banks. However, this had been arrested after injections of capital in these banks by SBP. Although profitability remained positive for private banks, a declining trend was witnessed in these indicators. Similar trend existed for foreign banks, with an accentuated decline after 1998; this is understandable due to larger exposure of foreign banks to FCAs. Indicators of liquidity and sensitivity to market risks showed a declining trend for all groups of banks, mainly due to the conscious policy of SBP in reducing SLR from 45 percent in

[1] From thereon, although the ratios increased, signs of stabilization became visible after 1999. Furthermore, this increase should be viewed in relation with increasing focus of SBP on declaring true value of NPLs under strict supervision.
[2] This is largely due to the two factors: better quality of assets of foreign banks, and predominance of FCAs in their deposits that pay lower returns.

December 1992 to 15 percent in December 2000. However, ratio of liquid assets to total assets remained higher in case of foreign banks, showing their voluntary holding of excess government securities and comparative reluctance in undertaking credit extension.

In terms of the health of the banking industry, very small improvements, or arrests in earlier declines, could be discerned in some of the CAMELS indicators after 1997. These improvements should be seen in the context of various negative factors that affected the banking industry after 1997. While SBP in that year required banks to enhance capital adequacy, strengthen asset quality, improve management, increase earnings and reduce sensitivity to various market risks, the freezing of foreign currency accounts in May 1998 instilled new pressures of weakening capital, deposit erosion, and dis-intermediation in the financial system. Persisting environment of low economic growth had also added a dampener to demand for credit, and at the same time the supply of the credit was negatively affected due to over-cautious attitude of banks following the drive for accountability and loan recovery that began in October 1999.

Performance of NBFIs and CDNS During 1990s

Assets of NBFIs grew very rapidly from Rs 133.9 billion in 1990, at a compound average growth rate of 17.3 percent per annum to Rs 410.3 billion in 1997. Growth trend reversed thereafter, with assets falling to Rs 351.7 billion in 2000 at an average rate of decline of 4.9 percent per annum. In terms of GDP, assets of NBFIs increased from 15.6 percent in 1990 to 16.7 percent in 1997, but later declined to 11.0 percent of GDP in 2000. The decade saw an upsurge in mobilization of funds through national saving schemes from Rs 131.9 billion in 1990, (at a compound average growth rate of 17.0 percent per annum) to Rs 633.8 billion in 2000. In terms of GDP, outstanding investment in NSS rose from 15.4 percent in the beginning of decade to 19.9 percent at the end. The tremendous growth came at the back of very high returns on NSS, and resulted not only in mounting debt and servicing burden, but significant dis-intermediation in the financial system as well.

Health of NBFIs weakened rapidly during the decade mainly due to deteriorating management of DFIs. Asset composition of these groups was altered significantly during the decade. Share of DFIs declined from 78.6 to 57.0 percent; investment banks increased from 1.8 to 12.0 percent; leasing companies from 4.7 to 11.1 percent; modarabas from nil to 4.3 percent; housing finance companies declined from 12.3 to 6.3 percent; and mutual funds increased from 1.9 to 8.6 percent. Discount houses and venture capital companies constituted less than 1 percent towards the end of decade.

Declining health of DFIs was visible from the beginning of decade. Capital to liability ratio not only declined continuously throughout the decade, it became negative as well during the last two years of the decade due to severe erosion of capital in some of the large DFIs. Poor asset quality, serious management problems, low earnings and profitability, and squeezed liquidity position of public sector DFIs combined with weak macroeconomic environment, played havoc with the capital of DFIs especially NDFC, one of the largest DFI whose equity showed a hole of Rs 16.6 billion towards the end of decade.[3] Rising number of sick industrial units during mid 1990s passed on a heavy size of NPLs to public sector DFIs that had the main exposure in project financing. In addition, increased competition to mobilize deposits by offering unrealistically high rates of return, discontinuation of credit lines from international finance institutions and freezing of foreign currency deposits aggravated their problems. Criminal mismanagement of BEL led to its liquidation towards the end of decade. However, these problems were confined to public sector DFIs. Foreign sponsored DFIs remained healthy and expanded their activities prudently during the decade.

Investment banks grew very sharply with their assets rising from 2.4 billion in 1990, (at a compound annual average growth rate of 33.2 percent) to Rs 42.1 billion in 2000. Speedy growth of investment

[3] NDFC was subsequently merged with NBP on 30th October 2001.

banks was aided by the boom in stock exchanges in early 1990s and mobilization of foreign exchange through certificates of investment. However, with the freezing of foreign currency deposits, investment banks were severely affected and their assets declined in 2000, after reaching Rs 48.7 billion in 1999. Structure of investment banks was also skewed, as only two out of sixteen investment banks jointly held around two-thirds of total assets.

CAMELS indicators of investment banks showed a mixed bag of performance. Capital to liability ratio remained stable, roughly within a band of 13.0 to 16.0 percent during FY93 to FY00, after declining first from a very high level during their formative years. Asset quality indicators showed increasing stress, both in terms of earning assets to total assets and NPLs to gross advances. Ratio of earning assets to total assets declined from 82.9 percent in the beginning of decade to 74.1 percent at the end; while the ratio of NPLs to gross advances climbed from a negligible value to 15.7 percent. Indicators of management soundness showed an increasing trend in expense to income ratio after 1994. Earnings and profitability indicators showed mixed trends, while the liquidity management indicators showed improvements.

Leasing companies had been the best performers amongst the eight groups of NBFIs. They had maintained not only a solid, steady and high growth trend but also a well-balanced and prudent performance in terms of financial indicators. Their assets increased from Rs 6.3 billion in 1990 (at a compound annual average growth rate of 20.1 percent) to Rs 39.1 billion in 2000. Capital adequacy in terms of capital to liability ratio remained stable during the decade at a comfortably high level of over 25 percent. Asset quality in terms of earning assets to total assets ratio, also remained at high levels. Their advances constituted more than 85 percent of earning assets throughout the decade.

Modaraba companies did not display the success of leasing despite their rapid growth in late 1980s and early 1990s. Their tax-free status, that seemed to have generated this growth, was withdrawn in 1992. Assets of modaraba companies grew from Rs 11.8 billion in 1994, (at a compound growth rate of 4.0 percent per annum) to Rs 15.0 billion in 2000. This was one of the lowest annual average growth rates during the decade amongst the eight NBFIs groups, even lower than that of DFIs. In terms of available indicators, it was difficult to reach specific conclusions about modaraba companies. However, the fact that modarabas significantly lost values, for a majority of their shares, added credence to their weak performance.

Group of Housing Finance Companies, like DFIs, was also at the losing end. However, the weaknesses stemmed entirely from HBFC, the largest among this group of only four, with 95 percent assets. Total assets of HFCs grew from Rs 16.5 billion in FY90 (at a compound annual average growth rate of only 3.0 percent) to Rs 22.3 billion in 2000. The group surprisingly showed increasing adequacy of capital in terms of capital to liability ratio. However, the asset quality indicators showed an alarming and deteriorating picture. Ratio of NPLs to gross advances had increased from 4.3 percent in FY90 to a very high level of 69.3 percent in FY00.

Mutual funds and their management companies came under severe pressure during the second half of the decade. Initially their total assets jumped from Rs 20.1 billion in 1991 (at a compound average growth rate of 278.9 percent per annum) to Rs 78.5 billion in 1994. After touching this peak, the total assets declined to Rs 23.7 billion in 1999, at an average rate of 19.1 percent per annum. Later, some respite was seen with assets going up to Rs 30.4 billion in 2000.

Discount houses and venture capital companies despite remaining profitable almost throughout the decade were not able to carve any significant share in the activities of NBFIs. Their share remained less than one-half of one percent throughout the decade. Discount houses were able to maintain steady profits, but venture capital companies showed high volatility in their profits, from the beginning of decade, that increased markedly towards the end.

Transformation of Financial Markets During the Reform Process

Reforms, that were initiated in late 1980s and continued in the 1990s, started to transform the financial markets rapidly from FY91. Structure of a well functioning money market quickly developed with the introduction of auctioning process of short and long-term government securities. Capital market activities expanded very quickly in response to opening up of equity markets to foreigners. Activities in foreign exchange market also expanded after residents were allowed to open foreign currency accounts in addition to granting licenses to money changers.

Pre-reform system of tap treasury bills at a fixed yield of 6 percent, quickly gave way to establishment of auctioning process and promotion of secondary market activities made possible by the inception of SBP 3-Day Repo facility. The reforms transformed the passive primary market of treasury bills into an active and competitive one within two months in just four auctions. Bidding pattern of participants demonstrated a quick adjustment to market pricing mechanism within this short period. The bid spreads decreased sharply during the first four auctions, indicating a quick move towards competitive pricing. Similar success was also witnessed in the auctions of newly introduced long-term government paper, the Federal Investment Bond (FIB) of 3, 5 and 10-year maturities, that also helped in establishment of a full spectrum yield curve of marketable government securities. Repo transactions made their way rapidly in the secondary market of T-bills and FIBs, and firmly established themselves as a fairly unregulated but orderly instrument of money market for the first time in South Asia.

With the establishment of money market, and emerging of short-term interest rates to be effectively used as signals of monetary policy changes, SBP dismantled almost all the direct controls of monetary policy. Abolishment of credit ceilings first gave way to a more flexible, albeit direct, mechanism of credit deposit ratio, which was subsequently removed in late 1994. Caps imposed on maximum lending rates for banks and NBFIs were also removed during that time to pave the way for effective use of open market operations (OMOs) as a major indirect instrument of monetary policy, in conjunction with SBP 3-Day Repo Rate and the cash reserve requirement. Though initial OMOs were not successful, subsequent learning process enabled both SBP and banks to participate efficiently therein.

Initially, SBP focused only on one-way OMOs mainly concerned with the objective of draining the excess liquidity from the commercial banks to restrain their credit expansion within the limits of credit plan. Later, in October 1997, SBP also started injecting short-term funds for liquidity management through OMOs. However, operational objective of this liquidity management was to control the reserve money rather than the overnight inter-bank rate that continued to exhibit considerable volatility in the inter-bank money market. Hence, the weighted average yield of six-month T-bill became the main benchmark for banks and NBFIs, because of its lower volatility, for setting their lending rates. Consequently, efficacy of the interest rate, in the transmission mechanism of monetary policy began to take root.

Capital market showed remarkable growth triggered by the inception of exchange and payment reforms undertaken in early 1990s, which allowed non-residents to trade in shares at the domestic stock exchanges and freely repatriate investment and profits. These reforms initiated a large mobilization of funds into the equity market, thus contributing to the growth of stock exchanges of the country. Market capitalization at the Karachi Stock Exchange rose very quickly from Rs 90.0 billion, or 8.8 percent of GDP in FY91 to Rs 218.4 billion, or 18.0 percent of GDP in FY92.

By the end of 1991, International Finance Corporation (IFC) ranked Pakistan as one of the leading emerging markets in the world. Consequently, a number of offshore funds were established in foreign countries and listed on foreign exchanges for investment either in Pakistan or in other emerging

markets. In addition, increased supply of securities due to the privatization of large state-owned enterprises such as the Pakistan Telecommunication Corporation (PTC) and the Muslim Commercial Bank (MCB), and the large issue of a power project HUBCO (Hub Power Company) had increased the depth of the market.

Market capitalization further increased to Rs 405 billion in FY94. Increased interest of international investors also enabled Government of Pakistan to raise US$ 150 million from Euro Dollar Market in FY95, through its first ever, sovereign bond of 5-year maturity. However, the political and economic instability of the country during most of 1990s brought volatility in the capital market. Market capitalization, after reaching a peak level of Rs 496 billion in FY97, fell to Rs 391.9 billion, or 12.3 percent of GDP in 2000. Year to year developments in equity market mostly reflected the political uncertainty brought about by frequent change of governments and sanctions imposed on Pakistan following nuclear detonation in 1998.

A market for corporate paper began to develop after private companies were allowed to issue Term Finance Certificates (TFCs) in FY95 to raise resources. Establishment of Pakistan Credit Rating Agency (PACRA) also provided a supporting infrastructure in terms of rating process. Progress was slow in the beginning due to presence of bonds with very high coupon rates, issued by some public sector enterprises, and carrying the guarantee of the federal government.[4] However, after the decline in short-term rates, and consequently in long-term yields, market for TFCs picked up with four new issues in 1999 alone. Two important policy changes aided in promoting TFC market. First, NSS rates were reduced in mid 1999 and again in 2000. Second, institutional investment was banned for NSS from March 2000. Five new issues of TFCs came to market in 2000 and with the launching of Pakistan Investment Bonds (PIBs) in December 2000, it is expected that TFC market will flourish further as pricing becomes easier with PIB benchmarks.

Structure of foreign exchange market did not transform quickly because the process of liberalization, initiated in early 1990s, was mainly concentrated in areas other than exchange rate regime. Permission to open resident foreign currency accounts started to contribute visibly in the deposit mobilization and credit expansion from commercial banks. Mobilization of FCAs was fuelled initially by the absence of any forward cover fee in the initial phase of the scheme. Later in July 1992 when fee was imposed,[5] its level was set on lower side with high implicit subsidy, that continued to attract increasing volume of foreign exchange in these accounts, mostly through dollarization made possible by the inception of money changers in early 1990s. Total foreign currency deposits mobilized by banks and NBFIs increased from $ 2.6 billion in June 1991 (at a compound average growth rate of 21.6 percent per annum) to $ 11.2 billion in April 1998, a month before the nuclear detonation by Pakistan to match the Indian initiative.

Although the reforms specific to foreign exchange market were started from March 1998, permitting authorized dealers to fix their own buying/selling rates for US dollar within the band widened from 0.5 to 1.0 percent, the reform program went off-track due to the balance of payments and confidence crisis triggered by nuclear detonation and subsequent freezing of foreign currency accounts. Major structural change came with the introduction of multiple exchange rate system in July 1998, which was gradually unified and transformed to a free-floating exchange rate regime.

Transformation to the free float was achieved first by the introduction of a floating inter-bank rate (FIBR) determined by market forces, side by side with the official SBP rate fixed initially at Rs 46 per

[4] For example, Wapda Bond which carried government guarantee besides offering coupon rates as high as 19 percent per annum.

[5] This fee was initially imposed only on US$ denominated FCAs in July 1992, but later extended to other currency denominations FCAs in December 1993.

US dollar while the former usually set by the market at comparatively depreciated levels. The pre-specified ratio (originally being 50:50) of these two rates determined their weighted average, known as composite rate. Subsequently, role of the FIBR was gradually enhanced by changing this ratio to 20:80 in December 1998, 5:95 in March 1999, and finally to 0:100 on 19th May 1999 when FIBR started covering all transactions. However, after only a few days an unofficial cap was imposed on FIBR, which remained in place for almost a year. The cap was revised upward twice in June 2000 and subsequently removed on 20th July 2000 giving way to the free-floating exchange rate regime.

Impact Analysis of Financial Reforms

As stated earlier, objectives of the reforms were to create a level-playing field for instilling competition in financial institutions, strengthening their governance and supervision, and adopting a market-based system of monetary, exchange and credit management for better allocation of financial resources. Specific achievements were expected in terms of greater ownership of private sector in financial institutions; increased financial depth, intermediation and efficiency; reduced interest rate spread; better management of domestic debt in terms of cost and sustainability; reduced segmentation in government debt market; reduced distortion in term structure of interest rates; reorientation of monetary policy from direct to indirect control; enhanced efficacy of monetary transmission; and increased effectiveness of SBP in supervising banks.

In terms of private sector ownership, financial sector witnessed a radical shift in the banking sector towards decreased control of government. Assets share of public sector banking companies fell from 92.2 percent in 1990, after establishment of new private banks and privatization of MCB and ABL in early 1990s, to 54.0 percent in 2000. Combined share of private, privatized and foreign banks, consequently rose from 7.8 percent in 1990 to 46.0 percent in 2000. Public sector ownership in overall financial sector (including banks, NBFIs and CDNS) declined from 94.7 percent in 1990 to 70.0 percent in 2000.

In terms of financial deepening, a one time jump was witnessed in the ratio of M_2 to GDP during FY93 from 41.7 to 44.4 percent, which increased the average ratio of 39.2 percent observed in the pre-reform 1980s to 43.5 percent during 1990s. However, this increase was largely brought about by the opening of resident foreign currency accounts that later caused serious balance of payments problems. When compared with peer countries, financial depth in terms of M_2 to GDP ratio improved only marginally in Pakistan during 1990s. In India, the ratio went up from 42.7 percent in 1990 to 56.9 percent in 2000. In Philippines, depth increased from 34.2 to 62.5 percent, Malaysia from 64.4 to 102.6 percent and in Turkey from 23.9 to 44.6 percent during the same period. Pakistan was at the mid of peer group of countries in terms of financial depth in 2000.

The extent of financial intermediation could be assessed by the currency to deposit ratio, with lower value indicating relatively higher level of intermediation. The ratio declined from 51.4 percent in 1990 to 34.3 percent in 2000, indicating substantial improvement in intermediation. The same trend was also observed in currency to GDP ratio that decreased from 14.7 percent to 12.9 percent during the same period. However, among the selected group of six peer countries Pakistan had the highest currency to GDP ratio. Besides, it was the only country excepting India with double digit value, showing the presence of large informal sector in their economies.

Financial efficiency could be gauged by interest rate spread.[7] It increased from 3.9 percent in 1990 to 4.7 percent in 2000, indicating decreased efficiency. Spread between weighted average lending and deposit rates widened much further, from 2.4 percent in 1990 to 8.1 percent in 2000. However, the latter should be interpreted with caution. In the pre-reform period, interest rates were controlled from both sides, with floors on deposit rates and ceilings on lending rates. Therefore, their widening

[7] It is the difference between effective return on assets and interest expense on interest paying liabilities.

indicated the change from repressed to a liberalized interest rate regime. Moreover, compared with the interest rate spread, the spread between weighted average lending and deposits rates is an inferior indicator of efficiency. This is because the former takes into account lending as well as investment activities, whereas the latter does not. Nevertheless, the fact remained that reforms could not succeed in increasing the efficiency of banking sector, when measured in terms of interest rate spread.

Admirable improvement was, however, witnessed in terms of increase in credit allocative efficiency. The share of concessionary and mandatory credit in total private sector credit declined from 44.2 percent in FY90 to 31.4 percent in FY00. Sectoral distribution of credit did not show significant change in 1990s, except for the increase in share of manufacturing from 42.5 per cent in the first half to 50.9 percent in second half, and a decrease for agriculture from 20.4 percent to 14.7 percent in the corresponding periods. Some inroads were, nevertheless, made in bringing down the share of credit to the government from 48.5 percent in 1990 to 41.8 percent in 2000. Performance of Pakistan was also admirable in this regard when compared with peer countries. Share of credit to government went up in Bangladesh, Philippines and Turkey during this period. Whereas, it fell in case of India, Sri Lanka and Malaysia. However, the level of share in Pakistan in 2000 was still very high compared with the peer country average of 29.5 percent.

Debt management reforms were expected to stabilize the level and cost of domestic debt to a sustainable level in the long run. However, interest costs as well as debt levels continued to rise at a fast pace in post-reform decade, albeit at a pace lower than that observed in pre-reform decade. It must be acknowledged at the outset, that the domestic debt burden was already very high when reforms started. Annual average rate of increase in nominal debt during 1980s was 20.4 percent, with unfunded debt comprising NSS at 28.3 percent. Some of the measures like discontinuation of costly Khas Deposit Scheme in February 1990 (with annual profit rate of 13.4 percent per annum and 68 percent share in NSS) did succeed in decelerating the interest costs, but others like the introduction of FIBs with high coupon rates and increase in yield of replenishment T-bills from 0.5 percent to market-determined weighted average yield, worked in opposite direction, together with the introduction of SSCs, RICs and subsequent increase in their profit rates and those of DSCs.

Reforms did result in a favorable impact in the first half of 1990s in decelerating the nominal as well as real debt levels. The pre-reform decade of 1980s witnessed a per annum growth rate of 20.4 percent, whereas post-reform decade of 1990s registered 15.7 percent per annum. However, the deceleration was not enough to make the earlier pace sustainable, due largely to effective reversal of reforms that again increased the profit rates of NSS and created new dis-intermediation pressures. Consequent impact on government budget was astronomical. Interest expenditure as percent of total revenue rose from 29.4 percent in FY90 to 49.5 percent in FY00. Interest expenditure in terms of GDP rose from 4.7 percent in FY90 to 8.1 percent in FY00.

Improper sequencing together with weaknesses in design of debt management reforms were both possibly at fault for the mounting debt burden as well as dis-intermediation of the financial system. Premature liberalization of government debt market in developing countries seldom lead to fiscal restraint, rather it became easier for these countries to get into trouble through rapidly rising interest expense on domestic debt. Thus, fiscal reforms should have preceded the financial reforms. However, the opposite sequencing was followed, probably because the fiscal reforms were the hardest to implement. Even within the financial reforms, debt management reforms were implemented first in early 1990s, instead of the banking institutional reforms, that should have been implemented first but had to wait till 1997.

Despite failing with regard to the objective of achieving domestic debt sustainability, debt management reforms succeeded in providing the necessary infrastructure and supporting environment for reorientation of monetary policy, away from instruments of direct control towards market-based

monetary management. Once SBP was empowered to change the basic monetary instruments like CRR, SLR and SBP 3-Day repo rate, establishment of primary and secondary markets of T-bills and FIBs prepared the arena for implementation of open market operations, after the abolishment of credit deposit ratio and caps on maximum lending rates of Banks and NBFIs.

Monetary transmission mechanism of the pre-reform period that allocated the credit through quantitative rationing, quickly changed and firmly established the credit channel through increasing efficacy of short-term interest rates as price signals. Transmission of monetary policy changes began to impact the money market immediately in terms of very quick changes in short-term money market rates, and with some lags, on banks' lending rates on fresh advances. However, the transmission mechanism through the traditional interest rate channel is still not very effective due to lack of a home mortgage market and absence of consumer financing of durable goods. Exchange rate channel that was already present through its effects on imports, exports and inflation, got also linked with the short-term interest rates after establishment of free float regime.

One of the most crucial sets of reforms that would continue to influence the financial sector, was the banking sector reforms implemented in late 1997. These encompassed not only the institutional strengthening and restructuring of nationalized banks and DFIs, but also those of supervisory authorities. Effectiveness of SBP supervision over banks was strengthened significantly after adoption of CAMELS framework, revision of disclosure requirements for banks and NBFIs in conformity with international standards, prescription of risk-weighted system of capital requirements and increasing compliance in adopting Core Principles of Effective Banking Supervision formulated by the Basel Committee. SBP is now fully or largely compliant in twenty-two out of twenty-five core principles and progress is underway to achieve full compliance. Furthermore, human resource quality of SBP officers has considerably been improved through extensive training in off-site surveillance and on-site inspection.

Future Direction of Reforms

Although Pakistan's financial sector has achieved a more competitive market structure with the expanding market share of private and foreign banks, there are still some major weaknesses particularly with respect to the efficiency of the banking sector. These include a highly infected loan portfolio and higher administrative cost reflected in widened spread between lending and deposit rates. These problems stemmed from a failure of governance and a breakdown of prudent credit culture. Thus, there is a great need to improving the environment in the banking sector for the required good governance and credit discipline, which are essentials for an efficient, sound and competitive banking system.

The reforms program should aim at the privatization of the state-owned commercial banks and larger development finance institutions, the enhancement of the authority and capacity of the State Bank to supervise and regulate the banks effectively, and the improvement of the legal and judicial processes for enforcing financial contracts. To arrest bad debts, a comprehensive strategy is needed which requires rationalization of the whole financial sector and coverage of four main areas: 1) a well functioning legal framework without any loop-holes; 2) strengthening and improving regulatory framework; 3) strengthening and widening the scope of Corporate and Industrial Restructuring Corporation to assume non-performing loans and assets and; 4) privatization of nationalized banks, merger/amalgamation of smaller banks and reduction in the number of DFIs.

For good corporate governance, the State Bank requires not only a continuous strict scrutiny but also strict adherence to the defined criteria for appointments of Chief Executive of public sector banks/DFIs to prevent intervention by the government and politicians. Ensuring SBP full autonomy in devising and applying its monetary policy requires establishing legal limits to the amount that it can advance to the government. To remove distortions in resource mobilization, the government

financing mechanism through NSS needs to be made more conducive to overall financial sector development. To remove the segmentation and increase the efficiency, merger of official and kerb markets of foreign exchange is required through transformation of existing licensed money changers into Exchange Companies with enhanced regulation.

To enhance competition and efficiency, consolidation of small institutions into bigger units is required which can be done by focusing on the legal and regulatory framework and on the mode of funding by institutions and deregulating the business side. Consequently, in the long-term, the financial system should be well served by a three-tier structure. Top tier will consist of strong universal banks providing credit and financial services to large-scale industries and other corporate clients, consumer financing, in addition to operating internationally. This tier would be mainly private sector owned and also encouraged to reach out to small and medium enterprises. Second tier would consist of specialized and other private sector banks, in addition to micro-finance institutions in public and private sector. The focus of this tier will be to provide credit and financial services to micro, small and medium enterprises, in addition to meeting specialized credit requirements for exports, agriculture and rural sectors. The third tier is conceived to consist of private non-bank financial companies resulting from the consolidation of existing fragmented NBFIs. They will undertake equity underwriting, merger and acquisition, asset management, corporate bond issues, securities trading, leasing, venture capital etc. This tier will be governed and supervised by the Securities and Exchange Commission of Pakistan (SECP). Implementing these reforms would result in self-sustained, sound and commercially viable financial institutions in Pakistan.

1 Pre-Reform Structure in 1990

At the beginning of 1990s, financial structure of Pakistan continued to reflect the policy initiatives taken in early 1970s that drastically enlarged the role of government in the process of deposit mobilization and credit allocation. Despite the opening of non-bank financial sector for private investment in mid 1980s, public sector financial institutions held the bulk of assets, deposits, advances and investments of the entire financial sector at the end of 1980s (see **Table 1.1**). Financial system was predominantly characterized by high government borrowing, bank-by-bank credit ceilings, interest rate controls, and directed and subsidized credit. Although the system was consciously put in place to promote economic and social goals, it was increasingly becoming evident that it largely worked to the contrary, and also proving as a hindrance to private sector initiatives.

Table 1.1: Structure of Financial Sector in 1990

shares in percent and amount in billion Rupees

	Numbers	Assets		Advances		Investment	
		Amount	Share	Amount	Share	Amount	Share
Banks	24	425.6	61.5	218.5	48.7	111.3	89.0
State-owned	7	392.3	56.7	201.2	44.8	104.1	83.2
Private	-	-	-	-	-	-	-
Foreign	17	33.4	4.8	17.3	3.9	7.3	5.8
NBFIs[1]	36	133.9	19.4	98.3	21.9	13.7	11.0
State-owned	13	124.3	18.0	94.7	21.1	13.3	10.6
Private	23	9.6	1.4	3.6	0.8	0.4	0.3
CDNS	1	131.9	19.1	131.9	29.4	-	-
Equity markets[2]	2	90.0	-	-	-	-	-
Total	63	691.5	100.0	448.7	100.0	125.1	100.0

[1] NBFIs also include four specialized banks and HBFC

[2] Market capitalization of KSE in lieu of assets; not added in total

1.1 Pre-Reform Financial Structure

The financial system consisted of commercial banks (including foreign banks) and non-bank financial institutions (including development finance institutions). At the apex, State Bank of Pakistan (SBP) was responsible for guiding and regulating the banking system of the country. However, there was substantial overlapping of regulatory functions, especially with Pakistan Banking Council (PBC) in matters relating to public sector banks and development finance institutions (DFIs), and with the Corporate Law Authority (CLA) for non-bank financial institutions (NBFIs). In 1990, the structure of financial system, especially of domestic banks and DFIs, was very close to the one that emerged following nationalization in 1974.[1] Since assets and deposits of the banking system were highly skewed towards nationalized commercial banks (NCBs) and DFIs, entry of foreign banks and domestic private NBFIs did not result in any significant structural change.

1.1.1 Banks

A total of 24 commercial banks (7 domestic and 17 foreign) were doing business in Pakistan as on 30th June 1990 (see **Table 1.2**).[2] Domestic banks, with absolute public sector ownership and a broad branch network, were catering to major commercial banking needs of the economy. This explains their very large share (around 90 percent) in total assets and total deposits of the banking sector.

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[1] During this period, only two domestic banks were established in the public sector.

[2] Six Indian banks (vested in custody of India since September 1965) are not included.

Foreign banks, on the other hand, were holding only 7.8 percent of total assets, and 7.0 percent of the total deposit base. Their activities were generally related to foreign trade. In addition, with restrictions on number of branches that foreign banks could open, their business was concentrated in large cities. However, the pattern of banking activities of the two groups was very similar as both had about 50 percent of their assets in the form of advances, and around one-fourth in investment.

Table 1.2: Structure of Banks in 1990
shares in percent

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

1.1.2 Non-bank Financial Institutions (NBFIs)

Since the establishment of one of the largest DFIs in early 1970s,[3] before nationalization of banks, NBFIs grew more rapidly up to 1980s at the expense of banks, primarily due to the emphasis of government policy for promoting industrial development through long-term financing. Although the business activities of NBFIs varied widely across each category; like banks, their structure was also heavily dominated by the public sector (see **Table 1.3**).[4] More specifically, DFIs, housing finance companies, and mutual funds, which were in the public sector, constituted a large part of NBFIs. However, in terms of number of institutions, these were only 15 out of 36 (see **Table 1.4**). Similarly, the breakup of assets and advances in terms of each category of NBFIs reveals that these three categories control over 90 percent of the business.

Table 1.3: Structure of NBFIs in 1990
shares in percent

	Assets	Advances	Investment
State-owned	92.8	96.3	97.4
Private	7.2	3.7	2.6

Table 1.4: Non-Bank Financial Institutions in 1990
shares in percent

	Number	Assets	Advances
Development finance institutions[1]	12	78.6	80.4
Investment banks	5	1.8	1.7
Leasing companies	5	4.7	1.9
Modaraba companies	10	n.a.	n.a.
Housing finance companies	1	12.3	14.8
Mutual funds	2	1.9	1.1
Discount houses	1	0.7	0.0
Total	**36**	**100.0**	**100.0**
Amount (billion Rs)	-	133.9	98.3

[1] DFIs also include four specialized banks.

1.1.3 Central Directorate of National Savings (CDNS)

Also known as National Savings Organization, CDNS is an attached department of the Ministry of Finance. This organization is engaged in the operations of various National Savings Schemes (NSS) and had mobilizec Rs 131.9 billion till 30th June 1990. CDNS had a network of 363 National Saving Centers as on 30th June 1991. Operations were executed by these centres across the country, directed by a head office and supported by several regional offices. Furthermore, some NCBs and Pakistan Post Offices also worked as its operating agents.

1.2 Supervisory Authorities

In 1990, there were three supervisory/regulatory bodies: (1) SBP, dispensing its functions under the SBP Act, 1956; (2) Pakistan Banking Council (PBC), monitoring the performance of nationalized commercial banks under the Banks (Nationalization) Act, 1974; and (3) Corporate Law Authority (CLA), regulating the equity market under Securities and Exchange Ordinance, 1969.

[3] National Development Finance Corporation (NDFC) was established in 1973.
[4] For details on business activities of each category of NBFIs, see Annex 4.1.

1.2.1 State Bank of Pakistan

Conduct of Monetary Policy

SBP was conducting monetary policy with the instruments of direct control. More specifically, the cash reserve requirement (CRR) as prescribed under the SBP Act, required every bank to maintain at least 5 percent of demand and time liabilities in cash with SBP. On the other hand, the statutory liquidity requirement (SLR) was prescribed under the Banking Companies Ordinance and fixed by the federal government. Accordingly, banks were required to maintain 35 percent of time and demand liabilities in cash or government securities. The bank rate was set at 10 percent since 1977.[5] However, bank-wise credit ceilings were used as active instrument of monetary control. This system was established after adoption of credit planning through the National Credit Consultative Council (NCCC), set up in SBP in 1972. Under this system, credit ceilings were allocated to banks depending upon their share in total deposits during previous year, size of the capital fund, foreign currency deposits and previous year's utilization of credit ceiling. In addition, SBP was also administering a number of directed credit schemes with subsidized financing.[6]

Exchange Rate Management

SBP was also pursuing the exchange rate policy under the provisions of Foreign Exchange Regulation Act, 1947. The exchange arrangement, introduced in January 1982, was characterized as managed floating. Frequent, but small adjustments continued to be made in Rupee/Dollar parity by the Foreign Exchange Rate Committee of the SBP under the chairmanship of the Governor.

With a view to regulate all dealings and debt instruments in the foreign exchange market, SBP set limits on open exchange position and balances of individual Authorized Dealers (ADs) over and above their daily operational requirements.[7] ADs were required to maintain square or near square exchange positions and keep their ready balances to the minimum in line with the operational requirements. In addition, SBP was providing forward exchange cover in respect of private foreign currency loans and suppliers' credit.

Banking Supervision

SBP was carrying out off-site surveillance of banks by requiring them to submit various returns, besides undertaking regular on-site inspections. However, the effectiveness of supervision had deteriorated over the years, largely due to the presence of Pakistan Banking Council (PBC), which was also empowered to carryout inspections of nationalized commercial banks. As a result, enforcement of regulations declined considerably for NCBs, largely due to the directives of government being passed on to these banks through PBC for compliance. Lack of empowerment and clear demarcation of roles in supervision of nationalized commercial banks resulted in gradual decline in quality of SBP supervision.

1.2.2 Pakistan Banking Council

Pakistan Banking Council (PBC) was formed under the Banks (Nationalization) Act, 1974 to perform various functions in line with the objectives of nationalization, i.e. "... to provide for directing banking activities towards national socio-economic objectives, co-ordinating banking policy and co-operation in various areas of feasible joint activity without eliminating healthy competition in various fields of operation, and ensuring complete security of depositors' funds...".[8]

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[5] The bank rate was the rate at which SBP could buy or rediscount bills of exchange or other eligible commercial papers. On 7th June 1977, this was increased to 10.0 percent from 9.0 percent (set on 3rd September 1974).

[6] For export sector, SBP was providing refinance to banks at 3.0 percent; for agriculture sector, refinance to the Federal Bank for Cooperatives at 0.5 percent and to Agricultural Development Bank of Pakistan at 6.0 percent; and for local industry, refinance for locally manufactured machinery at rates ranging from 3.0 to 4.5 percent.

[7] Open exchange position at any given time is the extent to which an AD has bought or sold foreign exchange on its own account without covering contracts with its constituent, the SBP, or other ADs.

[8] Source: Para (ii) of preface of Banks (Nationalization) Act, 1974.

PBC operated as a holding company and caused considerable distortion in the supervisory role of SBP, largely because of a wide nature of functions prescribed for PBC under the Banks (Nationalization) Act. In particular, the Act prescribed 21 specific functions broadly falling in six areas, some of which were exactly identical with the functions of a central bank. For example, PBC had authority to lay down performance criteria and formulate performance targets for banks, to monitor banks' progress in terms of profitability and efficiency, and carry out their inspection. Furthermore, it was also empowered to act as an arbitrator in inter-bank dispute settlements. It was also assigned the task of developing modernization schemes for nationalized banks, framing recruitment policy for bank officers and undertaking their pre-service and in-service training.

1.2.3 Corporate Law Authority (CLA)

The supervisory responsibility for capital market was vested in Corporate Law Authority (CLA), established in 1948 and working under the Ministry of Finance (MOF) with its headquarter in Islamabad and offices throughout the country. The main responsibilities of CLA under the Securities and Exchange Ordinance, 1969 were: (1) to grant registration to stock exchanges and ensure maintenance of their accounts as well as submission of annual reports; (2) listing of securities, ensuring annual general meetings by listed firms, and timely circulation of their half-yearly accounts, free transferability of shares, and dividend payment within 45 days of the declaration; (3) to ensure balloting of new issue applications within ten days of subscription and refunding to unsuccessful applicants within ten days of the ballot; (4) to ensure the issue of share certificates of new companies within thirty days of allotment; (5) to prescribe qualification requirements for the members of the stock exchange; and (6) to prescribe manner of transaction of stock brokers and ensure maintenance of their proper books of account. However, the CLA delegated much of its authority to the Stock Exchange Boards, which were largely self-regulated.

The capital market also had other regulators: the Controller of Capital Issues (CCI) and the Monopoly Control Authority (MCA). The Controller of Capital Issues was established in 1947 through Act No. XXIX that required companies to obtain prior approval from CCI for the issuance of securities. The Monopoly Control Authority was established in 1970 to check undue concentration of economic power. It had the authority to make recommendation to government to prevent or eliminate undesirable monopoly power or unreasonably restrictive trade practices.

1.3 Financial Markets

1.3.1 Money Market

The money market consisted of a primary market for treasury bills (tap) and government treasury deposit receipts (GTDRs), call money market, and a market for sale and purchase of unutilized portion of credit ceilings. Secondary market for treasury bills and GTDRs did not exist because of presence of discount window in SBP, which allowed early discharge of these bills.

Primary Market for Short-term Government Debt

The instruments traded in this market included: (1) three-month treasury bills sold to the banks at a fixed yield of 6.0 percent; and (2) GTDRs sold to non-banks at fixed return of 7.8 percent, 8.5 percent and 9.0 percent for maturity of 3, 6 and 12 months respectively.[9] Segmentation in the short-term government debt market was maintained by disallowing banks to purchase GTDRs. Market activity in these instruments consisted of almost continuous issues through the tap counter, discharge on maturity and rediscounting before maturity from the discount window. The former resulted in draining bank's liquidity, whereas the latter two activities provided continuous cash accommodation to banks.

[9] Outstanding amount of T-bills (tap) and GTDRs was Rs 58.7 and 16.1 billion respectively, as on end June 1990.

Call Money Market

With a view to maintain daily cash balances for clearing purpose and meeting the cash reserve requirement of SBP, all scheduled banks were allowed to lend and borrow overnight in the interbank money market.[10] All transactions were settled through cheques, which were ultimately recorded in respective banks' current account with SBP on the date of transaction.

Credit Ceiling Market

Bank-wise credit ceilings were set by SBP to achieve the global credit target fixed in the credit plan. Since it was almost impossible to achieve the exact target for each bank, they were allowed to trade in the unutilized portion of their ceilings. This enabled banks to avoid penalty due to over extension of credit, besides helping SBP to achieve credit plan targets. Similar to the call money activity, trading in credit ceilings did not involve any collateral. The rate was determined on the basis of market forces but tied to the call money rate.

1.3.2 Capital Market

The capital market, at the beginning of 1990s, consisted of market for equities (with three stock exchanges), term-loans, corporate debt, and mutual funds (with two mutual fund management companies). DFIs were dominant players in term-loan market, whereas the other NBFIs and commercial banks were providing market support for corporate debt issues, which were mostly issued by public sector enterprises.

The capital market at that time was not adequately supplementing the intermediary role of banking system as its activities were effectively confined to the Karachi Stock Exchange.[11] In addition, market for term-loans consisted of project financing at subsidized rates through DFIs, and as such was not a proper part of the capital market. In terms of corporate debt market, although some issues by public sector enterprises were outstanding, these were held mostly by banks and DFIs. Overall, participation of non-bank sector was not only very thin, but also confined to a few shares listed at KSE. The major reasons for companies not going public was the lack of proper investment advisory skills, weak underwriting capacity in the financial system, and poor distribution capacity of the stock market intermediaries.

Equity Market

In 1990, there were only two stock exchanges in Pakistan, one in Karachi and the other in Lahore.[12] Karachi Stock Exchange (KSE) was larger with more listed companies. During 1980s, KSE made some progress in terms of listed companies (see **Table 1.5**). However, this progress could not be considered significant, as only 150 companies were listed during the decade. This highlights certain structural issues that constrained the market progress. For example, foreign nationals were not allowed to make investment without prior approval from government and were also barred from owning 100 percent shares of a company. Moreover, restrictions on foreign exchange movement in and out of the country kept the foreign investors away from Pakistani markets.

On the supervisory front, though CLA was the primary regulator, its control over capital market was compromised due to lack of autonomy and overlapping of some functions with Monopoly Control Authority and Controller of Capital Issue. In addition, inadequate professional capacity restricted these agencies to exercise their supervisory functions effectively. On the other side, stock exchanges lacked proper infrastructure for trading and settlement. In particular, trading was carried out through

[10] Average call rate during FY90 was 6.7 percent per annum and money at call and short notice stood at Rs 10.0 billion (end June 1990).

[11] Market capitalization in terms of GDP remained very low at 6.4 percent in FY90.

[12] Islamabad Stock Exchange started functioning in 1992.

open outcry system. Due to lack of automation, turnover remained very low, and in the absence of a depository company, investors had to take physical delivery of shares.

Table 1.5: Profile of KSE

	Listed companies at KSE	Market capitalization (billion Rs)	Turnover of shares (million)	SBP general index[1]
FY80	312	6.7	36.6	129.8
FY81	311	6.6	29.4	128.5
FY82	326	9.4	36.5	100.3
FY83	328	13.3	67.7	131.6
FY84	347	19.7	88.9	182.4
FY85	362	22.0	84.2	176.3
FY86	360	24.4	175.2	171.0
FY87	378	31.6	147.0	222.7
FY88	385	38.2	175.2	260.6
FY89	416	43.9	172.7	273.2
FY90	462	48.6	236.4	283.5

[1] Base 1980-81=100

Almost all financial institutions in Pakistan were involved in the securities business. Nationalized Commercial Banks (NCB), Investment Corporation of Pakistan (ICP), National Investment Trust (NIT), newly created investment banks, and Development Finance Institutions (DFIs) were among the major players active in the underwriting business. Despite the active participation of these institutions, the equity market in Pakistan remained small. Since the corporate sector was relying more on DFIs for their financing needs, this did not allow equity market to develop significantly. This was a policy-induced outcome as most of the DFIs were in the public sector and were providing long-term finance at concessionary rates.

The activity in the capital market was further restricted due to liquidity constraints, narrow trading base, and limited use of technology. This limited the number of listed companies and their market capitalization. Consequently, the market was characterized by the limited equity of established, reputed and well-managed companies. Closely held companies were unwilling to go public for a variety of reasons. First, cost of equity was significantly higher than the debt as dividends were paid out of after-tax profits while interest on loans, invariably subsidized, was tax deductible. Also sponsors were generally able to finance projects with very low equity share. Second, fearing consequent dilution of shareholding and loss of control, family controlled companies were reluctant to go public and enlarge their capital base. Finally, listing involved obligation to disclose information, which these companies preferred to avoid.

Market for Term Loans

Term financing by NBFIs remained a significant part (mainly due to its concessionary price) of overall capital market activity. Data for selected DFIs show that during FY90 these DFIs approved an amount of Rs 18.3 billion, of which Rs 5.2 billion was actually disbursed (see **Table 1.6**). In view of the size of the equity market, this represented a significant amount.

Table 1.6: Sanctions and Disbursements by Selected DFIs in FY90

million Rupees

	Outstanding deposits	Sanctions	Disbursements
NDFC	12,422	5,123	2,272
RDFC	128	459	239
BEL	1,771	4,152	1,462
PICIC	1,191	8,591	1,239
Total	15,512	18,325	5,212

Corporate Debt Market

During 1960s and early 1970s, corporate debentures issued by Pakistani companies were not only listed on stock exchanges, there was even a secondary market for these instruments. However, following nationalization in 1972, this activity came to a standstill. In 1984, traditional debt instruments were substituted with TFCs (Term Finance Certificates) to make it conform to the principles of Islamic Sharia. However, till 1990, only major state-owned corporations like Water and Power Development Authority (WAPDA) issued TFCs, while private sector companies did not issue any TFC during this period.

Mutual Funds

National Investment Trust (NIT)

This institution was established in 1962 to cater the needs of small investors by promising them fixed returns in the equity market. This is a management company, with National Bank of Pakistan acting as a trustee. During FY90, net sale of NIT units stood at Rs 2.371 million showing a rise of 74 percent over the previous year (see **Table 1.7**). Being a government-controlled company, NIT enjoyed some preferential treatments, like quota allocation in all new offerings. This meant that a portion of every new issue was offered to the trust before being made public. Although the trust had a right to refuse such offerings; once bought, it was required to hold these shares for at least two years. During FY90, an amount of Rs 328 million was offered to NIT by 46 new offerings, of which NIT opted to subscribe equity of 42 companies worth Rs 291 million. NIT had also attracted savings in the form of participation in open-ended mutual funds.

Table 1.7: Net Sales of NIT Units

	million Rs	percent change
FY88	1,036	-
FY89	1,362	31
FY90	2,371	74

Investment Corporation of Pakistan (ICP)

The ICP was established in 1966 in public sector to develop and broaden the capital market. Since its inception, management of the company primarily focused on this mission. This undertaking clearly implied that priority should be given to national economic development. As a result, the focal point of ICP had been the broad market achievements, such as number of new companies listed, number of new projects financed, and aggregate new funds raised for investment in capital market. The key functions of ICP, among others, were to:

- act as underwriter of securities;
- act as a broker and investment counselor;
- manage investment portfolios; and,
- act as a trustee for ICP mutual funds.

For this purpose, ICP established a series of closed-end mutual funds for both institutional and individual investors (see **Table 1.8**). The closed structure of these funds did not permit investors to withdraw, and thus protected ICP during years of disappointing markets activity. During FY90, ICP approved Rs 580 million for different purposes; a bulk of this amount, i.e., Rs 339.1 million was committed for underwriting of shares. Disbursements during the same year stood at Rs 150 million, of which a major chunk was allocated for the take-up of Participation Term Certificates (PTCs).[13]

Table 1.8: ICP Mutual Funds

million Rupees

	Year listed	Paid up capital
1st	1967	5
2nd	1968	15
3rd	1969	20
4th	1970	15
5th	1972	5
6th	1973	10
7th	1975	10
8th	1976	10
9th	1976	10
10th	1977	10
11th	1978	10
12th	1979	10
13th	1982	10
14th	1983	10
15th	1985	10
16th	1986	10
17th	1988	20
18th	1989	50
19th	1990	50

1.3.3 Foreign Exchange Market

Foreign exchange market was heavily regulated by SBP through a system of exchange controls. All commercial banks were authorized dealers (ADs) and one of them was selected to work out the appropriate cross rates for major currencies by using the rate given by SBP and the rates closing the previous evening at the New York market. These rates were immediately sent out to other ADs.

Being the central bank, SBP had the responsibility of formulating exchange rate policy and conducting daily management of exchange regime. This was entrusted under provisions of the Foreign Exchange Regulation Act, 1947. This Act also required that all transactions in foreign

[13] PTCs were introduced in 1980 to replace debentures for providing medium and long-term rupee finance. The holders of PTCs participate, as a rule, in profit or losses of the company in each financial year.

exchange should be effected at rates authorized by SBP. Since the US Dollar remained the intervention currency, SBP set the Rupee rate at which it would purchase and sell US Dollar in its dealings with authorized dealers (ADs).[14] Furthermore, ADs rates (buying & selling) for public were set at 0.1 percent margin with respect to SBP's buying and selling rates.' All foreign exchange transactions by customers were conducted through ADs and authorized money changers (AMCs) at SBP's prescribed rates, whereas inter-bank transactions were taking place at rates varying within the range determined by SBP buying and selling spread.

In the forward market, SBP was not only assuming the responsibility of buying and selling US dollar from/to ADs in forward up to 12 months against their transaction with customers, but also regulating the forward premium charged by ADs. Furthermore, it was providing forward exchange cover in respect of private foreign currency loans, suppliers' credit and repatriable foreign currency loans for working capital requirements. In order to regulate sale and purchase of foreign exchange by ADs, the SBP prescribed limits on open exchange position and balances of individual ADs, after taking into account their daily operational requirements. The SBP maintained its own foreign currency reserves with the corresponding central banks and also maintained the foreign reserve deposits of its ADs.

In terms of market participants, exporters, remitters and tourists were main suppliers of foreign exchange, whereas importers and government sector organizations were major users. To manage the transactions between suppliers and users of foreign exchange, a system of ADs and AMCs was in place.[15]

1.4 Financial Repression

Complete nationalization of all domestic banks in January 1974 significantly altered the financial landscape of the country. The objectives of nationalization were to direct banking activities towards national socio-economic objectives and ensure complete security of depositors' funds. It is worth mentioning that monetary policy mechanism of SBP had already been changed a couple of years before nationalization through adoption of direct monetary controls and establishment of National Credit Consultative Council (NCCC). The new system was designed to limit the quantity of credit the banking system could extend to the private sector, while ensuring the flow of credit to government and priority sectors. Though the system was supposed to promote economic development and growth, it had its own repercussions, which are discussed in the following sections.

1.4.1 High Government Borrowing

Over the years, the deteriorating budgetary discipline had resulted into high domestic borrowings by the government (see **Table 1.9**).[16] The resulting domestic debt structure, which was characterized by presence of short and long-term government securities with administratively set yield structure, had been an important source of financial repression. In overall terms, the domestic debt was classified into permanent, floating and unfunded categories. The permanent debt consisted of government bonds (held by banks and financial institutions), and bearer instruments (held by individuals or corporate bodies), the floating debt comprised of three-month treasury bills sold to banks through tap system and adhoc treasury bills

Table 1.9: Fiscal Deficit and Financing (average 1984-90)

Overall fiscal deficit (as percent of GDP)	7.5
Financing (percent share in total)	
External borrowing	23.9
Bank borrowing	21.7
Non-bank borrowing	54.4

[14] The spread between buying and selling rate was equal to Rs 0.0156 per U.S. Dollar up to April 24, 1987, afterwards it was changed to 0.5 percent of the spot buying rate.

[15] For details on foreign exchange market participants, see **Annex 1.3**.

[16] In view of narrow tax base, lack of expertise in tax administration and expenditure controls, and limited foreign loans, the government had relied heavily on domestic borrowings that were a much easier source of funding expenditures.

purchased by SBP. Unfunded debt, on the other hand, consisted of various certificates and schemes of CDNS with very high rates of return and various tax incentives and exemptions.[17]

In terms of non-bank financing, the National Savings Schemes (NSS) had been the major source of funding as its average share in the total increased from about 12 percent in the second half of 1970s to 67 percent in the second half of 1980s. With a view to attract sufficient resources, the rate of return on Khas Deposits Certificates (KDCs) was increased to 15 percent on three-year maturity period, while the Government Treasury Deposit Receipts (GTDRs) were offering a maximum of 9 percent. Interestingly, the banking sector was not allowed to invest in both of these instruments.

As for the bank borrowing, the commercial banks were required to hold, as statutory liquidity requirement (SLR), 30 percent of their deposits in the form of government securities. Banks mainly held treasury bills, which were offering 6 percent rate of return that was also taxable. After tax, the return was only 2.1 percent compared to return on KDC of 15 percent for three-year maturity period. This 'on tap' availability of treasury bills meant that banks would require more securities with the increase in their deposits. In addition, the government also borrowed from SBP by selling adhoc treasury bills at 0.5 percent per annum, which was the most inflationary financing and termed as the monetization of government debt.

This composition of domestic borrowing adversely affected the banking system and the monetary control mechanism. Firstly, this led to low returns on banks portfolio. More specifically, although, commercial banks were obliged to accept all deposits, their lending operations were restricted in view of ceilings and subsidized credit to certain priority sectors. Furthermore, at least 30 percent of the deposit base had to be maintained in low yielding government securities as SLR, as stated earlier. This was in addition to a minimum of 5 percent CRR to be deposited in non-interest bearing accounts with SBP. In sum, these regulations led to low returns on assets portfolio, while a certain proportion of unutilized funds did not earn any return.

Secondly, this led to dis-intermediation in the banking system. While, NSS were offering a variety of tax incentives and relatively high returns (up to 15 percent per annum tax-free) at zero-risk to the end-investors, the financial institutions were providing 7 to 9 percent per annum on time deposits. Consequently, NSS was able to attract a large amount of funds away from the financial institutions. As a result, not only banks' share in financial savings declined, but also SBP's role as a monetary authority was weakened. The high currency/M_2 and M_1/M_2 ratios and declining M_2/M_3 ratio indicated increasing cash flows out of the banking system (see **Table 1.10**). Moreover, high currency to total deposit ratio implies the growing size of parallel economy.

Thirdly, the market segmentation (banks vis-à-vis non-bank) and resulting dispersion in interest rate structure, added to inefficiency of banking system as evident from high M_1/M_2 and M_3 to GDP ratios, suggesting the inability of banks to stimulate long-term savings. The ratio of M_2 with GDP had also been declining since 1986-87, suggesting that the financial sector was loosing its attractiveness for depositors (see **Table 1.10**).

1.4.2 Credit Controls

The absolute credit ceilings, which were widely used as a direct tool for controlling monetary expansion, also led to distortions in the financial sector. More specifically, since ceiling of individual bank was determined mainly on the basis of outstanding stock of deposits, it placed undue emphasis on historic market shares instead of bank's success in attracting new deposits. This, in turn, was impeding competition among banks for deposit mobilization.

[17] The average return on DSCs during 1980s was 15.6 percent against 7.1 percent on bank deposits.

Table 1.10: Selected Indicators of Financial Sector

	Currency/ total deposits	Time deposits/total deposits	Currency/M_2	M_1/M_2	M_2/M_3	Time deposits/ GDP	M_2/GDP	M_3/GDP
FY81	50.1	44.8	33.2	70.3	89.6	11.2	37.6	42.0
FY82	48.1	45.5	32.3	69.5	87.0	11.0	35.9	41.3
FY83	45.9	49.6	31.3	66.1	82.7	13.6	40.1	48.5
FY84	47.1	54.1	31.9	63.4	78.9	14.3	38.9	49.3
FY85	44.5	51.2	30.7	64.7	77.0	13.8	38.9	50.6
FY86	43.1	51.9	30.0	63.9	76.0	14.8	41.0	54.0
FY87	45.5	49.0	31.1	66.5	72.5	14.0	41.9	57.8
FY88	48.6	46.8	32.6	68.7	68.6	12.5	39.9	58.1
FY89	51.4	44.3	33.6	71.0	67.3	10.9	37.7	56.1
FY90	51.4	45.1	33.7	70.4	67.7	11.8	39.9	58.9

Note: M_3 series has been taken from Pakistan's Economic Survey for FY91.

The system of credit ceiling was also repercussive as the magnitude of credit flows to the private sector was determined only after accommodating public sector credit requirements. Hence, it was only the private sector that came under the ceiling. In addition, the ceiling also tended to accommodate established borrowers even if they were simply meant to rollover their loans, as banks were generally not willing to incur the cost of screening and evaluating new projects.

With these ceilings in place, the practice of accruing interest on infected loans by banks was very damaging. Since the unrealized income was liable to taxation, it reduced banks' ability to augment their capital base and to extend new loans.[18] At the same time, these ceilings also had an in-built incentive to evade. For example, with a view to avoid ceiling, a bank could arrange a loan from any NBFI against its guarantee. Hence, bank would book loans off-balance sheet by acting as a loan arranger for a fee, with the actual transaction being recorded on books of NBFI.

1.4.3 Sectoral Credit Allocation

The higher share of directed credit programs resulted in investments with low rates of return, which subsequently burdened banks with large non-performing loans.[19] The effectiveness of such programs was also questionable on the ground that it was difficult to ensure that the credit was being used by actual intended beneficiaries.

Over the years, concessional credit schemes have led to excessive monetary expansion, which in turn contributed to rising level of financial repression. Mandatory credit targets at concessional rates distorted the interest rate structure, thus widening the market segmentation. Moreover, profitability of the banking sector was also wiped out, to which the banks responded by pushing up their rates on other lending while keeping deposit rates down.

1.4.4 Administered Interest Rates

The interest rate restrictions were in the form of floors on deposit rates and ceilings on lending rates of commercial banks. These controls were motivated by a desire to provide low cost funds to encourage investment, particularly for priority sectors, and to safeguard against their increase as it was deemed politically or socially undesirable. Hence, the real interest rate on deposits remained virtually negative for most of the time, thereby discouraging savings and leading to financial dis-intermediation (see **Figure 1.1**).

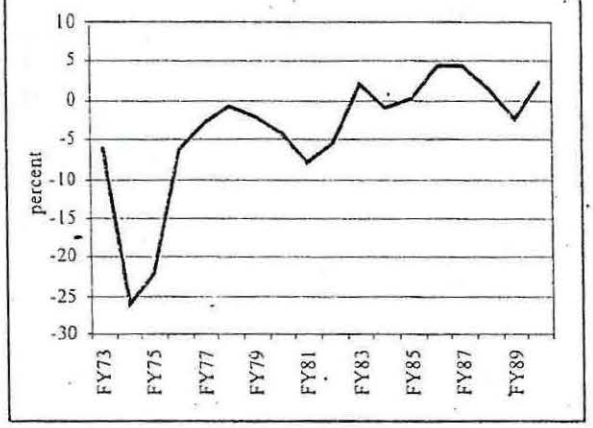
[18] Bank's capital base was one of the determinants of credit ceiling.

[19] The share of directed credit is provided in **Table 6.6**. This partly explains the larger share of state owned banks in total NPLs (see **Table 3.2**).

1.4.5 Implicit Risk Insurance

In some cases, like mandatory targets, credit risks were taken over by the government; liquidity risks were limited, as banks were allowed to discount excess treasury bills with SBP on daily basis; interest rate risks were negligible due to administered interest rates; and foreign exchange risk cover were provided by the government. In addition, government provided explicit guarantee to all depositors of NCBs and DFIs. This broad assurance reflected the desire to protect depositors and to maintain confidence in the stability of the financial system. However, such policies weakened market signals and stimulated risky investments (both by depositors and banks) without adequate checks and compensation.

Figure 1.1: Real Return on Deposits



1.4.6 Other Factors

The limited competition due to entry restrictions on new institutions and restrained activities of foreign banks, hampered the development of the financial system. Moreover, dominance of the public sector enabled successive governments to seek political power by distributing rents through banking system. The resulting inefficiencies of the system, required authorities to further tighten controls to achieve policy results, thereby creating a vicious circle of growing checks that became increasingly less effective.

In addition, underdeveloped money and capital markets limited the role of financial sector in terms of intermediating funds between borrowers and savers: firms and individuals were meeting their long-term financing needs from informal sector. Also, the absence of secondary market for government papers led to limited number of money market instruments, thus curtailing SBP's capacity to conduct short-term monetary operations.

2 Financial Sector Reforms During 1990s

By the end of 1980s, it was evident that the pervasive monetary and credit policies followed over the years had given way to the repressed financial system, affecting adversely the growth and efficiency of the financial sector. It was in this perspective that at the end of 1989, a reform program was initiated to reduce the market segmentation, instill competition, and switch over to market-based and relatively more efficient monetary and credit mechanism. However, this reform process gathered momentum since 1997, when a crucial set of reforms aiming at institutional strengthening, restructuring of banks and DFIs, and improvement in regulatory framework was introduced.

2.1 Institutional Reforms

The government ownership of commercial banks resulted in political intervention into credit allocation and loan recovery decisions besides other institutional inefficiencies. As a result, infected loans increased sharply, financial institutions suffered losses, and quality of services plummeted. In order to address these issues, a number of policy reforms were undertaken to encourage the participation of the private sector, such as transferring management and control of NCBs to the private sector, and permitting it to open banks and NBFIs. These measures were designed to improve the level of competition and efficiency in the financial system.

2.1.1 Financial Liberalization

Privatization

To facilitate the privatization process, the Banks (Nationalization) Act, 1974 was amended in 1990, empowering the Federal Government to sell all or any part of the share capital of NCBs. In a subsequent amendment, the government was allowed to suspend the provisions of the Banks (Nationalization) Act, in cases where 26 percent shares of any NCB were sold to the private sector. Furthermore, an NCB would fall outside the ambit of the Banks (Nationalization) Act, 1974 when 51 percent of the share capital was taken up by the private sector.

Accordingly, 26 percent shares of Muslim Commercial Bank (MCB) were sold to the private sector in April 1991. By January 1993, further 49 percent shares of MCB were disinvested in addition to transfer of its management and control to the buyer. In September 1991, 26 percent shares of Allied Bank Limited (ABL) were also disinvested under the Employee Stock Ownership Plan and the management and control of the bank was handed over to Employee Management Group. Further 25 percent shares were sold to private sector in August 1993. In the same year, the government decided to sell 26 percent shares of United Bank Limited (UBL) and transfer its management to the private sector. Although initial attempt to privatize UBL failed because of various technical reasons, privatization of NCBs remained a key element in government agenda.

Opening of New Banks

With a view to encourage private sector participation, enhance efficiency and promote competition among banks, the Banks (Nationalization) Act, 1974 was amended during 1991, allowing private sector to open banking companies. Subsequently, in August 1991, ten new Pakistani commercial banks were permitted to commence their operations.[1] In later years, eleven new banks were allowed to start commercial banking.[2] Moreover, two provincial banks, namely, the Bank of Khyber and the Bank of Punjab, were declared as scheduled banks in 1994.

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[1] These banks included: Bank Al-Habib Limited, Soneri Bank Limited, Union Bank Limited, Meezan Bank Limited, Indus Bank Limited, Prime Commercial Bank Limited, Askari Commercial Bank Limited, Bolan Bank Limited, Capital Bank Limited, and Republic Bank Limited. Of these, last two banks did not begin their business activity.

[2] These included: Metropolitan Bank Limited, Habib Credit & Exchange Bank Limited, Sehon Bank Limited, Faysal Bank Limited, Platinum Commercial Bank Limited, Prudential Commercial Bank Limited, Gulf Commercial Bank Limited, Bank Al-Falah Limited, Bank of Ceylon, Oman International Bank, and Trust Bank Limited.

In order to avoid the mushroom growth of banks a moratorium was imposed in 1995 and no new bank was allowed to open thereafter. However, the branch policy for both the domestic private banks and foreign banks was eased; this was done to provide the opportunity for existing banks to grow. On the contrary, nationalized banks were prevented to open new branches in December 1996 and asked to close unprofitable ones in 1997.

2.2 Institutional Strengthening of NCBs and DFIs

2.2.1 Strengthening of Self Governance

In order to strengthen self-governance, various amendments were made in Banking Companies Ordinance, 1962. More specifically, section 27B was inserted to curtail and make punishable disruptive union activities; according to a new section 83A, dishonest removal or disposal of goods (pledged as security for the payment of any debt or loan) was made liable for punishment; and extension of any financial facility to a borrower on verbal instructions was considered an offence. Furthermore, amendments were also made to empower the SBP to frame guidelines for recovery of bad or doubtful loans by giving incentives to borrowers for making repayments within a specified time. At the same time, SBP was also authorized to publish a list of defaulters after notifying and hearing from them in advance.

2.2.2 Restructuring of Banks and DFIs

Since NCBs had focused more on increasing their branch network to far-flung areas of the country, their efficiency began to decline with rising cost and oversized workforce. These, together with growing non-performing loans rapidly offset the initial benefits of nationalization. The more important concern was the increase in intermediation costs that translated into lower returns on deposits and higher lending rates.[3] The resulting stress on their profitability made it clear that without a significant restructuring, these banks would continue to pose systemic risks to the financial system. Keeping this in view, NCBs were asked to prepare restructuring plans to rationalize their work strength and size.

In September 1997, three NCBs, two specialized banks and two privatized banks introduced various separation schemes for employees besides chalking out plans for branch closure. With the help of golden handshake schemes, in a two-year period, these banks were able to reduce the size of their workforce from 99,954 to 81,079 as on end December 1999. In terms of branch closure program, an earlier criterion, which ensured that no area was rendered un-banked,[4] was changed and banks were allowed to close their branches entirely on commercial considerations. This resulted in a reduction of 718 branches from end June 1997 (8,673 branches) to end June 2000 (7,955 branches).

2.2.3 Strengthening of Prudential Measures

The rapidly deteriorating governance and credit discipline (especially in NCBs) not only aggravated structural problems, but also led to worsening level of non-performing loans. This necessitated mustering of efforts to strengthen prudential measures, focusing on capital adequacy, adequate provisioning and effective loan recovery mechanisms, and legal procedures.

In 1994, the capital adequacy requirements for NCBs and two large specialized banks (i.e., ADBP and IDBP) stood at 3 percent of call and time liabilities. This resulted in over-lending by these banks and weakening of capital base, thereby making them vulnerable. In FY96, all NCBs, foreign banks and

[3] Although this could not be substantiated with data, intermediation costs were rising but largely concealed in distorted lending and deposit rates, due to presence of elements of mandatory and concessionary credit and ceilings and floors on lending rates.

[4] A place/area is deemed to be un-banked if no branch of any other bank is operating within a radius of 5 km. Ref: BSD circular No.11, dated 17th March 2001 (branch licensing policy).

NBFIs were instructed to adopt the system of risk-weighted capital, in line with the Basle Accord. Consequently, effective from 31st December 1997, banks were required to maintain capital and unencumbered general reserves of not less than 8 percent of their risk-weighted assets. In addition, banks had to achieve a minimum paid-up capital of Rs 500 million by end December 1998. In December 2000, this minimum capital requirement has been doubled to Rs 1,000 million, with half of the increase i.e. up to Rs 750 million to be achieved by end December 2002 and the remaining till end December 2003. A banking company failing to meet the above requirement shall stand converted into a non-scheduled bank.

Since credit rating is considered as one of the measures of transparency, steps were taken to institutionalize the credit-rating process. Accordingly, in April 1995, all NBFIs were required to have themselves rated by one of the approved agencies. A similar condition was placed for all banks from June 2000 with a view to safeguard the interests of prospective investors, depositors and creditors.

In order to provide a level-playing field between banks and NBFIs, besides consolidating the supervisory role of SBP over NBFIs, a one percent cash reserve requirement (CRR) was imposed on NBFIs effective from January 7, 1996 besides statutory liquidity requirement (SLR) of 15 percent, which was imposed on January 1, 1992. In addition, the provisioning rules and interest suspension were imposed on DFIs from the end of the accounting year 1996.

Furthermore, in January 1997, SBP allowed banks to offer fund management and other investment advisory services by forming subsidiary companies. Consequently, banks meeting liquid assets requirement and other credit disciplines during the immediate 52 preceding weeks would be eligible to set up such subsidiaries. Such organizations, however, would not be permitted to invest in real estate or grant any form of credit. In April 1999, SBP amended this regulation, specifying minimum paid-up capital of Rs 100 million for subsidiaries formed for investment banking and fund management.

2.2.4 Strengthening of Loan Recovery Process

State Bank, during its periodic inspections of banks, classified, wherever necessary, loans and advances into three categories, namely, sub-standard, doubtful, and loss on the basis of assessment of risk to banks. However, in February 1989 banks were directed to classify themselves loans and advances in accordance with the detailed guidelines issued by SBP.[5] These guidelines were further strengthened in August 1992, whereby the determinant for the category of Other Assets Especially Mentioned (OAEM) was changed from 180 days or more to 90 days or more.

In November 1993, SBP asked banks to set quarterly recovery targets, submit progress reports, and form strategies to improve future recovery process. At the same time, minimum conditions for borrowers were also established to ensure that defaulters were not provided fresh loans. In this connection, banks were also required to furnish a list of defaulters to SBP, having a total borrowing of Rs 1 million and above, together with details of rescheduled and restructured loans. In order to clearly identify defaulters, SBP required banks to obtain information from Credit Information Bureau of SBP about total outstanding liabilities (to banks and other financial institutions) of any applicant seeking loans of Rs 0.5 million or more. In August 1997, SBP revised disclosure standards and banks were asked to submit their annual accounts on new formats in line with international accounting practices.

In 1993, the government increased the number of banking tribunals from three to eleven for non-interest bearing loans i.e. mark-up based loans, whereas for interest bearing loans, this was raised to fourteen. All financial institutions were also instructed not to accommodate defaulters unless

[5] These guidelines were laid down in BID circular No. 3 dated 20th February 1989.

rescheduling or restructuring of outstanding liabilities are completed to the satisfaction of lending institution. In December 1996, government restricted NCBs from making new project loans till June 1997.

In June 1997, SBP took a lead by launching a three-pronged loan recovery drive which comprised of: (1) an amnesty scheme, encouraging defaulters and sick units to settle their overdue/loans; (2) default cases of borrowers, who did not avail amnesty program by 5th September 1997 were to be filed with the new banking courts; and (3) asset recovery departments of the NCBs and DFIs were to be strengthened and placed under new management. In April 1998, SBP's prudential regulation for loan classification was rationalized, thereby requiring banks to make qualitative evaluation of their credit portfolios for risk assessment on the basis of adequacy of security, cash flows and credit worthiness of borrower.

By 15th November 1998, total cash recovery amounted to Rs 34.7 billion, or a quarter of total defaults. In October 1999, the military government issued a one-month deadline to defaulters for clearing of outstanding dues. Under this loan recovery drive, a total of Rs.13.5 billion were collected during October to December 1999.

2.3 Institutional Strengthening of SBP

The initiation of financial liberalization required the apex institution to work with more diligence and authority to achieve its objectives. Hence, in order to strengthen SBP's regulatory and supervisory authority, a number of policy and institutional measures were introduced.

2.3.1 Restructuring

In order to address core financial issues (such as non-performing loans, creation of marketable government securities, monitoring of NBFIs, strengthening of on-site and off-site surveillance, and enhancing the capacity of SBP), a process of internal SBP restructuring was initiated. With the purpose of monitoring leasing companies, modarabas, housing finance companies, investment banks and DFIs, the NBFIs Regulation and Supervision Department was setup. This department, which became functional from 1st January 1992, issued 'Rules of Business', requiring all NBFIs to submit periodic returns for evaluation of their performance.

Securities Department was setup in December 1990, to launch an auction system of public debts and develop a secondary market for government securities. In 1991, the Credit Information Bureau (CIB) was established to maintain record on all borrowers with liabilities, overdues and defaults of Rs 1 million and above, to any financial institution under SBP's Jurisdiction. Subsequently, in FY95 all information was computerized to minimize delay in information transmission to banks.

More importantly, the SBP Act was amended in February 1994, giving full autonomy to the Board of Directors of the Bank in all matters relating to administration and conduct of business of the Bank within the provisions of SBP Act, 1956. This act was amended again in 1997 to further enhance SBP's responsibilities (see **Section 2.6.1**).

Information from early warning system, off-site surveillance and on-site inspection was integrated and focused on risk analysis. At the same time, a system was put in place whereby performance of each bank and NBFI was evaluated under CAMELS and CAELS system. Exchange and Debt Management Department was established in FY00 by merging the Securities Department and the Foreign Exchange Dealing Room established in 1998. This paved the way for coordinated operations in foreign exchange and Pak Rupee denominated securities. This facilitated the free float of Pak Rupee achieved in FY01.

2.3.2 Consolidation of Regulatory Functions

The restructuring process received a major boost in May 1997 with the amendment of the SBP Act, 1956 and the Banking Companies Ordinance, 1962. These changes vested authority to SBP to regulate and supervise banks and the financial institutions, to conduct an independent monetary policy, and to set limit on government borrowings from the central bank. Besides, the Banks (Nationalization) Act 1974, was also amended, dissolving Pakistan Banking Council, and requiring SBP consultation in matters relating to appointment of chairman/president and members of the board of all government owned banks and DFIs. Private banks were also required to seek SBP approval to such appointments.

In April 1997, services of an international consulting firm --Arthur Andersen-- were acquired to undertake an in-depth review of the banking supervisory system and monitoring techniques. The firm assisted in modernizing and re-orienting inspection process besides providing training to SBP officials. More importantly, on their recommendations, a risk-based inspection of financial institutions and CAMELS system of off-site surveillance were introduced.

In February 2000, a Concept Paper outlining the future direction of SBP with the objective of transforming it into a highly professional, efficient and modern institution was approved by the Central Board of SBP.[6] To help achieve this objective, important measures were undertaken, including, increased emphasis on direct recruitment (which started in mid 1990s) at senior and middle management level on the basis of merit through open competition; strengthening of National Institute of Banking and Finance (NIBAF) -- the training wing of SBP; identification of core and non-core functions; and the introduction of an Early Retirement Incentive Scheme which was later converted into a permanent feature for employees with 25 years of service. Moreover, as a step towards decentralization of authority, administrative and financial powers were delegated to lower levels of hierarchy.

2.3.3 Computerization

Although the process of computerization was initiated in FY94 with the creation of Computer Services Department, a major step was the setting out of "Information System Strategy Plan" in FY99. The plan envisaged setting up of an intranet facility and the installation of in-house application software. SBP also launched its own website that hosts valuable information which are being regularly updated. Furthermore, in order to ensure greater security and efficiency in payment system, SBP acquired membership of Society for Worldwide Inter-bank Financial Telecommunication (SWIFT), which is operational since June 5, 2000.

2.4 Debt Management Reforms

The debt management reforms were initiated with a view to: reduce the segmentation in government debt market; rationalize the cost of raising long-term government debt; establish a market-based rate of return structure for government securities; and pave the way for implementation of monetary policy through instruments of indirect monetary control (see **Section 1.4**).

2.4.1 Replacing Tap System with Auction Based System

Realizing the negative repercussions of tap system of debt management, Government of Pakistan introduced a short-term paper in April 1989. Although these six-month debt instruments, also known as "Government of Pakistan Market Treasury Bills", were to be sold by SBP on behalf of government through an auction system, this experience was not very successful.[7] Consequently, Securities

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[6] The concept paper was prepared by Dr. Ishrat Husain, Governor, SBP.

[7] It is important to note that up to June 1989, in each of the total three auctions, all bids were rejected as quoted rates were considered too high. During 1989-90, out of 26 auctions, 17 were abandoned either due to lack of interest or high offered

Department was set up in December 1990 to launch auction system of public debt, and develop a secondary market for government securities. This was supported by an end to issuance of three-month T-bills and GTDRs sold through tap. In addition, following the introduction of 3-Day Repo facility in February 1992 the discount window was closed down in the same month. The system of credit ceilings was replaced in August 1992, by a relatively flexible control through fixing of Credit Deposit Ratio (CDR) in each quarter. However, this system was also abolished in September 1995, thereby encouraging scheduled banks to extend credit to the private sector through market-based mechanism, and helping SBP in managing its monetary policy through indirect control.

In terms of long-term government debt instruments, securities available to banks and NBFIs included, 'Market Loans', which were a kind of government bond sold through subscription at par with fixed rates of interest. However, they were not allowed to invest in CDNS schemes, which were available to individuals at very attractive returns with the option of premature encashment. More importantly, none of these securities were priced at market rates. In view of ample demand for a market based, long-term government paper by banks and NBFIs, Federal Investment Bonds (FIBs) of 3, 5 and 10-year maturities were introduced. These were fixed coupon bonds offering 13, 14, and 15 percent annual return respectively. First auction of FIBs was conducted on 30th March 1991. Although the market response quickly picked up, it failed to retain its attractiveness after reaching peak in FY93, as cut-off decisions did not match market expectations on pricing (see details in **Section 5.1.3**).

2.4.2 Promotion of Secondary Market

The development of a secondary market depends on a variety of factors, including capability and skills of dealers in market making, privileges provided by the central bank that allow dealers to carry out their obligations, quality of the payment system in terms of efficiency and ease, spectrum of alternative government and non-government debt instruments available to investors, and saving behavior of economic units in the country.

System of Approved Dealers

The reorientation of money market, particularly following the introduction of auction system, required efficient primary dealers (PDs). For that purpose, in December 1990, the former Secretary's Department of the SBP, sought applications for PDs from scheduled banks and DFIs.[3] The prospective PDs were not only required to maintain a minimum capital of Rs 100 million, but also obliged to follow SBP rules and procedures, participate actively in all issues of government securities, distribute their securities holding as broadly as possible, make efforts for secondary market development, provide two-way market prices, and report periodically to SBP. In return, SBP intended to provide certain privileges, including, extension of a market facility to provide liquidity support in case of shortage of funds, access to auctions and open market operations, access to SBP's book-based clearing and settlement system and access to the inter-dealer broker network as and when introduced.

However, in February 1991, to widen the scope of participation in auctions all banks were allowed to participate directly, thereby creating a category of 'Approved Dealers'. Although the selection criteria for PDs was articulated much later in the end of 2000, financial institutions were quickly granted the status of Approved Dealers, if they had a current account with SBP. Institutions, not having a current account, were required to enclose a letter from their bank, authorizing SBP to deduct the required amount from their balance to settle the accepted bids. Despite drawbacks, this system succeeded in firmly establishing the primary market of T-bills and FIBs.

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rates, and only Rs 4,250 million worth of T-bills were sold. In the next year, 10 auctions were held and all were abandoned due to similar reasons.

[3] Secretary's Department was named as such because its Director served as Secretary to the Central Board of Directors of SBP. This department was renamed as Corporate Affairs Department in FY92.

Book Based System of Government Securities Settlement

In order to promote secondary market activities, the facility of Subsidiary General Ledger Account (SGLA) was extended to NBFIs in March 1991. The system, which was further streamlined in June 1991, allowed the issuance of government securities without any physical movement. In this system, while settlement was accomplished via an entry in SGL (representing the ownership of the investor), the transfer of ownership required simultaneous debits and credits to respective accounts of holders. This system allowed two layers of accounting: (1) between SBP and banks/NBFIs with current accounts at SBP, known as SGLA, and (2) between banks/NBFIs and their clients, called "Investors' Portfolio of Securities". This system greatly eased the clearing and settlement of primary as well as secondary market transactions in T-bills and FIBs.

2.4.3 Measures Relating to National Savings Schemes

Since Khas Deposit Certificates (KDCs) were offering very high returns, these carried the largest share in unfunded debt.[7] These certificates were discontinued in February 1990 due to their costly nature. At the same time, three other instruments (Special Savings Certificates, Registered and Bearer, and Special Savings Accounts) were introduced.

Interestingly, despite lower returns on new instruments, these were still very attractive. In fact, contrary to reform objectives, these schemes were made more attractive overtime by administratively increasing their yields, which together with underlying tax incentives, further intensified the market segmentation. However, in FY99 the interest rate structure was rationalized to some extent, when compound annual average return on Defense Savings Certificates (DSCs) was reduced by two percentage points in May 1999, which were followed by further one percentage point cuts in FY00 and FY01, successively (see **Table 4.15**).

2.4.4 Measures Relating to Bearer Instruments

In order to tap finances from informal sector, one registered and two bearer instruments were introduced in mid 1980s. More specifically, Special National Fund Bonds (SNFBs) were zero-coupon two-year registered bonds with a yield of 5.6 percent and offered to individuals and corporate bodies; Bearer National Fund Bonds (BNFBs) were of one, two and three-year maturities, carried yields in the range of 8.7 to 13.2 percent, and Foreign Exchange Bearer Certificates (FEBCs), which were denominated in Pak Rupees but issued against foreign exchange, carried rates of return in the range of 14.5 to 15.0 percent. All these instruments were exempted from income tax. Furthermore, SNFBs provided the immunity from probe by tax authorities. This immunity was also given to FEBCs if these were encashed in Pak Rupees.[8]

To mobilize foreign exchange, US Dollar Bearer Certificates (DBCs) were introduced in February 1991. Five Year Foreign Currency Bearer Certificates (FCBCs) denominated in US Dollar, Pound Sterling, Deutsch Mark and Japanese Yen were initiated in March 1992. Their outstanding level peaked in FY97, however these were discontinued from January 1998. Three-year FCBCs denominated in US Dollar and Pound Sterling were introduced in February 1998 and discontinued in December 2000. Outstanding stock of these certificates was reported in domestic debt, because of Pak Rupee counterpart implications for budget.

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[7] Out of the total unfunded debt of Rs 113 billion as on end June 1989, KDCs share was 71.6 percent, followed by Defense Saving Certificates (22.5 percent) and other instruments like National Deposit Certificates/ Accounts, Premium Savings Certificates and Savings Accounts (5.9 percent).

[8] SNFBs, which were offered on tap for first two months of FY86, succeeded in raising Rs 15.1 billion, whereas BNFBs continued till 1992 and their rollover was allowed till 1998. At their peak in FY 92, their outstanding level was Rs 43.9 billion. On the other hand, FEBCs (which were made more attractive in FY 93) were discontinued on December 15, 2000. At their peak in FY 95, their outstanding level was Rs 13.5 billion.

2.5 Monetary Management Measures

Prior to financial sector reforms, monetary management was based on instruments of direct controls, such as administratively set interest rates, credit ceilings, directed and subsidized credit and direct involvement of government in formulation and implementation of monetary policy. Therefore, following measures were undertaken with the objective of addressing these structural weaknesses.

2.5.1 · Reorientation of Monetary Policy Instruments

Besides the introduction of auction-based government debt management, a flexible system of Credit-Deposit Ratio (CDR) was initiated in August 1992, which replaced ceilings for allocation of credit. Under this system, commercial banks were required to extend credit to the private sector within limits worked out on a quarterly basis in relation to CDR. This system was gradually liberalized and eventually abolished altogether in September 1995 (see **Section 2.4.1**).

A major shift in monetary management came about in January 1995 with the introduction of open market operations (OMOs), which have now become the major instrument of monetary policy. Since then, SBP has been using Market Related Treasury Bills (MRTBs) as the primary tool for conducting OMOs and, hence controlling inter-bank market liquidity. In order to ensure transparency and regularity, it was decided to follow a fixed schedule from 15th April 1999 for conducting auctions and open market operations.[9]

In February 1992, the rediscount facility was replaced with SBP 3-Day Repo facility against T-bills; later, banks were allowed to also use FIBs when accessing this facility. However, in order to limit any misuse, the procedure for acquiring this facility was amended in May 1993, and banks were directed to provide sufficient justification to SBP for using this source of funding. In addition, banks were also required to report all inter-bank call money and repo transactions to SBP.

The special cash deposit ratio (as a percentage of either total demand and time liabilities or outstanding credit) is effectively a statutory cash reserve requirement (CRR) with the difference that they are remunerated at some given interest rate. After the start of reforms program, this condition was first imposed on 9th October 1991, when banks were required to maintain 7 percent of their outstanding credit in addition to the CRR. However, this requirement was dropped from 15th January 1992. Again, on 9th February 1995, banks were directed to maintain 1.5 percent of their total demand and time liabilities (in Pakistan) as special cash deposit with SBP. This ratio was further enhanced to 3.5 percent of the total demand and time liabilities (excluding foreign currency accounts) from 11th December 1995 -- before abolishing it from 1st July 1996.

Since then, emphasis was placed more on cash reserve requirement (CRR), which normally stood at 5 percent on weekly average basis. Apart from that, banks were also required to maintain a given percentage of their demand and time liabilities in government securities as the statutory liquidity ratio (SLR). As a part of reforms, this ratio was gradually reduced from 45 to 35 percent in October 1993 and further to 25 percent in March 1994. At present, the ratio stands at 15 percent, set in June 1998.

2.5.2. Rationalization of Subsidized Credit Schemes

In order to eliminate the subsidy element and the attendant financial market distortions, the lending rates on special financing schemes including locally manufactured machinery (LMM) and export finance were gradually raised. At present, returns payable on special financing schemes are close to market rates, except for export finance and export sales of LMM. In addition, to ensure that financial institutions are not burdened with subsidized credit, all new schemes involving concessional finance were capped.

[9] Fixed schedule for OMOs was abandoned in July 2001. However it is still continuing for auctions.

Export finance scheme experienced a major change in 1992 when scheduled banks were asked to maintain an interest bearing Special Deposit Account with SBP, using the amount of refinance provided by central bank. In practice, this squeezed the banks' ability to expand credit and contained credit expansion in the system. Hence, in April 1997, this scheme was restored to its original.

2.5.3 Interest Rate Rationalization

As a major step towards market-based monetary management, caps on maximum lending rates of banks and NBFIs for trade related modes of financing (except for LMM and export finance scheme) were removed in March 1995. Subsequently, caps for project financing were also lifted in October 1995. Floors on minimum lending rates, for project and trade related financing were abolished in July 1997. Accordingly, banks and NBFIs were able to set their lending rates in relation to the demand/supply conditions in the market.

2.6 Banking Law Reforms

During 1990s, a number of amendments were made in the SBP Act, 1956; the Banking Companies Ordinance, 1962; the Banks (Nationalization) Act, 1974; the Banking Companies (Recovery of Loans) Ordinance, 1979 and the Banking Tribunals Ordinance, 1984. The key objectives of these changes were: to pave the way for privatization of NCBs; to enhance competition by allowing private sector to establish new banks; to increase the autonomy of SBP in formulating and implementing monetary policy; to consolidate its role as regulator of banks and non-bank financial institutions; to strengthen the internal governance of these institutions; and to improve the framework for recovery of loans.

2.6.1 Reforms in SBP Act, 1956

The Act was amended in February 1994 to increase autonomy of SBP in regulating the monetary and credit system. Accordingly, the Central Board of Directors of SBP was enlarged to accommodate full representation of provinces and economic sectors, and enhance its responsibilities in matters relating to administration and conduct of business. Meanwhile, an amendment in BCO empowered SBP to change CRR and SLR for scheduled banks. The amendment in SBP Act also institutionalized a framework for the coordination of monetary, fiscal, foreign trade and exchange rate policies by establishing a Monetary and Fiscal Policies Coordination Board.

In January 1997, section 46B was also inserted in SBP Act, 1956 to prohibit governmental or quasi-governmental bodies from issuing any directives to banking companies or other financial institutions regulated by SBP. Furthermore, the Central Board was entrusted to formulate monetary and credit policies consistent with targets and the recommendation of the Monetary and Fiscal Policies Coordination Board with respect to macroeconomic policy objectives. The Central Board was further assigned the responsibility to determine and enforce limits on SBP credit to the federal/provincial governments and their agencies; approve credit requirements of the private sector; submit a quarterly report to the Parliament on the state of the economy; and advise the federal government on economic policy issues.

The major responsibilities of Monetary and Fiscal Policies Coordination Board included: to coordinate between fiscal, monetary and exchange rate policies by ensuring consistency among macroeconomic targets; to determine government borrowing from commercial banks on the basis of liquidity expansion determined by the Central Board; to review the consistency of macroeconomic policies on quarterly basis and revisit initial limits/targets depending on developments in the economy; and to review expenditures incurred on raising of loans and government borrowing. This also required the Planning Commission and the Ministry of Finance, to periodically inform the Board about the impact of monetary policy on investment, growth and balance of payments. Similarly, the Ministry of Commerce was ordained to provide feedback to the Board regarding the impact of monetary policy on trade.

The aforesaid amendments triggered a process of institutional capacity building within SBP through restructuring of its departments, induction of professionalism, and development of its human resource base (see **Section 2.3**). This process took a definitive shape and direction in FY00 with the implementation of the 'Concept Paper' approved by the Central Board of SBP. This will continue in coming years with more vigor to enable SBP to assert and exercise greater autonomy already provided legislatively.

2.6.2 Amendments in Banks (Nationalization) Act, 1974

In 1997, an amendment in the Banks (Nationalization) Act further consolidated the regulatory functions of SBP. Accordingly, Pakistan Banking Council was dissolved; exclusive right of the government and its corporations to establish a bank were withdrawn; consultation with SBP was made necessary in the appointment of chairman, chief executive or any other member of the board of directors of NCBs and DFIs; and these boards were vested with respective superintendence of banking business and policy. Earlier in 1990, important changes were also made in this act, when government was empowered to privatize NCBs. In addition, DFIs were brought under the purview of PBC. In 1991, the government was allowed to permit the establishment of banks in the private sector.

2.6.3 Reforms in Banking Companies Ordinance, 1962

The consolidation of SBP's supervisory role also required amendments in BCO. Under Section 40A, SBP was made responsible to systematically monitor performance of every banking company to ensure their compliance with the applicable statutory criteria and banking rules and regulations. In case of non-compliance, SBP was authorized to take remedial steps in accordance with the law, and periodically report shortcomings or violations to the federal government. Section 41D empowered SBP to direct prosecution of a director or chief executive, who had knowingly caused loss to depositors' money or to the income of banking company.

Furthermore, sections 82A-G institutionalized the system of banking ombudsman (mohtasib), who had powers to investigate and adjudicate on complaints of banking malpractices; perverse, arbitrary or discriminatory actions; violations of banking law; inordinate delays or inefficiency, corruption, nepotism or other mal-administration. In addition, mohtasib could facilitate the amicable resolution of complaints, or report its recommendations to SBP for implementation. Provision of appeal to SBP by aggrieved parties was also made on orders of mohtasib, with finality in SBP's decision.

2.6.4 Banking Companies (Recovery of Loans, Advances, Credits and Finances) Act, 1997

This Act was enforced to consolidate and re-enact the Banking Companies (Recovery of Loans) Ordinance, 1979 and the Banking Tribunals Ordinance, 1984. This allowed establishment of banking courts to expedite recovery process for stuck-up loans. Besides disposing of suits within ninety days or asking defaulters to furnish security hereafter, these courts were allowed to pass interim decrees in respect of undisputed claims. In addition, an effective mechanism was also laid down, envisaging attachment before judgment and appointment of receiver, and allowing the bank to take over the possession of property (in case where it was authorized to do so) without filing a suit. These courts were authorized to dispense with, by passing a preliminary decree relating to suits based on mortgages, and pass final decree for foreclosure or sale. The Act also provided for recovery of loans written off on or after 1st January 1990, on basis other than bonafide business considerations.

2.7 Exchange and Payment Reforms During 1990s

The process of exchange and payment reforms, initiated in 1991, was intended to facilitate rapid industrialization by creating an environment conducive to domestic and foreign investment, trade and foreign exchange resource mobilization. Although this process received a serious set back due to the unsustainable balance of payments position following nuclear detonation, this was by no means an

end to reforms. Instead, the resulting restrictions were gradually lifted as soon as economic conditions improved. Given this, the liberalization process can be divided into two periods: 1) February 1991 to May 1998, and 2) May 1998 to December 2000.

2.7.1 Reforms During February 1991 - May 1998

Promoting Intermediation
With a view to attract funds held abroad by Pakistanis, the resident Pakistanis were allowed to open foreign currency accounts (FCAs) with banks in Pakistan, which were freely transferable abroad, exempted from income and wealth tax, and no question was to be asked about the source of foreign exchange. Persons holding FCAs could also obtain Rupee loans against such accounts.

Encouraging Foreign Investment
In order to encourage foreign investment, restrictions on capital inflows and outflows were liberalized. More specifically, not only foreign investment in all industries (particularly in services, infrastructure, and agriculture sector) was allowed without prior approval, investors were also permitted to purchase up to 100 percent of the equity in industrial companies on repatriable basis. Furthermore, investment shares (issued to non-residents) could be exported and remittance of dividend and disinvestment proceeds was permissible without prior approval of SBP.

In terms of corporate financing, branches of foreign banks in Pakistan, foreign controlled investment banks incorporated in Pakistan, and non-residents were allowed to invest in registered corporate debt issues, like TFCs etc. through public offerings and secondary market purchases. Other than liberalizing procedures for issue and transfer of securities, non-residents were also allowed to trade freely in the shares quoted on the stock exchanges in Pakistan. However, for that purpose, they were required to open a 'Special Convertible Rupee Account' (SCRA) with any authorized dealer (AD) in Pakistan, which could be fed by remittances from abroad and dividend payable to non-residents, whereas balances could be freely transferable abroad. In terms of royalty and technical fee, ceilings on these payments to non-residents were abolished. For domestic borrowings, rules intended for foreign controlled companies (for working capital and fixed investment) were streamlined. Further, private sector entrepreneurs were allowed to obtain long-term foreign currency loans from abroad subject to certain conditions.

Facilitating Forex Transactions
In this regard, the outward remittance facility available to publishers of newspapers and magazines, and for correspondence courses was extended. In addition, upper limit on remittance for membership of the educational, technical and professional organizations, and examination fee payable to foreign professional institutions was abolished. More importantly, restrictions on foreign exchange for education abroad were removed, procedures for the release of foreign exchange for living expenses/ renewal of exchange permits were relaxed, and facility of back-to-back remittances was allowed.[10] Besides, Pakistani nationals and resident companies/firms were licensed to work as money changers on payment of prescribed fee. These money changers were allowed to sell and purchase foreign currency notes and coins at their own exchange rates.

Promoting International Trade
On the export side, besides permitting exporters to retain the amount of commission (not exceeding 5 percent of FOB value of goods realized) in their special FCAs, they were allowed to use foreign currency balances for surrendering export proceeds to ADs. In addition, individual firms/organizations participating in international trade fairs/exhibitions were allowed to obtain foreign

[10] Back-to-back remittance facility permits ADs to issue TCs/MTs/TTs and drafts, without limit against surrender of equivalent amount in the shape of foreign currency notes.

exchange without prior approval. Moreover, upper ceiling on export of trade samples during a calendar year was raised. On the import side, the condition of obtaining import license from Chief Controller of Import & Export (CCI&E) was done away with. Importers, registered with EPB, were permitted to make imports up to US$10,000 (or equivalent in other currencies) without opening letters of credit or registering the indents/proforma invoices or orders with the ADs.

Liberalizing Forex Market

A milestone was achieved in July 1994, when the government accepted the obligations of Article VIII, sections 2, 3 and 4 of the IMF Articles of Agreement. Consequently, the Rupee was made convertible on current international transactions. Other major changes in exchange rate regime were introduced in February 1998 when ADs were permitted to determine their own exchange rates for currencies (other than US dollar) in terms of Rupee depending upon demand and supply position of the market. The exchange rate of US Dollar against Pak Rupee continued to be determined by SBP. However, the SBP's buying/selling spread for the US Dollar was widened from 0.5 percent to 1.0 percent of buying rate, and ADs were allowed to fix their own buying/selling rates for US Dollar within this band.

2.7.2 Measures Undertaken During May 1998 - December 2000

The economic sanctions by certain donor countries and multilateral institutions following nuclear detonation by Pakistan on 28th May 1998, created a state of uncertainty, especially regarding Pakistan's ability to meet its external obligations. In terms of inflows, remittances fell drastically, and foreign and programmed loans from IFIs dried up. On the other hand, constancy of claims on limited resources was bound to deplete the meager liquid foreign exchange reserves in a short time. The resulting balance of payments crisis was addressed by extensive controls on foreign exchange transactions.

Freeze of FCAs

In view of impending huge forex liability, withdrawal in hard currency from FCAs, certificates of investment issued by NBFIs and encashment of foreign currency instruments (FEBCs, FCBCs and DBCs) was suspended. However, these could be converted into Rupees at prevailing exchange rate.[11] In addition, exemptions on FCAs from tax and *zakat* deduction were withdrawn to encourage their conversion into the Rupees. Furthermore, holders of FCAs were also offered Special US Dollar Bonds against the foreign exchange in their accounts. These Bonds were later made more attractive by reducing the minimum maturity period from 5 to 3 years and raising the maximum rate of return from LIBOR +2 to LIBOR + 4 percent. In June 1998, a new FCA scheme was initiated, which had no surrender requirement for banks and no forward cover facility from SBP. However, in June 1999, banks/NBFIs were directed to keep these deposits within Pakistan only. At the same time, they were allowed to deposit such funds with the central bank.

Introduction Of Multiple Exchange Rate Regime

In the exchange rate regime, a new mechanism was introduced in July 1998, comprising of: a) official exchange rate, and b) floating inter-bank exchange rate (FIBR). While the official exchange rate was fixed by SBP, FIBR was determined in the inter-bank market. The composite of the two rates was applicable to all transactions, except for certain specified categories, which were subject to official exchange rate.[12] Subsequently, the share of FIBR in the composite exchange rate was gradually increased from 50 to 80 percent in December 1998, and further to 95 percent in March 1999. Finally, the market-based unified exchange rate system was adopted with effect from 19th May 1999, and FIBR became applicable to all foreign exchange transactions. In addition, the requirement on ADs to surrender all foreign exchange receipts to SBP was abolished. At the same time, forex demand for all

[11] Withdrawal of incremental deposits after July 1, 1998 was allowed in foreign exchange.
[12] The composite was initially defined as 50 percent official and 50 percent FIBR.

approved purposes was to be met from the inter-bank market. However, by the end of May 1999, an unofficial cap on the Rupee trading was imposed in the inter-bank market due to undesirable volatility. This cap remained effective for over one year, before its final removal on 21st July 2000 when the Rupee was put to a complete float, which was a major achievement in the area of exchange rate management.

Preventing Speculative Activity in Inter-bank Forex Market

In order to prevent speculative activities in the inter-bank market, ADs were prohibited from buying and selling foreign exchange from/to other ADs unless such purchase/sale was backed by permissible transactions with their customers. In addition, forward transactions of ADs with customers for tenure of less than one month were not permitted. ADs were further advised to ensure that Special Convertible Rupee Accounts (SCRAs) of non-residents are not used for speculation in respect of exchange rate of Rupee.

The operations of forex market were rationalized by replacing the system of Net Open Position with an aggregate foreign exposure limit for each bank. Furthermore, reporting system was strengthened and ADs were directed to report daily all forex transactions (ready, forward, take-ups, cancellation, adjusting entries etc.) creating exposure in any currency to the SBP. To ensure stability and transparency in the market operations, ADs were asked to revalue their books daily on mark-to-market basis.

Discouraging Capital Outflows

With a view to discourage capital outflows, some of the powers of ADs (relating to outward remittances) were withdrawn; the scope of back-to-back remittances was restricted and later this facility was withdrawn; and the release of foreign exchange by ADs for all travel purpose was prohibited. However, with improved economic conditions, most of these restrictions were relaxed.

Containing Import Demand

Besides doing away with the facility to import through contracts/purchase orders/proforma invoice/ indent etc., the minimum cash margin requirements were also used to contain imports. However, both of these restrictions were removed later with improvement in forex reserve position of the country.

Discouraging Overdue Export Bills

In order to eliminate incentives available to exporters for maintaining overdue export bills, it was decided that in case where an exporter does not repatriate export proceeds within three days of the due date or within 4 months of the shipment date, whichever is earlier, he shall be entitled to export proceeds at the rate of exchange prevailing on the due date or at the rate prevailing on the date of realization of export proceeds whichever is lower.

2.8 Capital Market Reforms

Capital market reforms were an integral part of overall financial sector liberalization program. The objective was to enable equity market to channel investment funds to the most productive uses. This was to be achieved through creating a favorable policy environment that instills competition and level playing field for investors, and by broadening the market base. The emphasis was also given on the strengthening of governance, institutions, regulation, and supervision. Furthermore, several steps were taken for the improvement and modernization of market infrastructure. Another target area of these reforms was the corporate debt market, which envisaged promotion of Term Finance Certificates (TFCs).

2.8.1 Privatization of State-owned Enterprises

The government policy to sell its share in large state-owned enterprises (SOEs) through stock exchanges was of great significance in development of the equity market. Increased supply of

securities such as the Pakistan Telecommunication Corporation (PTC) and the Muslim Commercial Bank (MCB), and the large issue of a power project, namely the Hub Power Company (HUBCO), which has been actively traded, had considerably increased the market depth.

2.8.2 Opening of Capital Market to Foreigners

Exchange and payment reforms (see **Section 2.7.1**) proved to be of great significance in the development of capital market. Through these reforms, foreigners and oversees Pakistanis were allowed to make investments without prior approval except in few specified industries. This resulted in large inflows of foreign funds. Furthermore, the permission to retain 100 percent equity by foreign investors in a company with no obligation to go public helped improve their confidence in Pakistani markets. Other important steps in this regard were: the permission to bring in any amount of foreign currency and to take it out freely; treatment of foreign private investment with regard to taxes on income, at par with those applicable to similar investment made by citizens of Pakistan; and relief from double taxation in cases of those countries with which Pakistan had treaties for avoidance of double taxation.

2.8.3 Creation of SECP

One of the items in reform agenda was the creation of an autonomous body that would replace Corporate Law Authority. This step was aimed at establishing a professional agency that would improve the regulation and supervision of securities market. Hence, in December 1997, Securities and Exchange Commission of Pakistan (SECP) replaced Corporate Law Authority through Act No. XLII of 1997. After its establishment, SECP played a proactive role in streamlining activities of capital market and protecting the interest of retail investors.

An important step taken by CLA was the easing of restrictions on pricing of new issues. More specifically, CLA repealed the Capital Issues (Continuance of Control) Act, 1947 and consequently abolished controls on pricing of new issues; and introduced the "Companies (Issue of Capital) Rules, 1996" via a notification on 8th February 1996, to encourage promoters' contribution, broaden public participation, and prevent premature projects from going to the public. This had a positive impact on initial public offering, subscriptions and private placements.

Another noteworthy step was the creation of the Central Depository Company of Pakistan Limited (CDC) in 1993 to facilitate electronic transfer of stocks. The CDC commenced its operations in September 1997. This depository company was established by stock exchanges in collaboration with the IFC, Citibank, leading commercial banks and DFIs. This greatly encouraged market activity and streamlined the settlement process.

The incorporation of the Pakistan Credit Rating Agency Limited (PACRA) and the DCR-VIS Credit Rating Co. Ltd considerably enhanced the market transparency.[13] Furthermore, automation of all three stock exchanges and their revised rules and regulations also helped in improving investors' confidence and led to increased trading activity.

2.8.4 Other Measures

The rationalization of interest rates in late 1990s facilitated the capital market growth. In addition, the ban on institutional investment in National Savings Schemes (NSS) in FY00, and launching of Pakistan Investment Bond (PIB) has created a huge potential for the development of corporate debt market. Tax incentives like exemption of income tax on bonus shares, abolition of wealth tax and capital gains tax exemption on conversion of individual membership into corporate membership of exchanges, helped in reshaping capital market structure in Pakistan.

[13] PACRA was established as a joint venture between IFC, IBCA limited of England, and Lahore stock Exchange. DCR-VIS Credit rating Co. Limited was established in association with Duff and Phelps Credit rating Co.

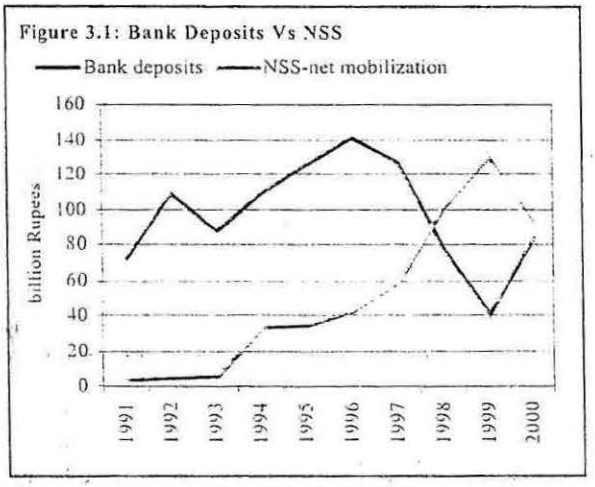
3 Performance of Commercial Banks during 1990s

The health of banking sector is discussed in this chapter under CAMELS framework, which involves the analysis of following six groups of indicators: (1) capital adequacy, (2) asset quality, (3) management soundness, (4) earnings and profitability, (5) liquidity, and (6) sensitivity to market risk (for details see **Annex 3.1**). For the purpose of analysis, banks are divided in three groups, namely: state-owned banks, private banks and foreign banks. After analyzing these groups separately, banking sector as a whole is discussed at the end of the chapter. List of all banks under review in their respective groups is given in **Annex 1.1**.[1] Glossary of important terms used in the chapter is given in **Annex 3.2**.

3.1 Overview

During 1990s, total assets of commercial banks grew at a compound annual growth rate of 14.4 percent, from Rs 426 billion at the beginning of decade to Rs 1,641 billion by the end of 2000 (see **Annex 3.3**). However, the growth trend indicated a structural break at the end of 1997. Specifically, annual average growth in the first period, up to 1997, was in double digit at 17.8 percent and decelerated to 7.0 percent in the last three years. Higher growth in the first phase was spurred by the entrance of new banks in the private sector and permission for residents to open foreign currency accounts. Whereas the deceleration in the second phase was largely brought about by the overall slowdown in macroeconomic growth; increased returns on NSS instruments; painful phase of golden handshake and branch closure program; crisis of confidence triggered by the freezing of FCAs following nuclear detonation; and the accountability drive of late 1999 that further tightened the credit expansion with slackening demand. However, with the inception of wide ranging banking reforms and rationalization of interest rate structure towards the end of the decade, pace of dis-intermediation had largely been arrested, as reflected in only 0.6 percentage point erosion of deposits in terms of GDP in 2000 compared with 2.6 percentage point observed a year earlier (see **Table 3.1**).

Amongst different groups, assets of private banks showed fastest growth during 1990s, followed by foreign banks. Assets of foreign banks experienced a significant drop in 1998 and 1999 following the freeze of FCAs in May 1998. However, during 2000, these banks managed to build their assets by 2.7 percent. Asset composition showed that advances remained the largest single item (around 45 percent on average) in total assets of commercial banks during1990s. Although its share in total assets remained stable, growth of advances declined for all three groups during second half of decade. This is understandable due to declining deposit mobilization by banks. In addition, huge infected loan portfolio was the major predicament for banks, particularly state-owned banks. These bad loans not only severely damaged the profitability and capital base of this group but also constrained the growth of net advances. Loans and advances are followed by investment, having an average share of 29.2 percent in total assets; however, its share (average) declined in the last three years of 1990s to 25.4 percent from 30.6 percent during 1990-97. This was primarily because of a drop in



[1] Banks closed during 1990s are not included in the analysis.

investment during 1999 by all groups and very nominal increase in 2000 (see **Annex 3.3**), at the back of decrease in yield on government securities.[2]

Table 3.1: Assets and Liabilities of Banking Sector During 1990s

percent

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Share in total assets											
State-owned banks											
Advances	51.3	45.9	41.6	46.1	42.7	44.7	44.4	42.3	40.3	43.2	46.9
Investment	26.5	28.6	34.3	30.8	33.3	31.6	29.9	29.6	30.6	25.6	22.9
Others assets	22.2	25.5	24.1	23.1	24.0	23.7	25.7	28.1	29.1	31.2	30.2
Private banks											
Advances			35.2	35.1	40.6	46.5	44.8	47.3	47.1	48.4	54.0
Investment			41.4	34.4	30.0	22.4	24.5	35.2	32.3	23.7	21.6
Others assets			23.4	30.4	29.4	31.0	30.6	17.5	20.6	27.9	24.3
Foreign banks											
Advances	52.0	41.6	41.8	37.7	40.6	46.0	42.0	44.7	45.8	49.5	51.6
Investment	21.8	32.0	35.9	37.3	33.6	25.7	31.2	29.1	26.8	12.9	20.5
Others assets	26.3	26.4	22.2	25.1	25.8	28.2	26.9	26.2	27.3	37.6	27.8
All banks											
Advances	51.3	45.4	41.4	44.3	42.3	45.0	44.0	43.4	42.1	44.8	48.7
Investment	26.2	29.0	34.8	31.9	33.1	30.0	29.6	30.1	30.3	23.3	22.3
Others assets	22.5	25.6	23.9	23.8	24.6	25.0	26.4	26.5	27.8	31.9	29.0
Share in total liabilities											
State-owned banks											
Deposits	87.4	88.0	87.8	88.0	87.6	88.3	88.2	86.2	87.5	86.4	87.8
Borrowing	6.0	4.9	5.1	4.8	5.4	5.2	5.0	5.3	5.2	6.5	5.0
Others	6.6	7.1	7.1	7.2	7.0	6.5	6.8	8.5	7.4	7.1	7.2
Private banks											
Deposits			72.5	72.3	75.1	75.4	78.3	83.3	82.3	77.5	77.3
Borrowing			15.5	13.7	13.8	12.2	10.7	12.0	14.6	18.8	19.0
Others			12.0	14.0	11.2	12.4	10.9	4.6	3.1	3.7	3.7
Foreign banks											
Deposits	80.7	84.7	84.6	85.3	86.9	87.8	90.0	89.4	88.7	80.3	79.6
Borrowing	10.5	8.2	9.4	8.4	7.5	6.6	5.8	5.7	7.3	15.7	16.0
Others	8.8	7.0	6.1	6.3	5.6	5.6	4.2	4.9	4.0	4.0	4.4
All banks											
Deposits	86.9	87.6	86.9	86.8	86.7	87.2	87.6	86.5	87.1	84.4	85.1
Borrowing	6.3	5.3	6.0	5.7	6.2	5.9	5.6	6.1	6.6	9.3	8.5
Others	6.8	7.1	7.2	7.4	7.1	6.9	6.7	7.4	6.3	6.3	6.3
As percent of GDP											
Assets	49.7	49.6	53.1	56.0	56.1	54.6	55.8	54.5	54.5	52.6	51.5
Deposits	41.4	41.7	44.1	46.4	46.5	45.5	47.0	45.7	44.8	42.2	41.6

On the liability side, deposits have remained the single largest source (almost 87 percent) of funds of the banking industry in Pakistan. Being prime support for the banks, fluctuations in deposits had direct bearing upon the constitution of asset portfolio and, thereby on profitability of the banks. Although its share in total liabilities remained stable over the period under review except for the slight fall in last two years, growth of deposits declined significantly after 1996. Besides all the factors discussed above, an important reason for this slow growth in banks' deposits was the diversion towards NSS instruments, with the increasing returns on these schemes from 1996 (see **Figure 3.1**). Downward revisions in yields on NSS in 1999 and ban on institutional investment in March 2000, helped banks in increasing their deposit base towards the end of the decade (for details see **Section 4.2**).

[2] Investment in government securities remained more then 80 percent of total investment during 1990s.

In group-wise analysis, both private and foreign banks were taking the lead in growth of deposit base till freeze of foreign currency accounts in May 1998. This apparent higher growth in private banks' deposits was primarily due to their eagerness to expand their low deposit base by offering relatively higher return. High growth in deposits of foreign banks was explainable given their reliance on Foreign Currency Accounts (FCAs). Compound average growth in the deposits of state-owned banks was significantly lower than the other two groups till 1997; however, comparatively higher growth recorded during next two years was mainly attributed to lottery schemes introduced by few banks in this group to capture the Rupee withdrawals from frozen FCAs. With the exception of these two years, performance of foreign and domestic banks was relatively better on this account.

Borrowing has remained a supplementary source of funding for the banking industry in Pakistan. Its share in total liabilities of the banking system increased during the period under study, especially after 1997, which added to financial cost of banks and, thereby affected the profitability in this period.[3]

3.2 State-owned Banks[4]

Being the largest group, performance of state-owned banks significantly affects overall indicators of the banking industry. However, its relative size declined continuously during the last decade, mainly due to the entry of new banks, especially domestic banks in the private sector after 1992. Moreover, if two privatized banks were excluded from this category, the share of state-owned banks declined even further (see **Table 3.2**). With growing competition from private sector, the state-owned banks were finding it difficult to maintain their market shares in terms of assets, deposits, advances and investment. In addition, political intervention, over-staffing, over-branching and inefficiencies in this group had led to the problems of large non-performing loans, high administrative expenses, huge losses and eroding capital base. Some of these inadequacies for the two large banks were addressed through capital injections and institutional restructuring measures (see **Chapter 2**).

Table 3.2: Share of State-owned Banks in Banking Sector

Percent

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2000[adj]
Assets	92.2	89.1	83.7	80.1	78.4	76.7	72.3	68.7	70.5	71.8	70.6	54.0
Advances	92.1	90.0	84.1	83.4	79.3	76.1	73.0	67.0	67.6	69.2	68.1	50.2
Investment	93.5	87.9	82.6	77.2	78.8	80.9	73.0	67.4	71.7	78.9	72.3	54.8
Deposits	93.0	89.8	85.4	82.1	80.2	78.8	74.1	69.9	71.7	74.6	73.7	56.2
Capital	85.4	80.4	65.5	60.6	57.8	52.6	41.7	20.8*	56.6	50.6	55.6	47.1
NPLs	95.0	95.8	92.6	94.4	95.8	94.1	92.5	91.7	90.9	88.9	88.1	72.1

*: This low ratio is due to the intensity of capital erosion in 1997 due to Rs 35 billion loss shown by two large banks.
adj: Excluding two privatized banks (MCB and ABL).

3.2.1 Capital Adequacy

Capital adequacy focuses on the total amount of bank capital, which is vital in reducing the risk of insolvency and potential cost of bank's failure. In other words, this determines the robustness of financial institutions against shocks to their balance sheets. Although it is useful to track capital adequacy ratios that take into account major financial risks (like credit risk,

Table 3.3: Capital Adequacy Indicators

percent

	1997	1998	1999	2000
Capital to risk-weighted assets	0.6	10.8	10.0	9.5
No. of banks below 8 percent CRWA	4	0	1	1

[3] It is important to note that higher share of borrowing after 1997 was primarily due to private and foreign banks, as these two groups took the main toll of the freeze of FCAs.

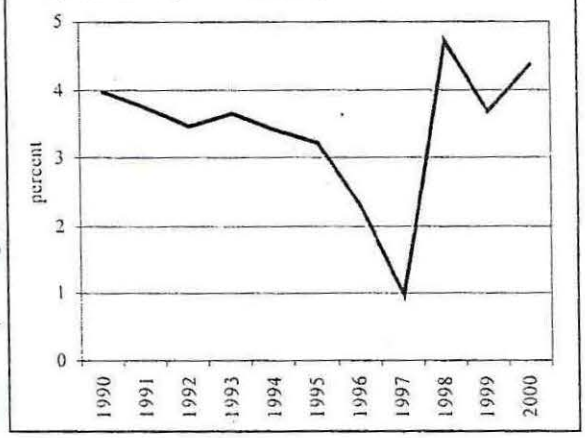
[4] Banks having government's equity greater then zero are included in this category. This includes Nationalized Commercial Bank (NCBs) i.e., NBP, HBL, UBL and FWBL; denationalized commercial banks including MCB and ABL; and two provincial banks namely Bank of Punjab and Bank of Khyber.

foreign exchange risk, interest rate risk, and risks involved in off-balance sheet operations), due to data limitation we have used two basic indicators for capital adequacy: (1) capital to risk-weighted assets (CRWA) ratio; and (2) capital to liabilities (CL) ratio.

In CRWA, which is the most commonly used indicator of capital adequacy, assets are calculated on the basis of risk weights determined under Basel Accord for each balance sheet item. This ratio is available since 1997 only, when SBP introduced the risk-based system for capital adequacy consistent with the BASEL Committee requirements.[5] As shown in **Table 3.3**, CRWA ratio was only 0.6 percent in 1997, considerably lower than the 8 percent benchmark set by the BASEL Committee and indicated severe solvency problem in that year. Although four out of eight banks in this group were below the criterion, the prime reason for this low ratio was huge losses suffered by two major banks of the group. As a result, in 1998 both the banks required capital support of Rs 30.7 billion from SBP, in addition to revaluation of fixed assets by Rs 13.9 billion, thereby raising the CRWA to 10.8 percent. Unfortunately, growing non-performing loans continued to erode the capital base of one of these banks during the 1999, thus leading to a gradual decline in this ratio. SBP had to again provide capital support of Rs 8 billion to that bank during 2000.

Another measure of capital adequacy is the bank's capital to its liability ratio that shows the extent to which capital and reserves of a bank provide coverage to liabilities (primarily to depositors). Although there is no benchmark, a high CL ratio signals strong position of a bank. As evident from **Figure 3.2**, CL ratio was declining from the very beginning of the decade, indicating erosion of capital base. However, the crunch came in 1996 and became more severe in 1997, when CL ratio reached its lowest point. All the four Nationalized Commercial Banks (NCBs) suffered losses in 1996 (Rs 5.0 billion), while huge losses by two of these banks in 1997 were responsible for this sharp decline. Capital injection and revaluation of fixed assets in the next year explain the subsequent recovery in 1998. However, SBP again supported one of NCBs through capital injection in 2000 that posted a loss in 1999. This resulted in the improvement in CL ratio in that year (see **Figure 3.2**).

Figure 3.2: Capital to Liability Ratio



It is important to note that the increase in capital along with profit earned (see **Section 3.2.4**) could not prevent CRWA from declining in 2000 (see **Table 3.3**). This may be due to rising share of riskier assets in their portfolio.[6] In overall terms, the frequent support from SBP to two large banks was one of the main factors that helped in arresting the erosion of capital of these banks and set it in the right direction only at the end of 1990s.

3.2.2 Asset Quality

The solvency risk of a financial institution often originates from the quality of its asset portfolio. Therefore, it is important to examine the asset quality by using indicators, such as earning assets to

[5] BPRD Circular No. 36, dated 4th November 1997.

[6] In 2000, as shown in Table 3.1, share of advances (riskier asset) increased to 46.9 percent of total assets against 43.2 percent a year earlier. This was possible mainly due to subsequent decline in the share of investment (mainly in government securities).

total assets, NPLs to advances, loan defaults to advances, and recovery to default ratios (see **Table 3.4**).

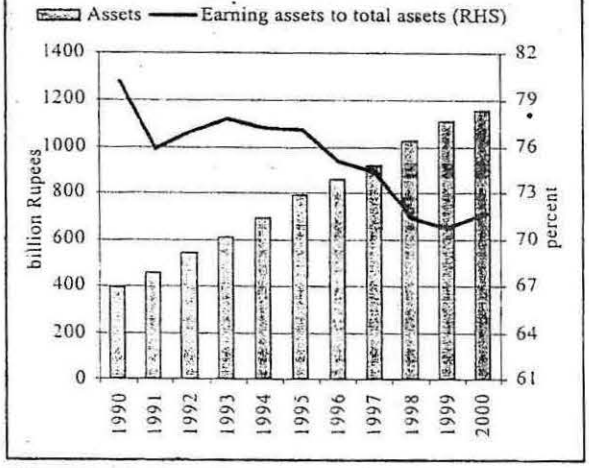
Table 3.4: Asset Quality Indicators

percent

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Earning assets to total assets	80.2	75.8	77.0	77.8	77.2	77.0	75.0	73.4	71.3	70.6	71.6
NPLs to gross advances	18.0	19.9	18.6	22.1	25.6	23.3	23.5	26.5	25.4	27.7	24.4
Loan defaults to gross advances	10.7	10.8	11.4	11.2	12.8	12.2	13.2	21.9	18.9	16.0	14.8
Provisioning to gross advances	6.6	7.4	9.3	8.1	8.0	7.6	9.0	14.1	13.7	12.7	13.2
Cash recoveries to total default	12.0	6.8	6.5	5.3	8.2	8.6	9.1	9.5	6.3	8.0	8.4

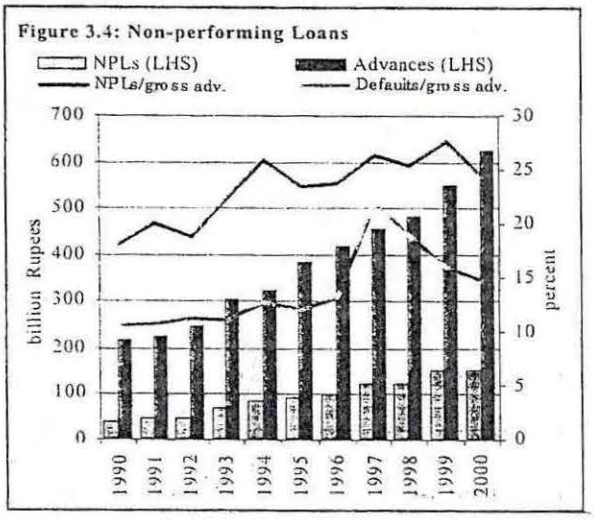
More specifically, a larger share of earning assets would lead to higher profitability at given level of expenses.[7] As shown in **Figure 3.3**, earning assets to total assets ratio has been declining continuously during 1990s except for the last year.[8] Advance tax payment to CBR, accounted in other assets, was one of the important factors behind larger increase in non-earning assets.[9] In 2000, this ratio showed some improvement due to relatively larger increase in advances that was partly offset by Rs 18.9 billion decline in investment. Had the investment not declined, this ratio would have been much higher.

Figure 3.3: Earning Assets to Total Assets Ratio



Another indicator of asset quality is the ratio of non-performing loans to total loans (gross). An increasing trend in this ratio signals deterioration in the quality of asset portfolio and, consequently, in financial institutions' cash flows, net income, and solvency.[10] State-owned banks had the largest share in total non-performing loans of the banking sector, which was much greater than their share in assets or deposits (see **Table 3.2**). Although this share declined in later part of 1990s, this was more due to increase in NPLs of private banks rather than any improvement in state-owned banks (see **Section 3.3.2**).

Figure 3.4: Non-performing Loans



As shown in **Figure 3.4**, the ratio of non-performing loans to gross advances increased from less than 17 percent in 1990, to 27.7 percent in 1999. This was due to substantial

[7] The earning assets are defined as the sum of net advances, net investment and money at call.
[8] The assets are net of provision.
[9] Cash and bank balances, operating fixed assets, income receivables and other assets are taken as non-earning assets.
[10] Adequate loan classifications are essential to have meaningful ratio of non-performing loans to total advances. The ratio may lose its importance if banks tend to reschedule their loans that otherwise should become non-performing -- a practice also described as 'ever greening'.

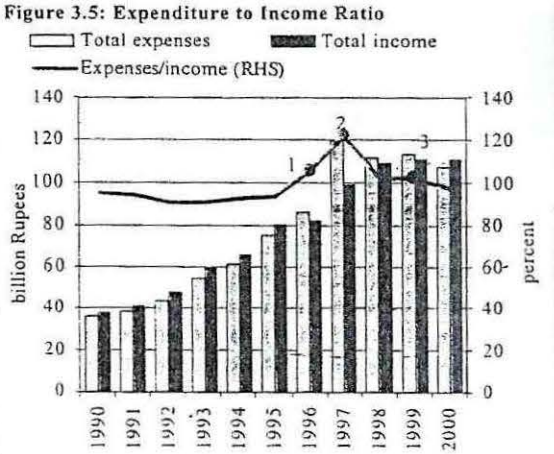
loans provided by NCBs on political grounds, especially during the early and mid 1990s that resulted in NPLs after a time lag. Furthermore, banks were reluctant in writing off the 'historically' bad loans mainly because of: (1) poor quality of underlying collateral, and (2) to avoid any possible legal complication due to lacunas in the respective judicial framework. This also contributed in pilling up of bad loans in the asset portfolio of these banks. In addition, strict disclosure requirement put in place by SBP in 1997, forced banks to disclose the true classification of their loans, hitherto undeclared as NPLs. This disclosure resulted in a substantial rise in NPLs. However, a larger increase in advances and almost stagnant value of NPLs at 1999 level, led to a fall in this ratio during 2000.[11] Nevertheless, the volume of NPLs severely constrained the earning capacity of these banks as depicted by declining share of earning assets in total assets (see **Figure 3.3**). Cash recoveries to defaults ratio, however, witnessed some signs of improvement, mainly attributed to steps taken with regard to internal restructuring of these banks to strengthen their loan recovery mechanism, and accountability and recovery drive initiated in October 1999 (see **Table 3.4**).

3.2.3. Management Soundness

A sound management is one of the most important pre-requisites for the strength and growth of any financial institution. Since indicators of management quality are primarily specific to individual institution, these cannot be easily aggregated across the sectors. In addition, it is difficult to draw any conclusion regarding management soundness on the basis of monetary indicators, as characteristics of a good management are rather qualitative in nature. Nevertheless, total expenses to total income, operating expense to total expenses, earnings and operating expense per employee, and interest rate spread are generally used to gauge management soundness.

In particular, a high and increasing expenses to income (EI) ratio indicates the operating inefficiency that could be due to flaws in management. As shown in **Table 3.5**, EI ratio for state-owned banks, which was already very high, increased further from 95.7 percent in 1990 to 96.8 percent in 2000. However, during 1996-99 this exceeded 100 percent mark, primarily due to the provisioning against NPLs (see **Figure 3.5**). It is important to note that 1997 was the only year when operating expenses were greater than interest expenditures, mainly because of, Rs 26.5 billion increase in provisioning against NPLs and, to some extent, Golden Hand Shake (GHS) schemes offered by three major nationalized banks.[12]

Figure 3.5: Expenditure to Income Ratio



1.Interest income ↓by Rs 2.2 bln due to ↑in NPLs by Rs 9.8 bln and provisioning (expense) ↑by Rs 8.3 bln.
2.Operating expenses ↑due to ↑in provisioning (Rs 26.5 bln) and GHS.
3. Provisioning ↑ by Rs 20.6 bln.

Interest rate spread could also be used as an important indictor of management efficiency, when seen in relation to profitability of the banks. This is because higher spread may be caused either by higher operating cost reflecting management inefficiencies, or by banks' desire to earn more profit. It is important to note that this interest rate spread is not the simple difference between weighted average lending and deposit rates, rather it reflects the difference between effective returns on earning assets and interest expense on interest paying liabilities (see Annex 3.2). This indicator covers all the

[11] Although quality of these advances could be judged only after couple of years, falling CRWA in this year may indicate riskiness of these assets.

[12] The trend shows major provisioning in 1996 and 1997, though NPLs were rising in earlier years as well.

interest earnings and interest paying activities of banks, whereas the spread between weighted average lending and deposit rates ignores the interest earned on investment and interest cost of borrowing, etc. Interest rate spread, therefore, is a better indicator than the spread between weighted average lending and deposits rates.

Table 3.5: Management Soundness Indicators

Percent

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Total expenses to total income	95.7	94.2	91.2	90.9	92.8	94.0	105.7	122.0	101.7	101.8	96.8
Operating expenses to total expenses	39.1	38.5	39.5	40.0	39.4	39.6	36.6	51.3	38.5	41.7	42.9
Earnings per employee (million Rs)	0.4	0.4	0.5	0.6	0.7	0.8	0.8	1.2	1.4	1.4	1.5
Interest rate spread	3.9	4.2	4.2	4.6	4.4	5.0	3.4	5.0	5.3	5.6	5.5
Operating expense per employee (million Rs)	0.15	0.15	0.18	0.22	0.24	0.29	0.30	0.67	0.54	0.61	0.63

It was expected that entrance of new banks in the private sector would increase competition for state-owned and foreign banks, thereby compelling them to improve efficiency. However, the rising trend in this spread with low and further deteriorating profitability indicated the growing inefficiencies of state-owned banks, which could also be retraced to higher operating expenses to total expenditure ratios. As discussed earlier, significantly large proportion of non-performing loans and provisioning thereon (required by SBP as a part of reform process) affected the earning profile of these banks negatively, and resulted in higher banking spread during second half of 1990s.[13] More importantly, sizeable deduction of advance tax from the banking industry was another factor behind rising interest rate spread, as these advance taxes were non-earning assets and treated as expense in income statements.

3.2.4 Earnings and Profitability

Strong earnings and profitability profile of a bank reflects its ability to support present and future operations. More specifically, this determines the capacity to absorb losses by building an adequate capital base, finance its expansion and pay adequate dividends to its shareholders. Although there are various measures of earnings and profitability, the best and widely used indicator is Return on Assets (ROA), which is supplemented by Return on Equity (ROE) and Net Interest Margin (NIM).[14]

As shown in **Table 3.6**, the profitability of state-owned banks deteriorated, especially after mid 1990s. This was the upshot of falling share of earning assets, mounting burden of NPLs coupled with increased provisioning requirements and, to some extent, cut in rates on government securities. On the expenditure side, the rising share of borrowing in total liabilities (partly due to slow growth in deposits), caused expenses to rise faster than income and, hence, reduced the profitability.

Table 3.6: Earnings and Profitability Indicators

Percent

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Net profit to asset ratio	0.4	0.5	0.5	0.7	0.2	0.2	-0.3	-2.3	0.5	-0.7	0.1
Net profit to equity ratio	10.5	13.4	15.3	19.2	7.5	5.9	-14.8	-243.9	11.5	-19.8	2.8
Net interest margin	3.2	3.2	3.3	3.7	3.4	3.9	1.9	3.2	3.5	3.8	4.1
Total income to total assets	9.6	9.1	8.9	10.0	9.6	10.2	9.6	10.7	10.6	10.0	9.5

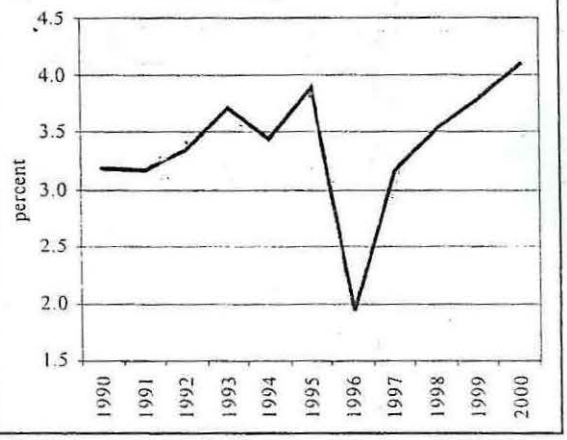
[13] It is important to note that NPLs not only constrain the earning opportunities of banks, but provisioning against these also increase the operating expenses, thereby compelling them to maintain profitability by increasing the spread.

[14] NIM is the net interest yield on net earning assets. It is calculated as the difference between net earning asset yield (total interest income / net earning assets) and break-even yield (total interest expenses / net earning assets).

In addition, banking has remained a heavily taxed industry in Pakistan and high tax deduction also contributed towards low after-tax profit. More distressing thing for state-owned banks has been the problem of advance taxes. Since banks had to pay 30 percent withholding tax on T-bills and 10 percent on FIBs, a significant increase in the volume of their transactions during 1990s created a serious advance tax burden for banks.[15] It is important to note that advance tax is a common practice in many countries, however the fact that CBR is currently assessing the actual tax liabilities of mid 1990s for these banks, shows the intensity of this problem. .

In terms of net interest margin, the ratio over the period increased gradually from 3.2 percent in 1990 to 4.1 percent in 2000, except 1996 (see **Figure 3.6**). The higher provisioning in this year led to a fall in interest income, which in turn, brought about a sharp drop in NIM to 1.9 percent in 1996 from 3.2 percent a year earlier.

Figure 3.6: Net Interest Margin



The return on equity reflects the yield on holding bank's capital. Since a higher ratio may indicate more profitability as well as low capitalization, this needs to be interpreted with caution, preferably in combination with the capital adequacy ratio. Similarly, a higher return on assets ratio indicates that banks are earning more on their assets, thus giving way to increase in profitability. In terms of state-owned banks, both ratios have remained low throughout the last decade. More specifically, in 1996 these ratios had turned negative due to provisioning (see **Figure 3.7** and **3.8**). However, stable trend of total income to total assets indicated that expenses increased disproportionately.

Figure 3.7: Return on Equity

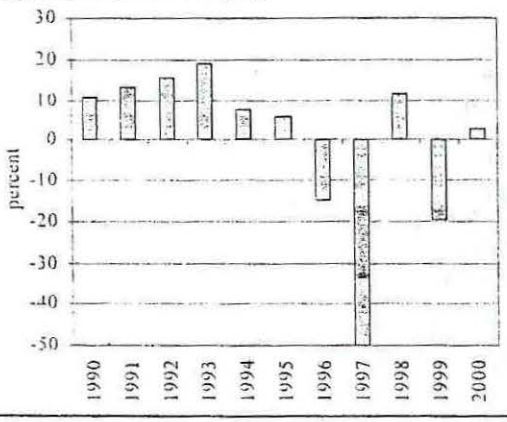
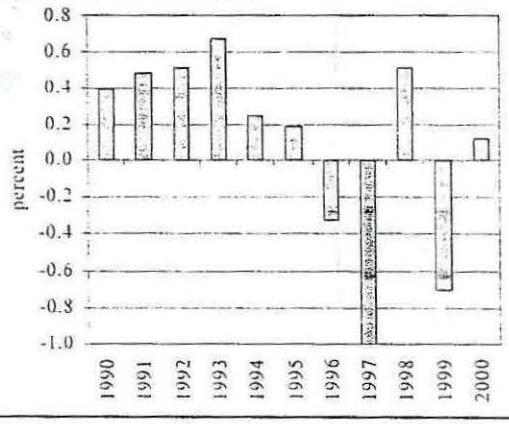


Figure 3.8: Return on Assets



3.2.5 Liquidity and Sensitivity to Market Risk

In terms of liquidity position, a falling liquid assets ratio or a rising loans to deposits ratio indicates problems for banks. As shown in **Table 3.7**, these two ratios seem to indicate some signs of difficulty for these banks after 1998 (see **Figure 3.9**). However, signs of stress should be interpreted with

[15] For foreign banks withholding tax on T-bills was 50 percent till June 1998, however, the actual tax paid by these banks was closed to their true tax liabilities. Private banks also did not face this problem.

caution, as this was consciously brought about by the monetary policy changes by SBP. In FY99, both the cash reserve requirement (CRR) and the statuary liquidity requirement (SLR) were reduced to tackle the increased withdrawals of deposits due to freezing of FCAs. These steps were reinforced by decline in SBP's discount and T-bill yields during FY00.

Table 3.7: Liquidity and Sensitivity Indicators

Percent

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Liquid assets to total assets	32.2	40.5	44.8	41.8	46.1	43.9	42.6	39.8	40.1	38.3	34.3
Loans to deposits	61.0	54.1	49.0	54.3	50.5	52.2	51.4	49.6	48.2	51.8	55.8
Gap (billion Rs)	-37.6	-62.1	-68.9	-70.6	-88.3	-106.6	-137.9	-158.2	-176.9	-218.3	-199.9
RSA/RSL	89.3	84.6	85.7	86.9	85.8	85.1	82.3	81.0	80.6	78.8	80.6

Note: GAP = RSA – RSL ; RSA = Rate sensitive assets ; RSL = Rate sensitive liabilities

In addition to liquidity problems, banks faced other risks as well. For example, a large investment in volatile assets would make banks more vulnerable to fluctuations in the prices of those assets. Similarly, a concentration of advances in a few sectors would increase default risks if these sectors do not perform well. Furthermore, interest rate and foreign exchange risk tend to have significant impact on financial institutions' assets and liabilities. However, due to data limitations, we have focused only on interest rate risks, i.e., the gap between rate sensitive assets (RSA) and rate sensitive liabilities (RSL) and their ratio.

In this regard, a higher RSL than RSA indicates that banks are risk sensitive to changes in interest rates; an increase in interest rate may affect them negatively, and vice versa (see **Table 3.7**). Looking at state-owned banks, the growing gap (or declining ratio) during 1990-98 shows their exposure to rising interest rates (see **Figure 3.10**). Although the gap was reduced during the last two years of 1990s, this was due to higher growth in rate sensitive assets, primarily in advances, and relatively slower growth in deposits (the largest component of RSL).

Figure 3.9: Liquidity Indicators

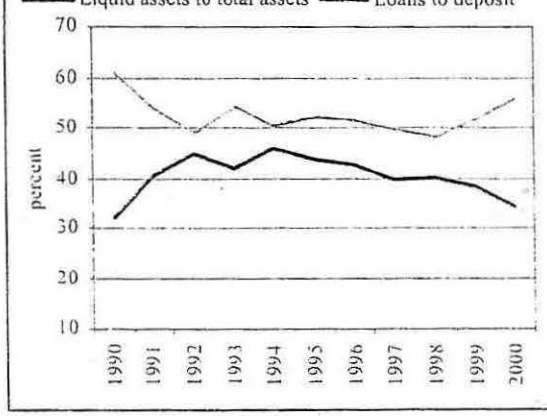
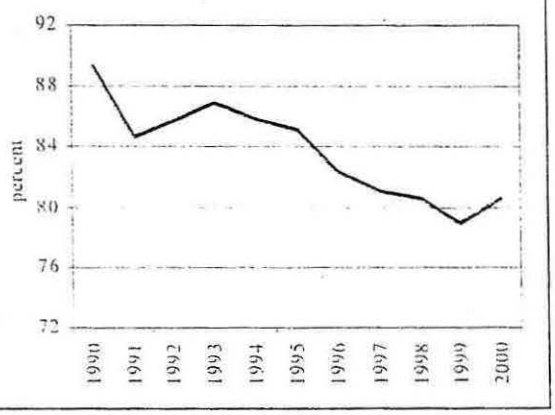


Figure 3.10: RSA/RSL



3.2 Private Banks

One of the objectives of banking reforms was to improve efficiency of the banking sector by instilling competition among banks. Accordingly, in August 1991, permission for opening of ten new banks was granted, of which eight started functioning. Subsequently, one more bank in FY94 and three in FY95 were established, thus raising the number of banks in the private sector to twelve. Afterward, Mehran bank was merged with NBP in February 1995. As shown in **Table 3.8**, these banks have firmly established their niche in the banking industry.

Table 3.8: Share of Private Banks in Banking Sector

percent

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Assets	3.8	5.2	6.3	8.5	9.7	11.3	11.4	11.9	13.6
Advances	3.2	4.2	6.1	8.8	9.9	12.3	12.8	12.8	15.1
Investment	4.6	5.6	5.7	6.3	8.0	13.2	12.2	12.2	13.2
Deposits	3.0	4.1	5.2	6.9	8.2	10.3	10.6	10.6	12.2
Capital	10.0	10.5	12.4	18.4	22.0*	28.3 *	14.8	17.8	16.5
NPLs	3.5	2.1	2.0	2.5	2.9	3.6	4.2	7.2	7.8

*: These high value of this ratio is due to capital erosion of state-owned banks

3.3.1 Capital Adequacy

Although the capital to risk-weighted assets ratio for private banks has remained well above the required level of 8 percent (see **Table 3.9**), this has been persistently declining during last three years of 1990s. However, this has to be seen in the context of post-detonation scenario, where a monetary ease resulted in a fall in yield of government securities, and hence banks' investment therein. Disinvestments of government securities (being zero-risk weighted asset) coupled with higher provisioning against NPLs and aggressive lending practices of these banks to expand their share in the banking industry, led to a fall in this ratio.[16]

Table 3.9: Capital Adequacy Indicators

percent

	1997	1998	1999	2000
Capital to risk-weighted assets	15.5	14.7	13.2	11.1
No. of banks below 8 % CRWA	0	0	0	2

Similarly, capital to liability ratio also showed downward trend during 1990s (see **Figure 3.11**).[17] However, compared to state-owned banks, private banks still enjoy stronger position (see **Section 3.2.1**).

Figure 3.11: Capital to Liability Ratio

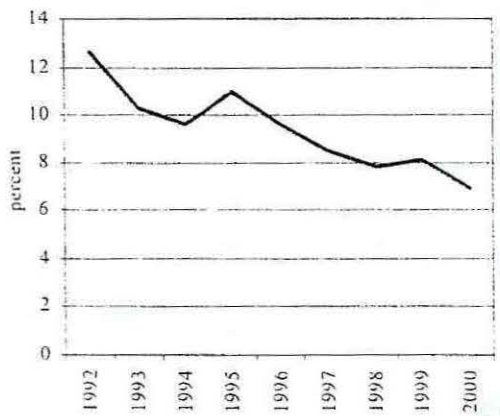
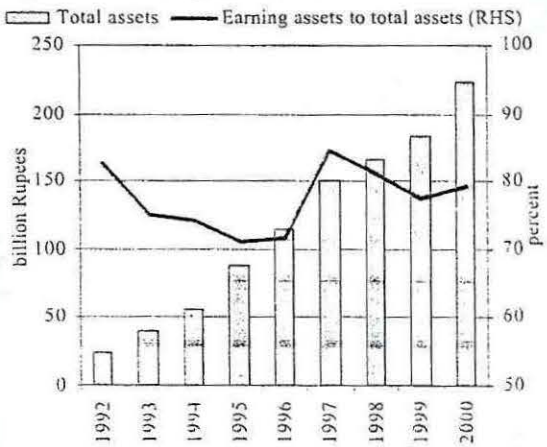


Figure 3.12: Earning Assets to Total Assets Ratio



3.3.2 Asset Quality

It might be misleading to rely on asset quality indicators of private banks till mid 1990s. Erratic trends therein are mainly due to opening of new banks. Earning assets to total assets ratio was continuously declining till 1995 (see **Figure 3.12**). However, the improvement during 1997 reflects a

[16] Higher provisioning negatively affects the capital base through profit and loss account, while higher growth in advances may increase the weight of risky assets in assets portfolio. Both lead to decline in CRWA ratio.

[17] The increase in 1995 was due to entry of three new banks in the industry.

sudden shift in asset composition. More specifically, better returns on government securities attracted large investment despite a fall in SLR from 25 to 20 percent in May 1997. As a result, share of investment in total assets jumped from less than 25 percent in 1996 to 35 percent in 1997.[18] However, the EI ratio again started declining after 1997 (see **Table 3.10**).

Table 3.10: Asset Quality Indicators

percent

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Earning assets to total assets	82.8	75.1	74.2	71.0	71.7	84.5	81.1	77.5	79.2
NPLs to gross advances	-	-	7.6	5.9	5.9	6.3	6.8	13.5	10.7
Loan defaults to gross advances	0.0	11.2	6.6	4.4	4.2	5.5	6.1	10.4	8.3
Cash recoveries to total default	-	-	14.0	13.5	19.4	8.1	3.4	3.5	8.4

The ratio of NPLs to gross advances remained below 10 percent except in the last two years of 1990s (see **Figure 3.13**). As mentioned earlier, the sharp increase after 1998 was on account of aggressive lending undertaken by these banks. In terms of loan defaults to gross advances, the ratio has moved upward with the development of their loan books after inception of their operations in early 1990s. This ratio seemed to be settling around 8 percent at the end of the decade, which was much lower than that of state-owned banks.

3.3.3 Management Soundness

Selected indicators of management soundness represent mixed trend over time (see **Table 3.11**). Total expenses to total income ratio showed a rising trend especially after 1996. This was primarily because of higher growth in expenses (see **Figure 3.14**). In order to maintain a momentum in advances against a slowdown in deposit growth, these banks resorted to borrowings, which was a prime reason for high interest expenditures after 1996.

Table 3.11: Management Soundness Indicators

percent

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Total expenses to total income	66.6	62.8	66.5	73.4	74.4	81.3	89.9	87.2	88.8
Operating expenses to total expenses	51.4	31.7	29.3	27.1	26.7	26.9	27.8	23.0	29.4
Earnings per employee (million Rs)	0.6	1.7	1.9	2.2	2.5	3.1	3.4	3.1	3.1
Interest rate spread	2.2	5.4	5.2	4.9	4.5	4.2	4.5	3.9	3.8
Operating expense per employee (million Rs)	0.2	0.3	0.4	0.4	0.5	0.7	0.8	0.6	0.8

However, after rising in 1993, interest rate spread has been falling overtime. Anecdotal evidence suggests that these banks, being new entrants, are offering relatively higher returns to carve out their niche in the banking industry and to compete for a larger share of deposits. Share of operating expenditures in total expenditures depicted mixed trend: the rising value during 1996-98 may be linked to provisioning against mounting NPLs and defaulted loans.

3.3.4 Earnings and Profitability

The declining spread and rising share of NPLs and defaulted loans in gross assets have played a major role in reducing the profitability of private banks (see **Table 3.12**). In particular, a drop in earning assets to total assets ratio coupled with continuously diminishing net interest margin is the reflection of falling return on assets and equity, especially after 1997.

[18] In contrast, shares of cash and bank balances and other assets declined.

Table 3.12: Earnings and Profitability Indicators

percent

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Net profit to assets ratio	0.7	1.9	1.5	1.4	1.5	1.0	0.6	0.6	0.3
Net profit to equity ratio	6.3	20.0	17.2	14.4	16.6	13.3	8.0	8.4	4.6
Net interest margin	2.3	5.2	4.7	4.0	3.4	3.9	3.5	2.6	2.8
Total income to total assets	4.3	10.3	10.5	11.7	12.3	12.7	13.1	11.5	10.2

Figure 3.13: Non-performing Loans

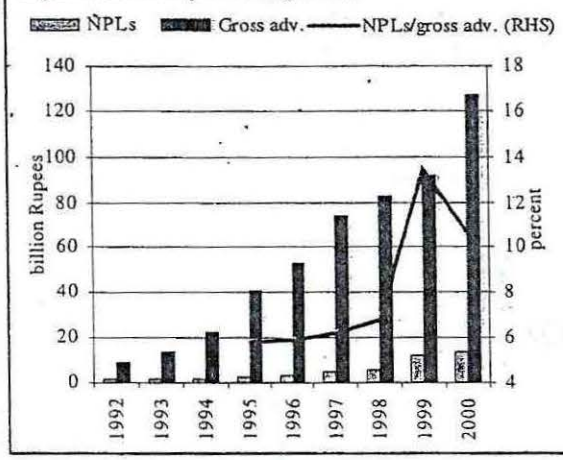
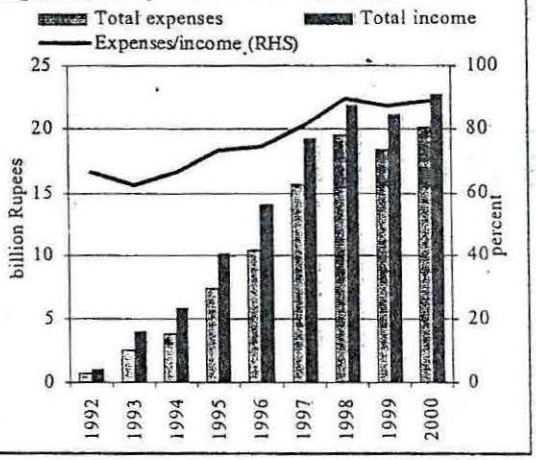


Figure 3.14: Expenditure to Income Ratio



3.3.5 Liquidity and Sensitivity to Market Risk

Liquid assets to total assets ratio of private banks saw a rapid decline in first half of the 1990s primarily due to reduction in SLR from 45 percent in early 1990s to 25 percent in 1994. Further cuts in SLR during 1995 to 1998 did not precipitate a sharp decline in the ratio as the period saw an increase in the yields of government securities. However, during the last two years not only the SLR was reduced to 15 percent but also yields witnessed a fall, leading to a decline in this ratio due to lower investment.

The negative gap between RSA and RSL is showing risk sensitivity towards liability side. Except for 1997, this gap constantly widened over the period (see **Table 3.13**). In 1997, the gap showed an abrupt contraction due to sharp increase in investment, especially in government securities.

Table 3.13: Liquidity and Sensitivity Indicators

percent

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Liquid assets to total assets	55.4	53.1	49.0	41.6	40.4	40.0	41.7	38.8	33.3
Loans to deposits	54.7	53.6	59.3	68.5	62.8	61.6	61.7	67.6	74.8
Gap (billion Rs)	1.2	-1.1	-3.8	-7.0	-10.9	-5.1	-14.6	-21.2	-24.4
RSA/RSL	106.0	96.4	91.6	89.8	88.2	96.2	90.3	87.0	87.9

Note: Gap = RSA – RSL; RSA = Rate sensitive assets; RSL = Rate sensitive liabilities.

Although the financial indicators of these banks have been deteriorating especially after 1997, performance of this group was far better than that of state-owned banks. Relatively low level of non-performing loans enabled these banks to keep interest rate spread relatively low, which was necessary for them to compete as an infant in the industry.

3.4 Foreign Banks

The number of foreign banks, interestingly, is almost equal to that of domestic banks at the end of 2000. This shows the degree of openness of the banking system in Pakistan. Although the share of foreign banks had been growing till 1997, freezing of foreign currency accounts in May 1998 severely affected their performance (see **Table 3.14**).

Table 3.14: Share of Foreign Banks in Banking Sector

percent

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Assets	7.8	10.9	12.5	14.7	15.2	14.8	18.0	20.1	18.1	16.3	15.8
Advances	7.9	10.0	12.6	12.5	14.6	15.2	17.2	20.7	19.7	18.0	16.8
Investment	6.5	12.1	12.9	17.1	15.4	12.7	18.9	19.4	16.1	9.1	14.5
Deposits	7.0	10.2	11.6	13.7	14.6	14.3	17.7	19.7	17.8	14.8	14.1
Capital	14.6	19.4	24.5	28.8	29.8	29.0	36.3*	50.9*	28.5	31.6	27.9
NPLs	5.0	4.2	3.8	3.5	2.2	3.4	4.6	4.7	5.0	3.8	4.0

*: The high value of this ratio is only due to capital erosion of state-owned banks

3.4.1 Capital Adequacy

Table 3.15: Capital Adequacy Indicators

percent

	1997	1998	1999	2000
Capital to risk-weighted assets	14.6	15.6	18.6	18.0
No. of banks below 8 % CRWA	1	0	0	0

The CRWA of foreign banks was well above the required level during the last four years of 1990s (see **Table 3.15**). However, the rising ratio in 1998 and 1999 was more due to a contraction in their assets following freeze in FCAs and resulting fall in deposits (see **Annex 3.3**). Nevertheless, rising trend in capital to liability ratio (almost throughout the decade) showed improvement in capital adequacy overtime (see **Figure 3.15**).

3.4.2 Asset Quality

As shown in **Table 3.16**, earning assets to total assets ratio remained stable (around 75 percent), except for 1999 when it fell to 64.9 percent. Since more than 95 percent investment of foreign banks were in government securities, a decline in interest rates thereon resulted in sharp fall in earning assets to total assets ratio in 1999 (see **Figure 3.16**).

Table 3.16: Asset Quality Indicators

percent

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Earning assets to total assets	77.2	76.7	80.1	77.1	76.0	72.9	74.4	74.4	73.7	64.9	75.0
NPLs to gross advances	11.8	8.3	5.6	5.9	3.4	4.5	5.3	5.0	5.3	5.1	5.1
Loan defaults to gross advances	12.3	8.8	4.7	5.3	2.7	3.7	3.8	4.1	5.4	5.0	3.7
Cash recoveries to total default	0.7	18.8	2.7	4.9	7.0	4.9	18.2	8.4	1.3	2.9	12.2

As regard NPLs, these had increased from Rs 2.1 billion in 1990 to Rs 7.0 billion in 2000. However, its ratio to gross advances remained stable in the range of 4 to 6 percent for most of the period (see **Figure 3.17**). Besides, low defaults to advances ratio and relatively high recovery rate against defaulted loans helped this group in maintaining the quality of their assets.

3.4.3 Management Soundness

In terms of indicators for management soundness, the sharp increase in expenses to income ratio during 1998 was due to freezing of FCAs (see **Table 3.17**). It is important to note that after 1998, both income and expenditure declined in almost equal proportions (see **Figure 3.18**).

During second half of 1990s, operating expenses to total expenses ratio of foreign banks was the lowest among all the groups. This ratio declined during the first half of 1990s, but started increasing during the last three years of the decade. Earnings per employee were not only the highest for this group but also increased over the period. As regards expense per employee, their high levels showed that foreign banks offered lucrative packages to their employees compared to the first two groups.

Table 3.17: Management Soundness Indicators

Percent

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Total expenses to total income	71.0	57.3	53.9	69.4	76.4	83.4	80.5	81.2	88.6	86.8	87.2
Operating expenses to total expenses	30.6	33.1	31.7	32.5	28.4	21.9	25.7	22.9	23.3	26.1	29.2
Earnings per employee (million Rs)	1.6	2.2	3.1	4.0	4.5	4.8	6.3	9.0	9.7	9.3	8.4
Interest rate spread	4.4	5.5	6.6	5.8	5.3	4.2	4.8	6.3	5.7	7.4	4.6
Operating expense per employee (million Rs)	0.3	0.4	0.5	0.9	1.0	0.9	1.3	1.7	2.0	2.1	2.1

Figure 3.15: Capital to Liability Ratio

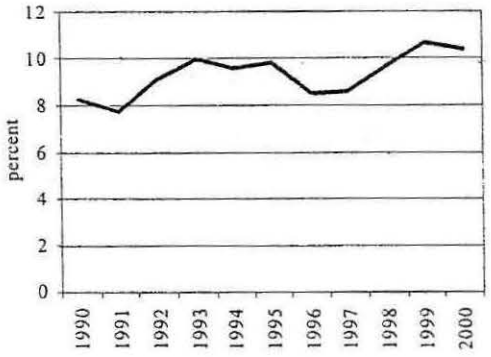


Figure 3.16: Earning Assets to Total Assets Ratio

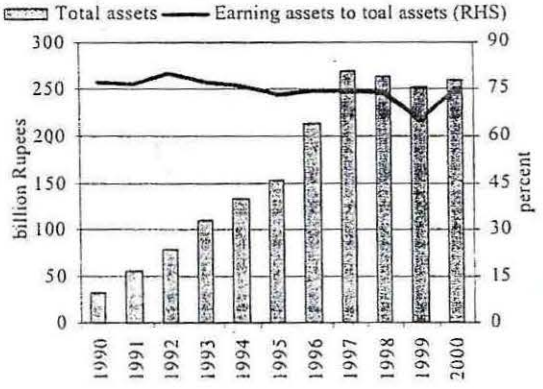


Figure 3.17: Non-performing Loans

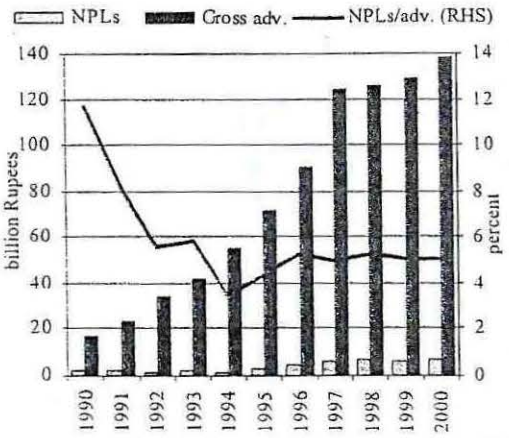
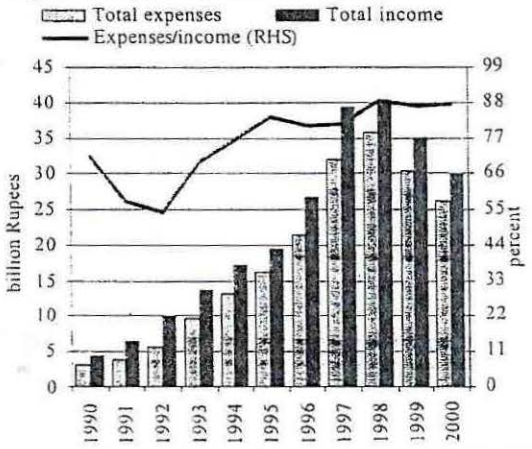


Figure 3.18: Expenditure to Income Ratio



3.4.4 Earnings and Profitability

Despite showing better asset quality, adequate capital base and sound management, foreign banks failed to retain their profitability during 1990s. Despite indicating comparatively better position than competitors in the banking industry, the first three indicators showed declining earning capacity and thereby constraining profitability for this group, especially after 1997 (see **Table 3.18**). Given the

fact that they were mainly dealing in foreign currency accounts, their freezing in May 1998 severely affected the earning capacity of foreign banks.

Table 3.18: Earnings and Profitability Indicators

Percent

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Net profit to assets ratio	0.8	1.9	2.6	1.2	0.8	0.4	1.0	1.3	0.4	0.7	0.6
Net profit to equity ratio	10.9	27.1	30.8	13.5	8.7	4.9	12.8	15.9	4.8	7.0	6.5
Net interest margin	3.5	4.8	6.2	5.1	4.2	2.5	3.2	4.4	3.5	4.0	3.4
Total income to total assets	11.9	11.1	12.1	12.1	12.6	12.5	12.5	14.6	15.2	13.9	11.5

3.4.5 Liquidity and Sensitivity to Market Risk

The freezing of FCAs in May 1998 led to a decline in deposits of foreign banks, thereby affecting their liquidity position (see **Table 3.19**). Both the loans to deposits and liquid assets to total assets ratios were indicating liquidity problem for this group after 1998. However, foreign banks continued to hold larger securities than the minimum required under SLR. This showed their relative reluctance in undertaking credit extension compared with their local competitors.

Table 3.19: Liquidity and Sensitivity Indicators

Percent

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Liquid assets to total assets	37.5	50.6	50.7	54.9	51.0	44.3	48.5	47.6	46.0	40.3	39.3
Loans to deposit	69.7	52.9	54.0	48.6	51.3	57.6	50.6	54.3	56.7	68.2	71.6
Gap (Rs billion)	-2.3	-5.3	-4.8	-8.9	-13.5	-19.9	-29.4	-35.4	-36.3	-55.2	-30.2
RSA/RSL	91.6	88.9	93.0	90.6	88.3	84.8	84.3	85.0	84.2	74.8	86.6

Note: Gap = RSA – RSL; RSA = Rate sensitive assets ; RSL = Rate sensitive liabilities

3.5 The Banking Industry

Performance indicators of overall banking industry (see **Table 3.20**) depict a trend similar to that of state-owned banks, which is understandable due to their predominant share. It is, however, important to note that the financial performance of private and foreign banks was far better than that of overall banking industry, especially before the freezing of foreign currency accounts in May 1998.

In terms of the health of the banking industry, very small improvements, or arrests in earlier declines, could be discerned in some of the CAMELS indicators after 1997. These improvements need to be seen in the context of various negative factors that affected the banking industry after 1997. While SBP, in that year, required banks to enhance capital adequacy, strengthen asset quality, improve management, increase earnings and reduce sensitivity to various market risks; the freezing of foreign currency accounts in May 1998 instilled new pressures of capital and deposit erosion, and dis-intermediation in the financial system. Persisting environment of low economic growth had also added a dampener to demand for credit, and at the same time the supply of credit was negatively affected, due to over cautious attitude of the banks during the drive for accountability and loan recovery that began in October 1999.

Pakistan banking industry has remained heavily taxed. Although the tax rate on banking system was gradually brought down from 66 percent at the beginning of 1990s to 58 percent towards the end, it was still very high compared to other sectors, like 45 percent for corporate and 35 percent for individuals. Since the provision against NPLs and the interest income in the suspense account was not exempted while calculating the tax liabilities, this was another source of concern for the banking business in Pakistan. Moreover, the problem of advance tax further drained the funds available to the banks; however, this problem basically pertained to the state-owned banks (for detail see **Section 3.2.4**).

Table 3.20: Performance Indicators of Banking Industry
Percent

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Capital Adequacy											
CRWA	-	-	-	-	-	-	-	6.0	12.5	12.2	11.4
No. of banks below 8% CRWA	-	-	-	-	-	-	-	5	0	1	3
Capital to liability ratio	4.3	4.2	4.5	4.9	4.7	4.8	4.0	3.2	5.9	5.3	5.6
Asset Quality											
Earning assets to total assets	80.0	75.9	77.6	77.6	76.8	75.9	74.6	74.9	72.8	70.5	73.2
NPLs to gross advances	17.6	18.9	17.4	20.0	21.7	19.3	19.2	20.1	19.5	22.0	19.5
Loan defaults to gross advances	10.8	10.7	10.3	10.5	11.1	10.3	10.8	16.6	14.9	13.5	12.2
Recoveries to total default	11.0	7.8	6.3	5.1	8.3	8.5	10.0	9.4	5.8	7.3	8.5
Management Soundness											
Total expense to total income	93.4	89.3	84.6	85.7	88.0	90.2	96.3	106.8	97.1	96.8	98.9
Operating expense to total expense	38.5	38.1	38.9	38.6	37.1	35.8	33.8	40.2	34.0	36.6	38.7
Earnings per employee (million Rs)	0.4	0.5	0.6	0.7	0.8	1.0	1.1	1.7	1.9	1.9	1.9
Interest rate spread	4.0	4.4	4.4	4.8	4.6	4.9	3.8	5.2	5.3	5.6	5.1
Operating expense per employee (million Rs)	0.2	0.2	0.2	0.2	0.3	0.3	0.3	0.7	0.6	0.7	0.7
Earnings and Profitability											
Net profit to assets ratio	0.4	0.6	0.8	0.8	0.4	0.3	0.1	-1.2	0.5	-0.3	0.2
Net profit to equity ratio	10.5	15.8	18.2	17.6	9.1	7.2	2.1	-38.8	9.1	-6.3	4.1
Net interest margin	3.2	3.3	3.7	4.0	3.6	3.7	2.3	3.5	3.5	3.7	3.8
Total income to total assets	9.8	9.3	9.2	10.3	10.1	10.7	10.4	11.7	11.7	10.8	9.9
Liquidity and Sensitivity to Market Risk											
Liquid assets to total assets ratio	32.6	41.6	46.0	44.4	47.0	43.7	43.4	41.4	41.3	38.7	34.9
Loans to deposits	61.6	54.0	49.7	53.4	51.0	54.1	52.2	51.8	51.2	55.9	60.3
Gap (billion Rs)	-40	-67	-73	-81	-106	-134	-178	-199	-228	-287	-255
RSA/RSL	89.5	85.1	87.3	87.8	86.5	85.4	83.2	83.5	82.3	79.2	82.5

Note: Gap = RSA – RSL; RSA = Rate sensitive assets ; RSL = Rate sensitive liabilities

3.6 Conclusion

Our analysis of performance of commercial banks during the reform process strongly points toward the need for continuity of banking sector reforms. Despite a radical change in the ownership structure of the banking sector, which had resulted in reduction in share of state-owned banks (excluding MCB and ABL) in total assets from 92.1 percent in 1990 to 54.0 percent in 2000, solid signs of improvements are difficult to spot. However, the problem of capital erosion has been addressed in addition to some improvements in recovery of defaulted loans.

In order to improve the health of banking industry further, following areas require focused attention:

- More vigor is required to deal with the mounting burden of non-performing and defaulted loans, especially historical loans. Further improvement in judicial and legal framework is needed to define the fate of historical bad debts. This will help banks in reducing their operating cost and ultimately the spread between lending and deposits rates. In this regard, CIRC has already been formed, which will purchase the NPLs of the banking institutions.[19]

[19] The Corporate and Industrial Restructuring Corporation Ordinance dated September 22, 2000.

- There is a need to speed up the undergoing restructuring process of Nationalized Commercial Banks (NCBs) to make them viable for privatization. This will help in insulating these banks from undue interference and political pressures in credit and investment decision-making.
- It is important to reduce the tax rate on banking industry. Moreover, the issue of advance taxes paid by banks needs attention.
- It is vital to further rationalize the yields on NSS instruments in order to minimize the possibility of dis-intermediation occurring in future.

4 Performance of NBFIs and CDNS During 1990s

Non-bank Financial Institutions (NBFIs) and Central Directorate of National Savings (CDNS) play a pivotal role in mobilizing savings in the economy. NBFIs collect savings by accepting term deposits of different maturities and provide financing to a variety of sectors of the economy. Parallel to the banking sector, financing activities of these institutions registered a healthy growth in 1990s, except for last three years. Deposits mobilized by NBFIs were 2.6 percent of GDP in FY90, which increased to 5.2 percent in FY97. This rapid growth, however, witnessed sharp reversal for the rest of the decade, as deposits to GDP ratio declined to 2.9 percent in just three years. This was mainly attributed to overall economic slowdown along with freezing of foreign currency accounts.

CDNS, a major source of non-bank borrowing for the government, also helps to mobilize savings by offering various saving schemes of different maturities. The net amount received from these schemes is directly used by the government to bridge the gap between revenues and expenditures. Total outstanding amount in all these schemes was 15.4 percent of GDP in FY90, which increased to 19.9 percent in FY00, mainly as a result of higher profit rates offered on these schemes as compared to deposit rates in the banking sector.

4.1 Non-Bank Financial Institutions

For the sake of analysis, NBFIs can be categorized into eight groups. The list of NBFIs in their respective groups is given in **Annex 1.2**. Wide variation exists within and across these groups in terms of their size. Development finance institutions (DFIs) is the largest in terms of assets on end June 2000, followed by investment banks (IBs), leasing companies, mutual funds, housing finance companies (HFCs), modaraba companies, discount houses (DHs) and venture capital companies (VCCs). The asset shares of all these institutions (as a proxy of their size) in overall NBFIs are presented in **Table 4.1**, reflecting that the DFIs and HFCs jointly held almost 91 percent assets of NBFIs in FY90, also pointing toward the meager share of the rest of NBFIs at that time. Furthermore, as all DFIs, one major HFC and two mutual fund management companies are state-owned, this also reflected the extent of public sector ownership in NBFIs.

Table 4.1 Assets of NBFIs

	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Assets (billion Rs)	133.9	167.8	231.9	269.6	335.3	360.1	377.1	410.3	369.3	356.4	351.7
Growth rate (percent)	-	25.3	38.2	16.3	24.3	7.4	4.7	8.8	-10.0	-3.5	-1.3
Asset shares (percent)											
DFIs	78.6	71.1	58.4	59.3	54.0	55.3	56.6	61.5	61.3	58.7	57.0
Investment banks	1.8	2.8	3.6	7.7	8.4	8.5	9.8	10.2	12.4	13.7	12.0
Leasing	4.7	3.1	3.5	4.0	4.7	5.7	7.3	7.6	8.9	10.0	11.1
Mutual funds	1.9	12.4	26.4	21.6	23.4	21.3	17.3	11.9	6.7	6.7	8.6
HFCs	12.3	10.0	7.7	6.9	5.7	5.4	5.3	5.0	5.8	6.0	6.3
Modaraba	-	-	-	-	3.5	3.5	3.4	3.4	4.1	4.2	4.3
Discount houses	0.7	0.7	0.4	0.5	0.2	0.2	0.3	0.4	0.4	0.4	0.4
VCCs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.3	0.4	0.3

This highly skewed distribution of assets has changed significantly since 1990, which is partially explained by the emergence of new institutions under the reform process, particularly IBs, leasing and modaraba companies. These newly established institutions witnessed rapid growth in the first half of 1990s, as compared to other NBFIs. Furthermore, leasing companies outperformed other groups during the later half of 1990s.

Despite all these developments, asset distribution is still skewed as DFIs continue to dominate the NBFIs, but obviously less so than in 1990. Asset shares recorded in **Table 4.1** reveal that the prime

losers were the HFCs, whose share declined sharply from 12.3 percent in 1990 to 6.3 percent in 2000, and the clear gainers were the IBs and leasing companies. Relatively big institutions like DFIs, IBs, and leasing companies held around 80 percent of total assets in FY00 compared with 85.1 percent in FY90. Since DFIs, HFCs and mutual funds were mainly state-owned, during the decade of 1990s, the private sector share in NBFIs increased significantly from 7.2 percent to 28.6 percent.

Deposits of NBFIs portrayed almost the same picture as those of assets. As is evident from **Table 4.2**, leasing companies continued to attract larger share of savings towards NBFIs. The overall deposit growth of NBFIs also remained healthy except for the last three years, as total deposits increased from Rs 22.4 billion in FY90 to Rs 127.2 billion in FY97 and then declined to Rs 93.3 billion in FY00. Sharp upsurge in FY97 was mainly on account of heavy inflows in foreign currency deposits of a foreign sponsored DFI, while reversal in FY98 was explained by the outflow of deposits from the same institution. The freezing of foreign currency deposits in 1998 (after nuclear tests) seriously undermined NBFIs' ability to mobilize deposits. In the post detonation period, the domestic deposit mobilization efforts could not keep pace with increasing outflow from foreign currency deposits. This resulted in negative deposit growth in the last three years of 1990s.

Table 4.2: Deposits of NBFIs

	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Deposits (billion Rs)	22.4	31.0	40.4	57.1	71.5	80.8	94.0	127.2	110.7	106.7	93.3
Growth rate (percent)	-	38.4	30.4	41.4	25.2	12.9	16.4	35.3	-13.0	-3.6	-12.5
Deposit shares (percent)											
DFIs	90.6	87.7	83.1	68.9	66.1	67.0	62.8	69.5	62.5	59.1	61.9
Investment banks	8.2	11.1	14.6	28.2	29.6	28.5	31.6	25.6	32.0	34.4	28.4
Leasing	1.3	1.2	1.8	2.4	2.8	2.6	3.7	3.7	4.1	5.0	8.2
Modaraba	-	-	-	-	0.6	0.7	0.7	0.6	0.7	0.7	0.9
Mutual funds	0.0	0.0	0.5	0.6	1.0	1.1	1.0	0.6	0.6	0.6	0.4
HFCs	0.0	0.0	0.0	0.0	0.0	0.1	0.2	0.1	0.1	0.2	0.1

Loans and advances of NBFIs are reported in **Table 4.3**, revealing almost same ranking as in case of asset shares. The growth rate of loans and advances followed the pattern of deposit growth rates; healthy positive growth upto FY97 and negative for rest of the decade.

Table 4.3: Loans and Advances

	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Advances (billion Rs)	98.3	114.4	123.6	143.5	162.2	176.1	185.8	218.3	194.1	185.4	171.2
Growth Rate (percent)	-	16.4	8.0	16.1	13.0	8.6	5.5	17.5	-11.1	-4.5	-7.6
Shares in advances (percent)											
DFIs	80.4	80.9	79.5	75.6	72.3	74.0	71.7	74.1	70.3	70.1	71.6
Leasing	1.9	2.2	3.4	4.1	5.3	5.8	8.1	7.3	7.7	8.8	10.1
Investment banks	1.7	3.1	4.3	9.1	10.4	9.3	10.2	9.7	11.6	11.3	7.9
HFCs	14.8	12.8	11.7	10.2	8.8	7.8	7.3	6.2	6.9	6.3	6.7
Modaraba	-	-	-	-	4.7	4.3	3.9	4.1	5.1	5.2	5.7
Mutual funds	1.1	1.0	1.0	1.0	0.7	0.6	0.4	0.3	0.3	0.2	0.1
Discount houses	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.1

The overall business activities (in terms of deposit mobilization and extending loans and advances) of NBFIs registered double-digit compound annual growth up to FY97. Later years witnessed negative growth due to reasons described above. Given the overall position of dominance in terms of assets, advances, and deposits; relatively big institutions like DFIs, IBs and leasing companies that control over 80 percent business activities of NBFIs will be focused in our discussion, while discount houses

and venture capital companies will be discussed in brief. At present, SBP is using CAMELS framework to review the health of NBFIs,[1] which is used here to analyze the performance of these major groups of institutions.

4.1.1 Development Finance Institutions

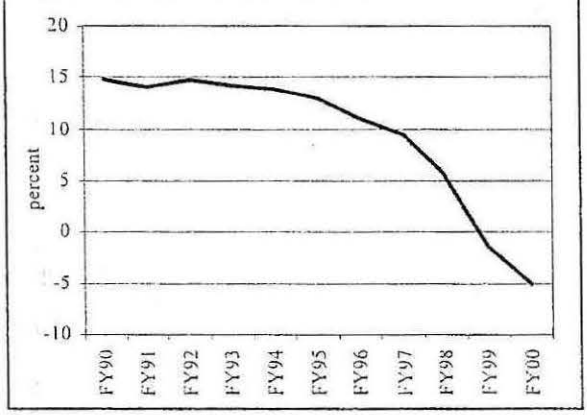
The list of DFIs includes 12 institutions (see **Annex 1.2**); their names along with asset shares of individual institutions are given in **Annex 4** (see **Table 4A.3**), showing that ADBP, NDFC and IDBP with around two-thirds of the total assets dominate the rest of DFIs. The list also contains three foreign sponsored DFIs (PLHC, SPIAIC and PKIC) and four specialized banks. Specialized banks include IDBP, ADBP, FBC and PPCB, which are almost similar to DFIs, but are licensed as scheduled banks.[2] The framework used to gauge the financial health of these institutions is almost same as used in **Chapter 3** for banks.

Capital Adequacy

Capital adequacy is generally gauged by capital to risk-weighted assets ratio, while other indicators include capital to liability ratio, growth rate of capital, growth rate of assets etc. Due to non-availability of data on risk-weighted assets, capital to liability ratio and some other indicators are discussed to assess the capital adequacy. Higher capital to liability ratio promotes public confidence in that institution and vice versa. In **Table 4.4**, four indicators of capital adequacy are reported, which jointly highlight the problem of weak capital position of DFIs.

Capital to liability ratio has not only declined from 14.7 percent in FY90 but also reached a negative level of 5.0 percent in FY00, indicating the severe erosion of capital base in second half of 1990s (see **Figure 4.1**). The steep decline in second half of 1990s was the consequence of financial weakening of two big state-owned DFIs, including NDFC which technically became insolvent. The BEL, another public sector DFI also contributed to this end. Contrary to this poor position of capital adequacy, all foreign sponsored DFIs have maintained a relatively sound capital base.

Figure 4.1:Capital to Liability Ratio



Another important indicator of capital adequacy is the ratio of growth rate of capital to growth rate of assets. This ratio explains that the capital should grow in relation to growth in assets, so that the institutions' ability to absorb shocks and unanticipated losses remains intact. If this ratio is less than one, it implies that growth of capital did not keep pace with the growth of assets. It is clear from **Table 4.4** that the ratio was less than one for most of the period and even negative for the last two years.[3] The erosion of capital base was mainly attributed to heavy losses, which stemmed from loan defaults as well as rising non-performing loans experienced by public sector DFIs. The above trend indicates that the group of DFIs is facing a severe problem of capital adequacy, and points to the need of a drastic restructuring of DFIs on urgent basis.[4]

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[1] Due to differences in the structure of banks and NBFIs, their respective CAMELS frameworks differ slightly with each other.

[2] These four specialized banks are part of scheduled banks, however, these are included in our list of DFIs because of similarity of their functions.

[3] This ratio must be interpreted with caution as negative growth in both assets and capital will provide positive figure; similarly negative growth in one variable will lead to a negative ratio.

[4] NDFC was subsequently merged with NBP on November 1, 2001. RDFC and SBFC were also merged with each other to form SME bank on January 1, 2002.

Table 4.4: CAMELS Indicators of DFIs

Percent

	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Capital Adequacy											
Capital to liability ratio	14.7	13.9	14.7	14.2	13.8	12.9	11.0	9.4	5.5	-1.3	-5.0
Growth rate of capital (GRC)	75.5	7.9	19.0	14.7	10.7	3.4	-7.2	2.6	-45.7	-123.1	287.2
Growth rate of assets (GRA)	153.3	13.3	13.5	18.1	13.3	10.0	7.2	18.1	-10.2	-7.6	-4.2
Ratio of GRC to GRA	0.5	0.6	1.4	0.8	0.8	0.3	-1.0	0.1	4.5	16.1	-69.0
Asset Quality											
Earning assets to total assets ratio	86.7	85.4	85.3	85.2	83.7	80.5	78.6	80.7	75.0	77.0	77.4
NPLs to gross advances	27.9	18.3	20.3	22.0	30.9	29.0	40.2	36.9	44.6	52.2	58.7
Loan default to gross advances	6.8	5.7	6.7	8.9	10.7	12.0	17.4	16.4	18.8	17.5	22.0
Provisions to gross advances	3.5	3.7	4.6	5.4	5.2	4.5	5.1	4.2	10.4	15.3	13.6
Recoveries of default to total default	69.0	54.1	56.9	40.0	33.4	31.2	19.8	28.5	33.4	28.1	32.3
NPLs to total assets	21.7	14.7	15.5	15.8	21.1	19.9	26.5	24.7	30.0	38.3	41.6
Advances to earning assets ratio	86.6	90.8	85.1	79.6	77.3	81.3	79.4	79.4	80.3	80.7	79.1
Investment to earning assets ratio	13.1	8.8	13.5	17.1	18.1	16.9	18.9	18.1	16.9	18.3	19.1
Management Soundness											
Total expense to total income ratio	73.6	76.6	73.5	71.7	78.7	87.9	98.6	89.1	115.1	104.8	101.9
Earnings per employee*	0.7	0.8	0.9	1.2	1.3	1.3	1.3	1.6	1.8	1.6	1.7
Operating expense per employee*	0.2	0.3	0.3	0.4	0.4	0.5	0.5	0.6	1.2	0.7	0.9
Total expense per employee	0.5	0.6	0.7	0.8	1.0	1.1	1.3	1.4	2.1	1.7	1.7
Earnings and Profitability											
Return on assets	1.5	1.5	1.3	1.5	1.9	0.8	-0.7	0.5	-3.9	-3.3	-1.7
Net interest margin	3.1	3.0	3.4	3.7	2.9	2.9	2.7	3.4	3.3	2.6	3.5
Net income to total assets	8.9	9.5	9.8	10.7	10.6	9.7	9.3	9.8	10.8	10.5	11.4
Interest income to total assets	6.4	6.5	6.8	7.6	7.5	7.2	7.6	7.9	8.0	8.6	8.6
Interest expense to earning assets	4.3	4.6	4.6	5.2	6.0	6.1	7.0	6.5	7.3	8.6	7.6
Interest income to total income	69.2	67.9	68.3	70.5	70.3	74.7	80.7	80.7	73.3	81.2	75.4
Interest expense to total expense	54.9	53.8	53.0	57.9	59.9	57.8	59.4	59.5	44.0	59.5	50.5
Provisions to total assets	2.8	3.1	3.6	4.0	3.7	3.2	3.5	3.0	7.7	11.7	10.6
Liquidity and Sensitivity to Market Risk											
Liquid assets to total assets	12.8	9.8	15.0	17.3	16.2	11.7	11.0	12.0	15.7	13.1	12.8
Loans to deposit ratio	389.8	340.5	292.9	275.9	248.0	240.7	225.6	183.0	197.1	206.2	212.2
Borrowing to advances ratio	72.0	72.7	77.3	82.9	84.9	83.7	88.3	75.6	92.4	99.4	102.7
Borrowing to liabilities ratio	62.0	64.2	64.3	64.3	62.6	61.8	61.1	53.0	58.7	61.0	59.7
RSA to RSL ratio	118.2	107.9	105.5	105.4	103.3	98.2	95.0	96.7	87.0	83.8	84.4
Gap to capital ratio	104.0	51.0	34.8	34.9	21.9	-12.7	-41.9	-32.1	-215.0	1145.2	271.9
Gap to total assets ratio	13.3	6.2	4.5	4.3	2.7	-1.5	-4.2	-2.8	-11.2	-14.9	-14.3

*: million Rupees

Asset Quality

The asset quality of DFIs is measured in relation to the level and severity of non-performing loans, the adequacy of provisions, recoveries, distribution of assets etc. **Table 4.4** shows that non-performing loans in relation to total assets and gross advances have significantly increased in late 1990s, hinting towards mismanaged loans and advances portfolios of these institutions. Besides, loan default to gross advances also increased significantly over the period under consideration. Mounting non-performing loans also eroded the earnings base of these institutions. **Figure 4.2** displays ratio of non-performing loans to gross advances, indicating massive increase over the whole decade. Moreover, declining recoveries to default ratio added an extra dampener to DFIs' growth.

The severity of non-performing loans becomes more pronounced when analyzed in the context of capital adequacy. **Figure 4.3** shows non-performing loans and capital to asset ratios as almost a mirror image of each other, particularly after FY97--the year in which prudential regulations for DFIs were strengthened. The prudential regulations enacted in FY97 made it mandatory to disclose a

Figure 4.2: NPLs to Gross Advances Ratio

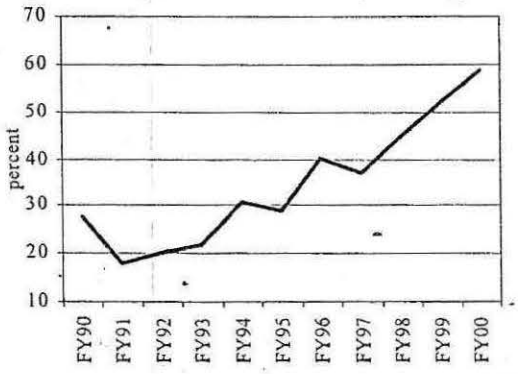
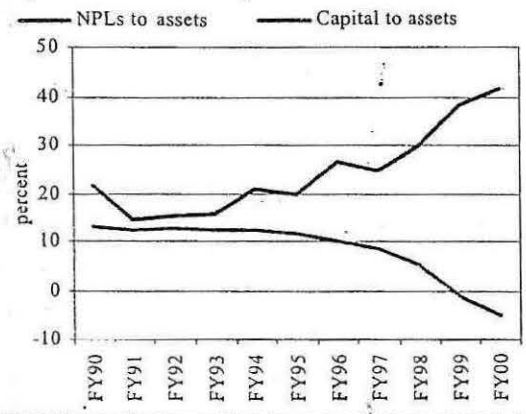


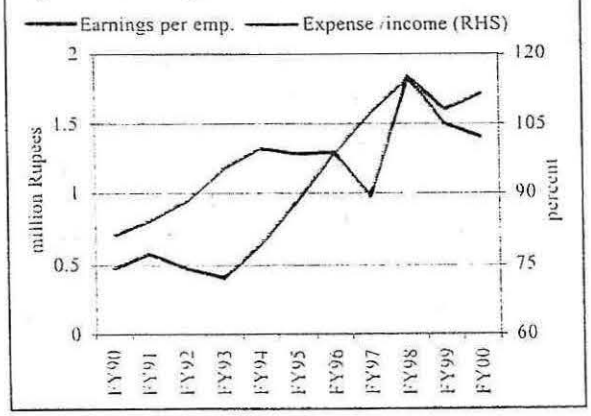
Figure 4.3: NPLs and Capital to Asset Ratio



certain level of information about non-performing loans and make provisions for loan losses according to a set of criteria. These regulations, together with slower economic and industrial sector growth, lack of proper monitoring of pre and post disbursement of loans, and lack of professionalism resulted in steep increase in non-performing loans.[5] Furthermore, declining trend in earning assets to total assets ratio signaled the gravity of the problem. The only positive point in reported asset quality indicators is the positive trend in default recoveries to gross advances in late 1990s, mainly due to special loan recovery drives.

Despite overall weak asset quality, foreign sponsored DFIs and PICIC performed relatively better as compared to overall trend for DFIs. Since the share of these institutions was not very high in total assets of DFIs group, the overall asset quality indicators of DFIs hardly showed any sign of improvement over the decade.

Figure 4.4: Management Soundness



Management Soundness

The evaluation of management includes performance in relation to capital adequacy, asset quality, earnings, sensitivity to market risk and liquidity. Compliance with set norms, ability to plan and adoption to changing circumstances also indicate management soundness. In addition, technical competence, leadership and administrative ability also matter a lot. An overall good management results in a strong financial structure with consistent earnings performance. **Table 4.4** presents four indicators of management soundness. Earnings per employee witnessed a positive trend in 1990s, mainly caused by a reduction in staff through Golden Handshake Schemes (GHS) in late 1990s.[6]

This apparently positive point loses its credibility, when observed jointly with total expense per employee, which also included GHS cost. Per employee expenses continued to increase over the whole decade and even exceeded the earnings per employee in FY98. A more meaningful ratio is

[5] This does not mean that prudential regulations are responsible for poor health of DFIs. The only point is that the hidden risks to DFIs were exposed by these regulations.

[6] Five DFIs, including two specialized banks launched GHS in late 1990s.

expense to income, which jumped from 73.6 percent in FY90 to 115.1 percent in FY98 before declining to 101.9 in FY00. It seems that staff reduction did not have the intended result of better profitability because of other structural weaknesses in these institutions. Major increase in earnings, operating expense and total expense per employee ratios in FY98 was a consequence of GHS. **Figure 4.4** displays that total expense to total income ratio gradually increased after FY93, indicating weak management of DFIs. Although this ratio marginally declined in last two years, it remained over the mark of hundred percent due to losses suffered by DFIs.

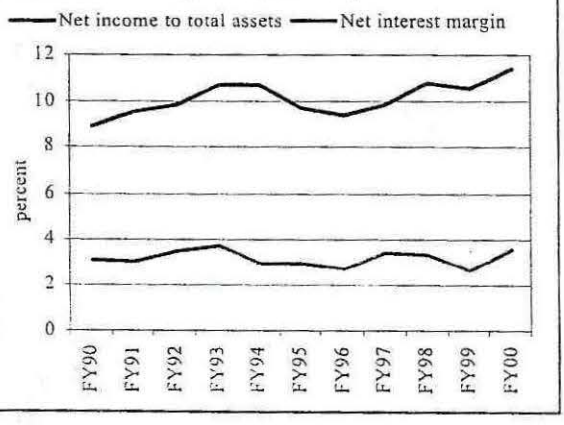
These indicators, combined with capital inadequacy and poor asset quality, gave clear indication that the managements of DFIs were unable to generate consistent income stream for the institutions. However, foreign sponsored DFIs again stayed within the healthy circle, as their management performance indicators were exceptionally good.

Earnings and Profitability

Table 4.4 reports various indicators that depict the earnings and profitability of DFIs. Most important ratios are return on assets and net interest margin (NIM). The former registered a marginal increase over the period, mainly due to widened interest rate spread.

Increasing trend of break-even yield (BEY) along with marginal increase of NIM provides clear indication of increasing interest rate spread. The former also reflected that the profitability of these institutions required higher interest rates. In addition, return on assets was negative during the second half of 1990s, indicating losses to DFIs. Moreover, as can be seen from **Figure 4.5**, the net income to total assets and NIM fluctuated in a narrow band over the entire period of analysis. As we have already discussed, expenses to income ratio not only increased considerably in late 1990s, but also crossed the alarming level of hundred percent, indicating losses to DFIs.

Figure 4.5: Earnings and Profitability



The period of losses (second half of 1990s) coincided with the weak performance of other indicators like capital adequacy, asset quality etc., reflecting that persistent poor performance in one area will ultimately eclipse the good performance of other indicators. Tabular and graphical representation provide strong evidence to conclude that earnings and profitability of DFIs has rapidly gone down in late 1990s, requiring structural reforms for smooth functioning in future. Again, foreign sponsored DFIs retained their separate identity, as management soundness indicators showed strong earnings and profitability profile.

Liquidity and Sensitivity to Market Risk

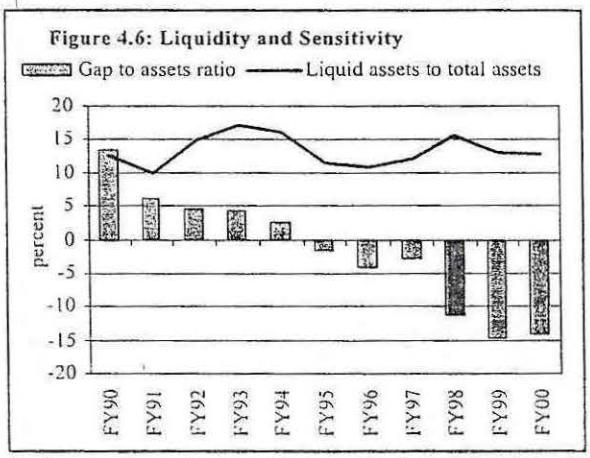
Most commonly used indicator to assess liquidity position is liquid to total assets ratio. Liquid assets include cash and balances with other institutions, call money and investment in government securities. Since, NBFIs are not operating like commercial banks, their liquidity requirements are not as strapping as for commercial banks. **Table 4.4** reports various indicators to assess the liquidity position. Liquid assets to total assets ratio fluctuated in a narrow band during 1990s, indicating that the liquidity position of DFIs remained almost the same. However, other indicators like borrowing to advances and liabilities ratios indicated that DFIs heavily relied on borrowing to make investments, and loans and advances, as their borrowing to liability ratio remained above 50 percent.

Borrowing to advances and liability ratios also continued to increase over the period of analysis, pointing towards the inability of management to generate resources at a cheaper cost to meet its credit needs. Borrowing might be needed to bridge the gap between maturity of an investment and liability or to make exceptional lending to priority sectors; either way, a high ratio is not desirable.

Another important ratio used to judge liquidity position is the loans to deposits ratio, which signals the ability of a financial institution to mobilize deposits to fulfill its credit needs. However, this ratio must be interpreted with caveat for NBFIs, as certain groups of institutions were not initially mobilizing deposits. Further, most of NBFIs have a limited deposit taking authority (not of less than 30 days maturity). Therefore, deposits with NBFIs are of different nature as compared to demand deposits with commercial banks. Initially, loans to deposits ratio was very high because of their low deposit base and heavy reliance on long-term borrowing. Although liquid assets to total assets ratio remained almost stable, the increasing trend of borrowing to advances and liability ratios indicate deteriorating liquidity position.

Difference between rate sensitive assets and rate sensitive liabilities--known as the gap--is used to measure interest rate risk exposure. The gap was positive upto 1994, indicating that DFIs were asset sensitive. It means that DFIs were able to realize an increase in income if interest rate rose because more assets could be reinvested at higher market rates than the liabilities. After 1994, the gap became negative, showing that DFIs were liability sensitive in second half of 1990s. Other indicators like gap to equity ratio showed considerable variations, ranging from positive 1145.2 to negative 215.0, exceeding the test limits of prudence (+200 and –200 percent). Similarly, as can be seen from the **Figure 4.6** that gap to asset ratio varied from positive 13.3 to negative 14.9, again exceeding the prudent limit of negative 10. The ratio falls within test range[7] of +10 and –10 from FY91 to FY97 and crosses the prudence range after that, showing that DFIs are highly exposed to changes in interest rates. This has happened due to a variety of factors: freezing of foreign currency certificates of investment (COIs) and consequent decline in deposits; liquidation of advances against COIs; and unanticipated decline in short-term interest rates due to monetary policy actions of SBP to tackle the aftermath of freeze. Owing to these factors, balance sheets of NBFIs, especially DFIs and IBs, changed significantly from the asset as well as liability side. Moreover, the differing impact of variation in interest rates on assets and liabilities resulted in their gap to change its sign within a year.

Figure 4.6: Liquidity and Sensitivity



Conclusion

Inadequate level of capital, poor asset quality, weak management performance, low earnings and profitability profile along with a deteriorating liquidity position are suffice to conclude overall weak financial health of DFIs. Current distressed state of DFIs is an upshot of the high level of non-performing loans, political interference in their management and business, and overall weak economic situation in 1990s.[8] In addition, increased competition in mobilizing deposits, discontinuation of credit lines from international finance institutions along with overall limited ability to generate

[7] Test range specifies the exposure of an institution towards interest rate risk. If an institution is highly sensitive to assets or liabilities, a small incorrect forecast of interest rate will result in exceptional losses to the institution. To avoid significant risk in the event of interest rate forecast, prudent limits are defined in terms of gap to equity and asset ratios.

[8] The distressed state of DFIs is not exceptional; Japan, Korea and New Zealand faced the same problems with DFIs in 1980s.

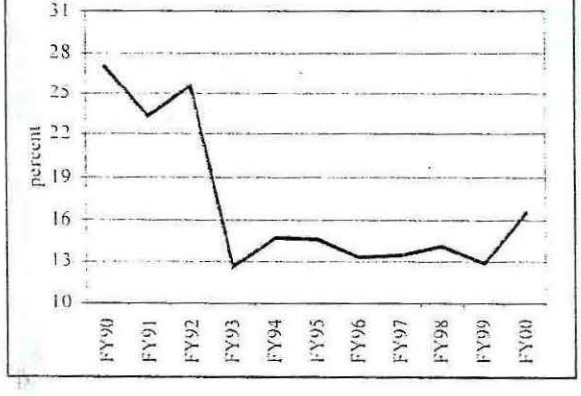
resources intensified the problem. Freezing of foreign currency accounts in FY98 also aggravated the problems. To cope with this situation, DFIs need drastic restructuring; at least minimum reforms aiming to resolve the problem of non-performing loans and concrete efforts to enhance sound management. Moreover, all DFIs must be set free from political pressure and steps must be taken to enhance their commercial business orientation along with efforts to manage these professionally and prudently.

4.1.2 Investment Banks

Investment banks (all in private sector) were established in late 1980s and early 1990s, and made rapid progress thereafter. Boom in stock exchanges, opening of FCAs along with favorable economic conditions in early 1990s contributed to speedy growth of investment banks. Total assets of investment banks witnessed sharp increase to Rs 42.1 billion in FY00 as compared to Rs 2.4 billion in FY90. As a result, their share in overall assets of NBFIs also increased significantly. The assets share of IBs increased from 1.9 percent in FY90 to 12.0 percent in FY00, indicating increased business activities of investment banks. As on end June 2000, 16 investment banks were in operation; their names along with their share in total assets are presented in **Annex 4** (see **Table 4A. 4**). The size of investment banks also varies considerably, as Al-Faysal and Crescent investment banks jointly hold around two-thirds of total assets.

Investment banks can undertake a wide range of business activities related to project financing and capital market, but they are not allowed to issue their own papers for less than 30 days maturity. IBs were also allowed to trade in listed securities, provide professional analysis of securities to investors, float and manage both open-end and closed-end mutual funds, and provide numerous corporate services. Due to these wide-ranging activities, IBs emerged as a new useful channel for both savers and borrowers, particularly when all banks were state-owned and lacked efficiency and quality of services. The favorable indicators like increasing share in assets, growth in deposits, and increase in loans and advances are suffice to prove the usefulness of these institutions. However, financial health review of these institutions requires detailed information about their capital adequacy, liquidity position, asset quality etc. Therefore, performance of investment banks in 1990s is evaluated with the help of CAMELS indicators.

Figure 4.7: Capital to Liability Ratio



Capital adequacy indicators of investment banks are reported in **Table 4.5**, indicating normal capital base. As shown in **Figure 4.7**, capital to liability ratio declined significantly upto FY93, mainly because of increasing liabilities (base effect). Since IBs were established in early 1990s, and as soon as business activities started to flourish, natural changes in their assets and liabilities structure occurred. In the initial years, the very high growth rates of assets and capital were due to lower base at that time. This, understandably, was not sustainable for longer period, implying a declining trend in capital to assets ratio in early 1990s, and a relatively stable trend for rest of the period, with most of the IBs well established by that time.

Table 4.5: CAMELS Indicators of Investment Banks

percent

	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Capital Adequacy											
Capital to liability ratio	27.3	23.7	25.8	12.8	14.9	14.8	13.5	13.6	14.2	13.0	16.6
Growth rate of capital (GRC)	414.7	74.3	92.2	36.4	55.0	8.0	11.0	14.4	14.2	-1.7	7.2
Growth rate of assets (GRA)	2300.2	95.3	79.3	146.6	35.4	8.4	20.8	13.3	10.1	6.2	-13.5
Ratio of GRC to GRA	0.2	0.8	1.2	0.2	1.6	1.0	0.5	1.1	1.4	-0.3	-0.5
Asset Quality											
Earning assets to total assets ratio	82.9	84.6	84.3	83.0	84.2	84.2	79.7	81.2	75.4	74.4	74.1
NPLs to gross advances	0.0	0.0	0.0	0.0	0.7	0.7	1.6	4.2	3.8	8.1	15.7
Loan defaults to gross advances	0.0	0.0	0.0	0.0	0.2	0.2	1.4	1.9	2.7	5.2	12.0
Recoveries to total default	-	-	-	-	17.7	17.7	0.5	6.2	24.0	12.5	5.2
NPLs to total assets	0.0	0.0	0.0	0.0	0.4	0.4	0.8	2.1	1.6	3.4	5.0
Advances to earning assets ratio	86.3	88.1	74.6	75.6	71.6	63.8	64.4	62.5	65.0	57.6	43.0
Investment to earning assets ratio	13.1	11.9	25.4	24.3	26.9	34.8	34.9	37.4	34.7	41.0	56.5
Management Soundness											
Total expense to total income ratio	92.4	87.2	83.6	83.4	81.9	86.3	92.0	91.5	99.9	99.8	93.4
Earning per employee*	0.7	3.1	3.5	6.7	7.9	8.5	11.7	8.2	9.9	10.7	9.1
Operating expense per employee*	0.3	0.4	0.6	0.8	1.9	1.8	2.0	1.2	1.5	1.3	1.2
Total expense per employee	0.7	2.7	2.9	5.6	6.5	7.3	10.8	7.5	9.9	10.6	8.5
Earnings and Profitability											
Return on assets	0.7	2.0	1.9	1.7	2.5	1.7	1.0	1.1	0.6	0.9	3.5
Net interest margin	1.3	2.3	2.5	2.2	3.3	2.3	1.5	1.3	0.6	0.0	0.8
Net income to total assets	2.6	10.3	9.5	10.6	12.9	13.4	17.4	13.3	13.1	13.3	14.6
Interest income to total assets	2.5	9.8	8.7	9.7	10.6	10.9	14.6	11.6	11.8	11.8	12.5
Interest expense to earning assets	1.8	9.3	7.8	9.5	9.3	10.6	16.7	12.9	15.1	15.9	16.1
Interest income to total income	96.8	91.5	87.5	87.2	79.0	79.0	81.7	84.9	88.0	87.2	83.9
Interest expense to total expense	61.0	84.1	79.4	85.3	71.4	75.1	81.3	84.0	84.4	87.4	85.8
Provisions to total assets	0.0	0.1	0.2	0.1	0.3	0.8	0.8	0.6	1.0	0.4	1.2
Liquidity and Sensitivity											
Liquid assets to total assets	16.2	12.0	17.4	20.4	18.8	17.7	14.5	10.9	15.0	16.8	14.0
Loans to deposits ratio	93.7	101.9	89.6	80.9	80.1	71.1	63.5	65.0	63.5	56.9	50.7
Borrowing to advances ratio	0.2	4.5	7.5	11.4	12.3	12.1	4.6	6.6	10.5	16.1	42.3
Borrowing to liabilities ratio	0.2	4.2	6.0	8.1	8.5	7.5	2.7	3.8	5.9	7.8	15.7
RSA to RSL ratio	108.3	110.6	112.5	97.9	101.9	102.5	95.9	99.6	91.5	90.6	97.0
Gap to capital ratio	29.6	42.4	45.8	-15.5	12.1	16.1	-28.5	-2.4	-56.0	-67.1	-16.0
Gap to total assets ratio	6.4	8.1	9.4	-1.8	1.6	2.1	-3.4	-0.3	-7.0	-7.7	-2.3

* million Rupees

After FY93, capital to liability ratio also remained stable with little variations. The other indicators including growth rates of assets and capital also showed normal trend, except for last two years. Given the poor growth rate of capital and assets in FY99, it is apparent that some of the IBs started to face the problem of capital adequacy.

As can be seen from **Table 4.5** and **Figure 4.8**, earning assets to total assets ratio showed declining trend in 1990s, indicating the squeezing earning base. Other indicators like non-performing loans to assets and gross advances ratios have also picked up momentum in second half of 1990s that may create problems for IBs in future. In addition, increasing loan defaults to gross advances ratio combined with widely fluctuating recoveries to default ratio may further aggravate the problem.

Although investment banks have changed their lending strategies, as their loans and advances have substantially decreased in relation to earning assets, this may not be sufficient to resolve the problem. An upward trend in non-performing loans to total assets and gross advances along with increasing loan defaults to gross advances signaled deteriorating asset quality, particularly in late 1990s.

Figure4.8: Asset Quality Indicators



Management soundness indicators are presented in **Table 4.5** and **Figure 4.9**, indicating upward trend in earnings and total expense per employee. The operating expense per employee also displayed an increasing trend, especially in mid 1990s, indicating that investment banks might have adequately compensated their employees for inflation. The table and figure also depict that expense to income ratio continued to increase from FY94, except for FY00, demonstrating that management could not succeeded in curtailing total expenses.

Figure 4.9: Management Soundness

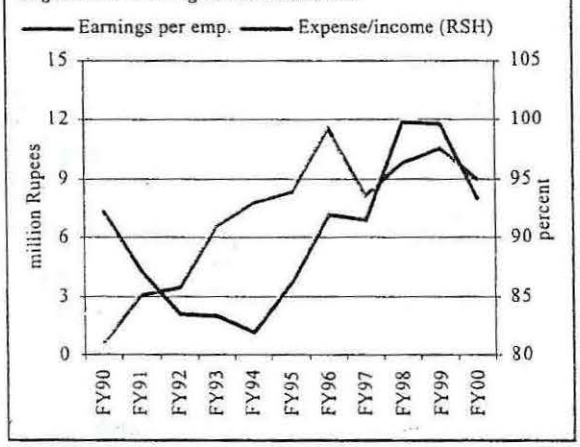
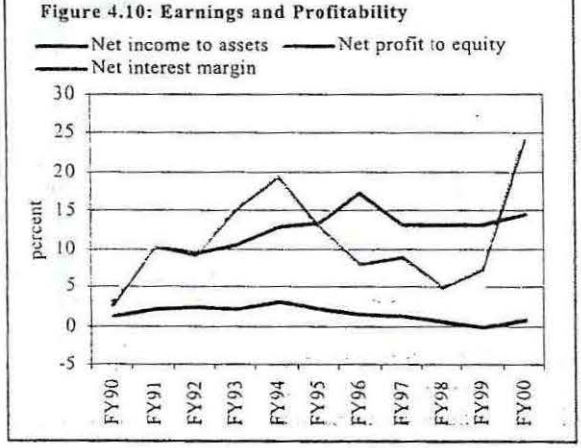


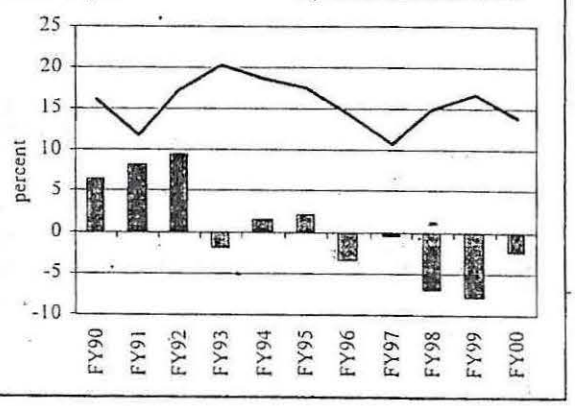
Table 4.5 displays the earnings and profitability indicators of investment banks. These provide mixed type of evidence as return on assets showed an upward trend with some fluctuations, resulting in an inconsistent income stream over time. In addition, **Figure 4.10** depicts that NIM has decreased from 1.3 percent in FY90 to 0.8 in FY00, showing decreasing possibilities to make profits. Interest expense to earning assets ratio--break-even yield--has jumped up from 1.8 percent to 16.1 percent during the decade , which shows that investment banks require high interest rates to earn some profits. This is mostly due to the liquidation of foreign currency certificates of investment (COIs) and declining return from their investment portfolio. However, the situation has marginally improved in FY00, as return on assets, net income to assets ratio and NIM slightly increased. Along with freezing of foreign currency COIs, poor earnings and profitability was attributed to some weak investment banks, and overall slower macroeconomic situation. Furthermore, the fact that interest income accounted for around 80 percent of IBs total income shows that fee-based financial activities of IBs to capital market investors and corporate sector remained limited.

Figure 4.10: Earnings and Profitability



Liquidity indicators painted almost the same picture as in early 1990s. **Table 4.5** and **Figure 4.11** display that liquid to total assets ratio fluctuated in a narrow band and did not show any significant decline in 1990s. Another important indicator, loans to deposits ratio declined significantly, demonstrating the efforts to mobilize deposits to meet their financing requirements. It also depicts that risk exposure indicators remained within the range of test limits, reflecting prudent interest rate polices. IBs remained balanced in terms of asset and liability sensitivity as their gap to assets ratio remained within the test limits, but fluctuated around zero.

Figure 4.11: Liquidity and Sensitivity



In short, the indicators discussed above provide mixed type of analysis, as asset quality indicators show a trend of deterioration whereas liquidity indicators showed some improvement. This type of situation indicates that certain IBs are facing problems in select areas, like poor asset quality, but the intensity of the problem is not severe. However, the mounting non-performing loans may hurt investment banks in future by eroding their capital base. Recoveries of defaulted loans to total advances ratio witnessed negative trend in late 1990s, indicating the need for extra efforts from management side to cope with this problem. Furthermore, their market niche seems to have been affected particularly with the emergence of private banks, the freezing of FCAs, and limited activity of IBs in the area of project financing, a fact confirmed by some IBs in recent years merging with banks and NBFIs. In a nutshell, IBs could not perform their basic role as a promoter of project financing and provider of professional financial services to their clients.

4.1.3 Leasing Companies

The commencement of leasing business dates back to mid 1980s, when first leasing company was established in 1984. Since then leasing companies grew rapidly, particularly in late 1980s and early 1990s. Their share in business activities also increased significantly in 1990s. As already shown in **Table 4.1**, the assets share of leasing companies increased from 4.7 percent in FY90 to 11.1 percent in FY00. The driving force behind this phenomenal growth was increasing demand for corporate credit, and fiscal incentives provided to the leasing companies through depreciation allowance that reduced their current tax liabilities. The policy to introduce Islamic modes of financing in mid 1980s also played an important role in creation of leasing companies. To benefit from this favorable environment, many financial institutions and business groups set up their own leasing companies. Their focus was on special market segments like leasing of plant and machinery, vehicle leasing, and consumer durables.

As was the case with other NBFIs, leasing companies also experienced slackening of growth in late 1990s, mainly attributed to slower economic and industrial activities. Despite these adverse developments, leasing companies remained financially viable as compared to other NBFIs, mainly due to shift in their business focus toward consumer durables, like vehicle lease financing.

Performance of leasing companies also measured well in terms of key indicators. It is clear from **Table 4.6** that leasing companies enjoyed ease of capital adequacy, as their capital to liability ratio remained above 20 percent except for FY90, also indicating the ability of leasing companies to absorb shocks or unanticipated losses. In addition, this helped to build market confidence and attract new investment as well. However, this higher ratio witnessed significant decline in the second half of 1990s.

Two other indicators, growth rates of capital and growth rate of assets also recorded an increase for most of the years. The double digit growth in assets and capital was severely undermined in 1998 due to a variety of factors. Overall slower growth of the economy in late 1990s coupled with problems pertaining to the long-term resource mobilization was mainly responsible for the lower leveraging of leasing companies. That is one reason for better capital adequacy in this sector, as institutions were utilizing their own resources.

Table 4.6: Performance Indicators of Leasing Companies

percent

	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Capital Adequacy											
Capital to liability ratio	13.2	29.3	33.4	32.5	27.3	35.3	30.4	29.9	29.1	26.9	25.1
Growth rate of capital	-	61.4	71.2	31.2	28.8	56.5	20.1	12.7	3.3	0.9	4.4
Growth rate of assets	-	17.2	54.9	34.2	47.2	28.5	34.3	14.3	5.4	7.5	10.0
Asset Quality											
Earning assets to total assets ratio	84.8	88.2	89.2	89.8	89.6	87.3	89.4	88.5	87.1	87.3	87.0
Equity to total assets ratio	11.6	22.7	25.1	24.5	21.4	26.1	23.3	23.0	22.6	21.2	20.1
Lease finance to earning assets	85.8	90.0	89.1	90.7	90.3	89.1	89.6	89.0	87.0	87.3	87.2
Investment to earning assets	14.1	9.9	10.8	9.0	9.5	10.5	9.6	10.8	12.3	11.6	11.6
Earnings and Profitability											
Expense to income ratio	95.1	83.7	69.7	69.5	67.1	71.6	76.8	83.2	87.3	88.4	87.1
Return on Assets	2.6	3.4	4.0	4.3	5.5	4.2	3.9	2.4	1.5	1.5	1.7
Return on Equity	22.4	15.2	15.8	17.7	25.6	16.2	16.7	10.6	6.7	7.0	8.4
Operating expense to total expense	45.2	38.3	33.4	29.7	26.3	23.1	26.4	22.2	20.6	20.7	22.0
Financial expense to total expense	51.7	55.3	60.4	65.6	69.5	71.1	68.5	68.0	68.9	69.1	67.6
Provisions to total expense	3.8	7.8	9.1	7.6	7.1	8.7	7.8	9.8	10.5	10.3	10.3
Other Indicators											
Long-term liabilities to total liabilities	33.9	55.6	61.8	63.4	54.8	54.7	50.1	54.9	48.5	49.7	55.0
Long-term assets to total assets	30.9	50.4	52.2	56.0	54.3	52.3	55.8	51.6	46.3	47.7	46.3

Asset quality indicators, presented in **Table 4.6**, show that earning assets to total assets ratio remained over 80 percent for the period under consideration, fluctuating in a narrow band of 5 percentage points. This also highlights a strong earning base. Leasing companies are mainly engaged in extending lease financing, with over 85 percent earning assets locked therein. The rest of earning assets are parked in long as well as short-term investment activities. Initially, leasing companies were supposed to facilitate BMR activities of the industrial sector, with major focus on lease of plant and machinery, which constituted over 80 percent of total lease finance in early 1990s. This share later declined to around 50 percent due to slower growth in textile sector along with overall weak performance of the economy. This declining share was captured by vehicle lease finance as leasing companies changed their focus to consumer durables. The share of vehicle financing is now over 30 percent in total lease finance, indicating that these companies were able to retain good quality of assets by changing their focus of business from one sector to another.

Earnings and profitability indicators of leasing companies provide mixed evidence. Expense to income ratio, although remained lower than 100 percent during the period under consideration, witnessed persistent increase from FY94 to FY99.[9] However, this situation has marginally improved in FY00. Another important indicator, the return on assets, also declined significantly. Increasing

[9] This was the period of slower overall economic growth. At the same time, leasing companies were trying to change focus of lease finance form plant and machinery to consumer durables.

trend in other indicators like financial expense to total expense and provisions to total expense mainly drove down their profitability. Furthermore, these indicators also highlight the problem of resource mobilization. The rising portion of financial expense clearly suggests that leasing companies had to offer higher interest on certificates of investment as well as on long-term deposits. The increasing provisions against bad loans as well as investment also contributed to higher expenses and ultimately to lower profit.

Other indicators showed that long-term liabilities to total liabilities ratio increased from 33.9 percent in FY90 to 63.4 percent in FY93, which suggests that leasing companies were able to mobilize long-term resources in early 1990s. This ratio declined by around 15 percentage points from FY93 to FY98. This massive decline reflects the inability of leasing companies to generate long-term resources, which also led to higher financial expense over the same period. However, the situation slightly improved over the last two years. On the asset side, long-term assets to total assets ratio approximately followed the same path as the long-term liabilities to total liabilities ratio. This suggests that leasing companies were mostly able to match their long-term assets to long-term liabilities.

The above indicators jointly suggest that the business of leasing companies remained financially viable as a whole. However, the poor performance of some indicators like increasing financial expense to total expense, provisions to total expense, return on assets etc., provide indications of presence of some weak leasing companies. To protect the financial health of leasing companies, the minimum paid-up capital requirement was raised to Rs 200 million in 1997. The companies were asked to meet the new limit by the end of December 1999. Later on, this date was extended to 30th June 2001, as most of the companies were unable to meet the new minimum paid-up capital. Upto 30th June 2000, only nine companies were fully compliant with the new limit and this number increased to twelve on 31st December 2000. Besides this requirement, increasing competition in lease finance due to entrance of banks in this business, and proactive role of banks in SMEs may result in the merger of some leasing companies.[10] However, it is hoped that financially strong leasing companies will continue to play an increasingly vital role in overall activities of NBFIs.

4.1.4 Modaraba Companies[11]

Following leasing companies and investment banks, modaraba companies also grew rapidly in late 1980s and early 1990s. Specifically, the modaraba business came into being in July 1980 when the first modaraba company was established. Later on two other modaraba companies started business in 1985, and one in 1987. The driving force behind this growth of modaraba companies was Islamization efforts in mid 1980s, because their modes of financing were compatible with the views of Islamic Shariah. However, real impetus to modaraba business came in early 1990s, when financial market was growing in response to liberalization of the economy. Tax-free status of modaraba companies, subject to 90 percent dividend distribution, also played a critical role in the mushroom growth of these companies. Besides, modaraba companies established in 1990 to 1993 heavily benefited from the boom in stock exchanges. Furthermore, growing need of financing from corporate sector coupled with higher growth of the economy in early 1990s also contributed positively to create favorable environment for modaraba business. The wider range of financing activities of modaraba companies, including vehicles in addition to industrial machinery and other goods, also played its role. However, this smooth sailing of modaraba business was disrupted by the withdrawal of tax concession.[12]

[10] The process of mergers and issuance of right shares to meet the minimum paid up capital has been started, as Ghandhara Leasing Company Limited merged with Al-Zamin Leasing Modaraba; Ibrahim Leasing Limited with Ibrahim Modaraba; and Mercantile Leasing Cooperation Limited with Universal Leasing Cooperation.

[11] The analysis of modaraba companies is based on data from FY94 to FY00.

[12] In Finance Act 1992, modaraba companies were brought under tax net by withdrawing the exemption. However, these companies remained exempted from income tax for the first three years and taxed at the rate of 2.5 percent for another two

The number of operating companies increased from 10 to 45 over the period of analysis. Despite positive developments in early 1990s, the business activities of modaraba companies did not keep pace with growing activities of leasing and investment banking, and their share in overall assets of NBFIs only marginally increased from 3.5 percent in FY94 to 4.3 percent in FY00. As already mentioned, the prime dampener to their growth was the withdrawal of tax-free status in 1992. In this backdrop, the total assets of modaraba companies witnessed slower growth as it increased from Rs 11.8 billion in FY94 to only Rs 15.0 billion in FY00.

The performance indicators of modaraba companies painted an assorted picture. As can be seen from **Table 4.7**, the various indicators witnessed marginal improvements in the last couple of years. More specifically, modaraba companies were lucky enough to benefit from a very strong capital base, as the capital to liability ratio was over 100 percent for most of the years. This higher ratio could be explained by the fact that several modaraba companies based their financing activities on their own equity capital. Although this ratio witnessed persistent decline form FY94, it remained fairly high, indicating that modaraba companies were also facing difficulties in mobilizing long-term resources. Two other indicators, growth rate of capital and assets are also worth mentioning. Growth of capital was lower than the growth of assets, which suggests that capital base of these companies did not keep pace with the increasing assets.

Table 4.7: Performance Indicators of Modaraba Companies

percent

	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Capital Adequacy							
Capital to liability ratio	142.2	138.7	138.2	119.2	107.7	90.5	89.4
Growth rate of capital	-	6.7	-0.7	2.8	4.1	-10.6	0.5
Growth rate of assets	-	7.8	-0.6	9.7	9.1	-2.5	1.1
Capital to Asset Ratio	58.7	58.1	58.0	54.4	51.8	47.5	47.2
Asset Quality							
Earning assets to total assets ratio	70.8	69.6	69.4	73.1	75.5	78.3	77.8
LT earning assets to total earning assets	54.3	60.7	64.9	59.2	64.3	65.9	67.4
Lease finance to earning assets	44.2	48.1	49.9	51.9	54.9	52.3	52.7
Investment to earning assets	11.9	17.4	21.2	15.2	17.5	20.8	20.8
Morabaha and Musharaka to earning assets	43.9	34.6	28.9	32.9	27.6	26.9	26.4
Earnings and Profitability							
Expense to income ratio	62.5	72.9	81.1	78.5	87.7	80.8	81.6
Return on Assets	10.7	4.9	3.3	4.4	2.2	4.6	4.6
Return on Equity	18.2	8.4	5.8	8.1	4.2	9.8	9.7
Operating expense to total expense	14.2	19.5	11.0	12.3	10.5	10.3	10.8
Financial expense to total expense	21.4	20.8	22.1	23.2	22.1	33.1	28.6
Provisions to total expense	4.3	12.3	11.9	9.4	18.7	7.6	5.8
Amortization/Depreciation	54.9	43.9	52.5	52.2	47.6	46.9	52.2
Dividend Payouts	39.5	49.7	91.6	69.7	121.1	85.4	86.7
Other Indicators							
Long term liabilities to total liabilities	15.2	17.4	39.6	35.9	44.2	44.6	42.7
Long term assets to total assets	40.2	45.0	49.0	47.5	51.9	53.3	54.4

Earning assets to total assets ratio had a moderately increasing trend over the period under consideration (see **Table 4.7**), indicating that earning capacity of these companies remained intact or marginally increased. However, this ratio should be interpreted with caveat as marginal returns on

years. After that the rate became 25 percent. Tax exemption status of modaraba companies was reviewed again in 1998 and restored for non-trading modaraba companies with effect from 1st July 1999.

earning assets have significantly declined over the same period. The portfolio of modaraba companies witnessed significant changes over the period under review. As can be seen from the **Table 4.7**, the modaraba companies were actively participating in lease financing, which in FY00 constituted over 50 percent of earning assets.[13] The share of investment in earning assets has increased while the share of Morabaha and Musharaka has significantly declined from FY94 to FY00.[14] This changing portfolio provides clear evidence that the share of risky assets (equity investment) increased in total earning assets of these companies. Furthermore, the profitability of the modaraba companies also depends heavily on the performance of equity market.[15]

Expense to income ratio has increased significantly over the period under consideration. More specifically, the ratio has surged from 62.5 percent in FY94 to 81.6 percent in FY00. This rise in the ratio stemmed from both declining income as well as increasing expenditure. The former was the upshot of overall slower economic growth along with weak performance of equity markets in late 1990s. Furthermore, declining capital gains on investment in equity market also resulted in lower growth in income. On expenditure front, despite almost stagnant operating expenses the growth in total expenditure was more visible. The push factors were increasing financial charges, higher provisions for bad debts and for diminishing value of investment in capital market. All these factors can easily be observed from **Table 4.7**. The higher provisions on investment in capital market are of vital concern and its roots date back to early 1990s when stock market was at its peak. The modaraba companies entered the market at that time and bought shares at high prices. When stock market collapsed, these companies were unable to off load their holdings to a large extent. This resulted in a large number of sick modarabas holding shares that were bought at higher prices. This can also be seen from increasing provisions against diminishing value of investment, which is one of the major push factors for higher expenditures.

Furthermore, the funds locked in equity investment also created a resource problem. Given the weak performance of equity market and limited ability of modarabas to mobilize funds, the tight regulations also played a role as modaraba companies with credit rating less than B-3 could not borrow from the banking system. Furthermore, instruments approved by Religious Board are also not acceptable for bank borrowing. This situation forced these companies to borrow at higher rates, which resulted in higher financial charges leading to higher expenditures.

Two other ratios, long-term liabilities to total liabilities and long-term assets to total assets have increased considerably from FY94 to FY00. The former shows that modaraba companies were able to attract long-term resources but at a very high cost as the financial expense to total expense was also increasing over the same period. While the latter suggests that modaraba companies have locked their assets for longer time.

In sum, the overall performance of modaraba companies was affected by the withdrawal of tax-free status granted to them earlier. Due to this reason, the business growth of modaraba companies was quite limited from FY94 to FY00. An additional dampener to modaraba companies came from weak position of stock exchanges as compared to early 1990s. The overall weak performance of the economy in the second half of 1990s compared to first half also played a role.

4.1.5 Housing Finance Companies

Like DFIs, HFCs were also on losing end, as their share in total assets of NBFIs declined from 12.3 percent in FY90 to just 6.3 percent in FY00. Although total assets of HFCs increased from Rs 16.5

[13] In FY00, around 70 percent of leased out assets were in plant and machinery, while the rest were motor vehicle lease.
[14] Like modaraba, morabaha and musharaka are different Islamic modes of financing. For definitions, see Faruqi, Shakil "Glossary: Banking and Finance" Institute of Bankers Pakistan, Second edition June 2001.
[15] The modaraba companies are allowed to invest 20 percent of their capital in equity market.

billion to 22.3 billion over the period, the growth was lower as compared to other NBFIs like investment banks and leasing companies.

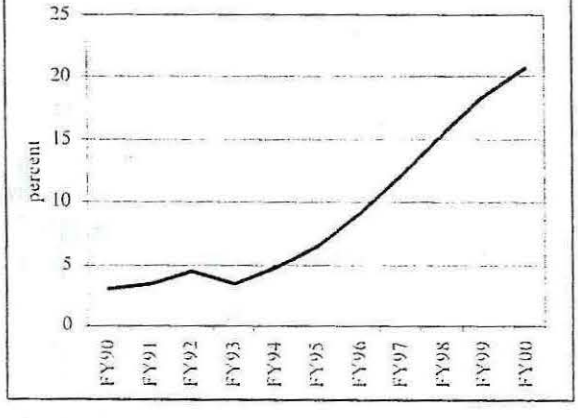
Before the emergence of new housing finance companies, HBFC enjoyed monopoly power in housing finance, as commercial banks were not allowed to enter into these activities. The share of HBFC is over 95 percent in overall assets of HFCs. The history of HBFC dates back to 1952, when it was established to cater the needs of housing finance sector. In 1990s, three new housing companies were established, but held a meager share in total assets of HFCs and still trying to find their niche. Asset shares of these companies are presented in **Table 4.8**, indicating that new entrants remained unable to provide any major break-through in housing finance.

Table 4.8: Asset Shares of Housing Finance Companies

	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Total assets (billion Rupees)	16.5	16.7	17.9	18.6	18.9	19.4	20.2	20.4	21.3	21.5	22.3
Growth rate (percent)		1.5	6.6	4.0	2.0	2.6	3.7	1.0	4.6	1.1	3.3
Asset shares (percent)											
HBFC	100.0	100.0	99.4	98.7	97.7	97.0	94.1	94.6	95.2	95.9	96.9
LTV Housing Finance Ltd	-	-	-	-	-	0.3	0.2	0.2	0.2	0.2	0.2
International Housing Finance Ltd	-	0.0	0.0	0.4	0.3	0.3	2.0	2.0	1.9	2.0	1.8
Citibank Housing Finance Co. Ltd	-	0.0	0.6	0.9	2.0	2.5	3.6	3.1	2.7	1.8	1.1
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

The financial health of HFCs is evaluated with the help of CAMELS framework, indicating overall normal position of HFCs. Capital adequacy indicators presented in **Table 4.9**, showed considerable improvement in 1990s in terms of their capital to liability ratio, which increased from 2.8 percent in FY90 to 20.6 percent in FY00. **Figure 4.12** displays that capital to liability ratio witnessed a persistent increase from FY93. In addition, growth rate of capital remained higher than the growth rate of assets, indicating the efforts to improve their capital base. Despite all these positive indicators, the growth of assets remained very slow, which also explains the declining share of HFCs in overall assets of NBFIs.

Figure 4.12: Capital to Liability Ratio



Contrary to adequate level of capital, asset quality indicators painted a pale picture. As shown in **Table 4.9**, non-performing loans to total assets ratio showed a significant increase in 1990s, doubling in just five years. The problem is further intensified, when analyzed in the context of earning assets to total assets ratio, which has also declined from 90.8 percent in FY90 to 78.2 percent in FY00.

In addition, continuously increasing non-performing loans to gross advances ratio indicates the squeezed earning base of HFCs. **Figure 4.13** shows that NPLs to total assets and gross advances are constantly growing, which may hurt the HFCs in near future. Although capital to assets ratio is increasing, this trend does not seem sustainable. In brief, the asset quality of HFCs has deteriorated considerably because of increasing non-performing loans, but strong capital base may help to honor their liabilities in near future. Over the period under review, the composition of earning assets has drastically changed, as the share of investment in total earning assets has increased from 3 percent in FY90 to 34.5 percent in FY00. This also implies that HFCs were not extending loans to housing

sector (for which these companies were created) but diverting their resources towards investment. This is reinforced when seen in the context of declining earnings to total assets ratio.

Figure 4.13: Asset Quality

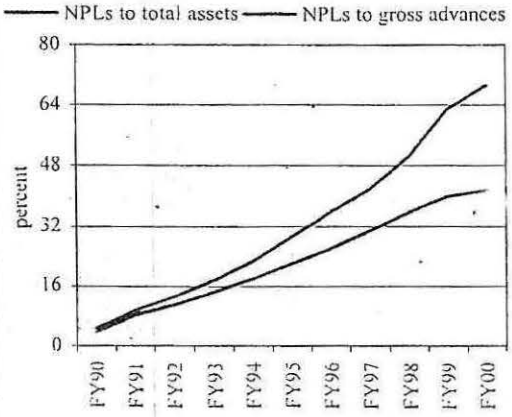


Figure 4.14: Management Soundness*

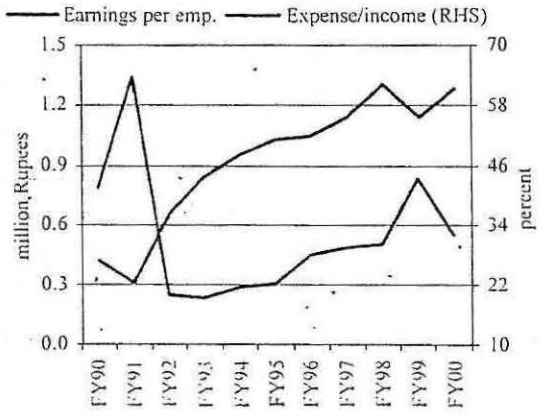


Figure 4.15: Earnings and Profitability

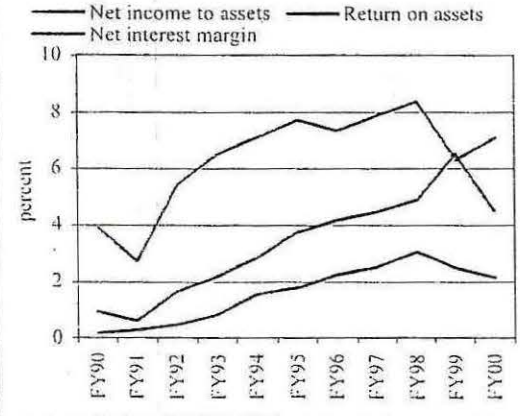
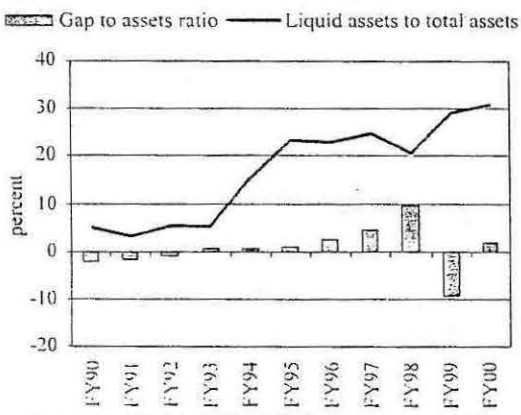


Figure 4.16: Liquidity and Sensitivity



Management soundness indicators are reported in **Table 4.9**, which provide some evidence of their cost effective policies, as total expense per employee are significantly lower as compared to earnings per employee. As can be seen from **Table 4.9**, the gap between earnings and total expense per employee was almost constant except for few years, indicating the management efforts to generate consistent income stream for the institutions. Operating expense per employee also remained constant upto FY97; marginal increase afterwards might be attributed to inflation compensation to employees in late 1990s.

Earnings and profitability indicators as shown in **Table 4.9** portray a strong earning profile in 1990s, as return on assets and interest income to total assets increased significantly. In addition, NIM has also increased from 0.9 percent in FY90 to 4.5 percent in FY00, reflecting the strong possibilities to earn profit. Interest expense to total assets ratio--break-even yield--remained below one percent, showing that profit earnings capability of HFCs have increased even at lower interest rates. **Figure 4.15** displays the rising trend of earnings and profitability indicators, with some fluctuation toward the end of the decade. Although provisions for loan losses to assets ratio have increased considerably, huge non-performing loans may hurt these institutions in future.

Table 4.9: CAMELS Indicators of Housing Finance Companies

percent

	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Capital Adequacy											
Capital to liability ratio	2.8	3.3	4.4	3.4	4.6	6.4	9.1	11.9	15.2	18.3	20.6
Growth rate of capital (GRC)	7.5	18.2	39.3	-18.9	37.6	39.0	43.9	29.5	29.8	18.6	13.8
Growth rate of assets (GRA)	7.9	1.5	6.6	4.0	2.0	2.6	3.7	1.0	4.6	1.1	3.3
Ratio of GRC to GRA	1.0	12.1	5.9	-4.7	18.6	14.8	11.8	28.8	6.5	16.5	4.1
Asset Quality											
Earning assets to total assets ratio	90.8	91.8	89.5	89.7	90.0	88.4	89.4	89.8	90.6	70.1	78.2
NPLs to gross advances	4.3	9.2	13.2	17.7	22.6	29.2	35.8	41.8	50.4	62.9	69.3
NPLs to total assets	3.8	8.2	11.1	14.6	18.1	22.1	26.4	30.9	35.8	40.0	41.7
Advances to earning assets ratio	97.0	95.5	90.7	87.6	84.0	80.0	75.5	74.1	69.3	77.6	65.5
Investment to earning assets ratio	3.0	4.5	9.3	12.4	16.0	20.0	24.5	25.9	30.7	22.4	34.5
Management Soundness											
Total expense to total income ratio	41.3	63.4	19.7	19.3	21.4	22.1	27.9	29.5	30.3	43.2	31.8
Earnings per employee*	0.4	0.3	0.7	0.8	1.0	1.0	1.0	1.1	1.3	1.1	1.3
Operating expense per employee*	0.2	0.2	0.1	0.2	0.2	0.2	0.2	0.2	0.3	0.4	0.4
Total expense per employee	0.2	0.2	0.1	0.2	0.2	0.2	0.3	0.3	0.4	0.5	0.4
Earnings and Profitability											
Return on total assets	0.1	0.3	0.5	0.9	1.5	1.8	2.2	2.5	3.1	2.5	2.2
Net interest margin	0.9	0.6	1.6	2.2	2.9	3.7	4.1	4.4	4.9	6.5	4.5
Interest income to total assets	0.9	0.6	1.5	2.0	2.8	3.6	4.2	4.8	5.0	5.1	3.9
Net income to assets ratio	3.9	2.7	5.4	6.5	7.1	7.8	7.3	7.8	8.4	6.4	7.1
Interest expense to earning assets	0.1	0.0	0.1	0.1	0.2	0.3	0.6	0.9	0.7	0.8	0.5
Interest income to total income	22.1	20.7	25.6	28.6	35.0	41.5	49.8	52.6	51.0	67.4	47.5
Interest expense to total expense	4.0	2.3	5.4	5.1	11.0	15.9	21.6	29.7	20.3	16.7	13.9
Provisions for loan losses to total assets	1.0	4.8	5.8	6.4	7.0	7.6	8.6	9.7	10.5	11.6	11.3
Liquidity and Sensitivity to Market Risk											
Liquid assets to total assets	4.7	2.9	5.3	5.1	15.2	23.4	22.9	24.6	20.5	29.0	30.8
Borrowing to advances ratio	105.6	106.6	111.4	113.1	118.0	123.5	127.5	127.2	128.4	144.0	148.0
Borrowing to liabilities ratio	95.7	96.6	94.4	91.9	93.3	92.8	93.9	94.8	92.9	92.7	91.4
RSA to RSL ratio	97.6	98.2	99.0	100.9	100.9	101.0	102.9	105.3	111.8	88.3	102.3
Gap to capital ratio	-80.5	-51.8	-22.2	25.0	17.3	14.0	30.8	42.5	72.3	-59.9	10.2
Gap to total assets ratio	-2.2	-1.7	-0.9	0.8	0.8	0.8	2.6	4.5	9.6	-9.3	1.7

*: million Rupees

HFCs enjoyed the ease of liquidity position because of high liquid assets to total assets ratio as shown in **Table 4.9** and **Figure 4.16**. The ratio has increased from 4.7 percent in FY90 to 30.8 percent in FY00. An interesting indicator is borrowing to advances ratio, which consistently remained over the mark of hundred percent during the period under review. This implies that HFCs are borrowing not only to finance their loans and advances but also to make other assets. This also suggests that the HFCs do not have their own resource base to finance higher demand of housing sector. Borrowing to liability ratio of over 90 percent also strengthens this point.

The sensitivity indicators portray a reasonable picture, as interest/markup policies remained effective. The gap to equity and assets ratios fluctuated within the test limits. In addition, difference between rate sensitive assets and rate sensitive liabilities did not follow any systematic pattern, indicating efforts of these companies to remain at balance, i.e. neither asset sensitive nor liability sensitive.

As a whole, increasing capital base, strong earning profile, easy liquidity position combined with prudent interest rate/markup policies indicate normal financial health of HFCs. However, these indicators do not reflect the true picture of HFCs as the deteriorating asset quality along with very high borrowing to liability ratios suggest that the financial health of HFCs is far from normal. The strong profitability indicators look contradictory when jointly seen with asset quality indicators. This might be attributed to two factors; first, these institutions might have classified the income against non-performing loans in receivable income, instead of showing in suspense account; and secondly, the poor asset quality might affect the profitability of the institution with some time lag. However, the first case is more likely, as the higher income may seem to be enhancing the performance of management and profitability indicators.

4.1.6. Mutual Funds

The history of mutual funds in Pakistan dates back to early 1960s, when National Investment Trust Limited (NIT) was established to manage an open-end mutual fund. In the second half of the decade, the government established another institution named Investment Corporation of Pakistan (ICP) to float and manage closed-end mutual funds.[16] On 30th June 2000, the total holding of mutual funds industry stood at Rs 30.4 billion, with 8.6 percent share in overall assets of NBFIs. As ICP and NIT deal with entirely different type of mutual funds, it is therefore necessary to analyze the closed-end and open-end mutual funds separately.

NIT is the largest open-end mutual fund in Pakistan, operating with the objective to cater long term investment requirement of the investors and play its role in the development of capital markets. NIT's open-end fund of size Rs 20.6 billion in FY00 represents over 98 percent of total open-end funds in the country.[17] NIT fund, which depicted a mixed growth performance over the decade, continued to dominate the open-end funds. As can be seen from **Table 4.10**, NIT fund recorded massive growth in first half of 1990s, as the size of the fund surged to Rs 52.1 billion in FY94 as compared to Rs 17.8 billion in FY91. This phenomenal growth, besides overall conducive environment of equity market, was largely driven by higher dividend payouts. In addition to this, capital gains in terms of higher price of NIT units were obviously contributing to this positive end.

Table 4.10: Key Statistics of NIT Open-end Mutual Fund

	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Par value (Rupees)	10	10	10	10	10	10	10	10	10	10
Dividend payout (Rupees)	-	-	2.25	2.35	2.35	1.50	1.00	1.30	1.00	1.10
Net asset value (Rupees)	-	-	-	-	14.43	13.83	12.02	6.53	7.64	10.69
Capital (bln Rupees)	15.6	30.5	28.9	46.3	32.8	34.0	24.9	11.0	12.7	16.9
Size of fund (bln Rupees)	17.8	33.8	33.4	52.1	39.0	38.2	29.0	16.1	16.2	20.6

This massive growth in first half of 1990s witnessed sharp reversal in the second half, as NIT units started loosing its net asset value following the weak performance of equity markets. However, the situation has marginally improved in the last couple of years.

The financial health of National Investment Trust Limited (NITL), which manages NIT open-end mutual, closely followed the performance of this fund; impressive growth in early 1990s and deteriorating position later. Total equity of the company increased from Rs 56 million in FY90 to Rs 417 in FY94 and witnessed a sharp decline to reach Rs 115 million in FY98. Although equity position slightly improved in last two years, it was far below the level achieved in FY94. The income

[16] Specifically, NIT was established in 1962, while ICP in 1966.

[17] The government notified Asset Management Rules in 1995 to promote open-end funds in the country. Following this, Unit Trust of Pakistan (an open-end fund) was established in 1997. As already mentioned, NIT holds over 98 percent of open-end funds, therefore, private open-end funds have yet to carve their niche.

of the company also followed almost the same pattern as that of equity and the size of open-end fund, indicating that management fee was the prime source of income for the company. Compared to income trend, the total expense of the company continued to increase upto 1996. After declining in 1997, an upsurge in FY98 occurred on account of Golden Handshake Scheme (GHS).

Investment Corporation of Pakistan (ICP) is managing closed-end funds. Upto June 2000, ICP has floated 26 closed-end mutual funds, whereas the first was launched in June 1967. ICP enjoyed monopoly status in the establishment of closed-end mutual funds until 1981 when the government allowed the private sector to establish and manage closed-end funds. The first closed-end fund in private sector named Golden Arrow was established in 1983. By FY00, the number of closed-end funds launched and managed by the private sector increased to 13. Contrary to this increase in number of funds, the share of private sector mutual funds remained very low, as the ICP-managed funds represent over 75 percent of total closed-end funds in Pakistan.

The performance indicators of closed-end funds are shown in **Table 4.11**, which shows that ICP managed funds performed relatively better compared to private sector. Net asset value of privately managed funds was as low as Rs 5.10 in FY99 against par value of Rs 10. However, the situation improved considerably in FY00. Besides other factors, the private mutual fund business did not commence at a favorable time, as most of the funds were established in second half of 1990s. Nevertheless, closed-end mutual funds managed by ICP remained financially viable, as the net asset value of these funds (in totality) was higher than the par value of Rs 10. Compared to this, the private mutual fund business is still in its infancy.

Table 4.11: Key Statistics of Closed-end Mutual Funds

	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Number of funds	23	25	29	37	39	39	39	39	39
Managed by ICP	21	23	23	26	26	26	26	26	26
Private	2	2	6	11	13	13	13	13	13
Dividend payouts by funds (Numbers)									
Managed by ICP	21	21	23	23	23	21	21	15	15
Private	2	2	0	0	0	2	2	4	6
Net asset value (Rupees)	121.27	92.34	77.15	77.46	46.95	28.65	9.11	9.22	13.86
Managed by ICP	129.58	97.85	91.20	103.56	66.22	39.67	10.96	11.36	17.07
Private	12.81	8.86	10.19	10.34	9.60	7.32	5.51	5.07	7.64
Listed capital (mln Rupees)	1,981	2,281	2,831	4,361	4,761	4,761	4,761	4,761	4,761
Managed by ICP	1,840	2,140	2,340	3,140	3,140	3,140	3,140	3,140	3,140
Private	141	141	491	1,221	1,621	1,621	1,621	1,621	1,621
Net assets (mln Rupees)	24,024	21,064	21,841	33,782	22,351	13,641	4,335	4,389	6,600
Managed by ICP	23,843	20,939	21,341	32,519	20,795	12,455	3,442	3,568	5,361
Private	181	125	500	1,263	1,556	1,186	893	821	1,239

In contrast with the performance of ICP-managed funds, ICP performed poorly. The total assets of ICP almost doubled from Rs 2.4 billion in FY90 to Rs 4.6 billion in FY97 but witnessed a sharp decline during the last three years reaching a level of Rs 2.6 billion in FY00. Following the same pattern, the equity of the company increased to Rs 613 million in FY97 as compared to Rs 280 million in FY90. In sharp contrast with the earlier performance, the ICP became technically insolvent in FY98, as it showed a negative net worth of Rs 633 million.

As already mentioned, the net asset value of closed-end mutual funds managed by ICP was higher than Rs 10 while dividend was also announced by 15 funds, indicating that mutual fund business of ICP seemed to be financially viable. Therefore, the poor performance of ICP could mainly be

attributed to its other business activities like project loan program, deposit schemes etc. Non-performing loans of ICP touched the level of Rs 1.5 billion in FY00 against Rs 0.8 billion in FY90, a further threat to ICP financial health.

Due to the poor performance of ICP and NITL, the government has ordered the proceedings for the winding up of ICP and the funds managed by ICP are being handed over to prospective buyers through privatization. Similarly, NIT is also expected to be privatized.

4.1.7 Discount Houses

Discount houses, which are only allowed to undertake discounting and related services in the country, hold a tiny share in overall business activities of NBFIs. Only three discount houses were in operation in FY00 and these jointly held assets of Rs 1.3 billion as compared to Rs 0.9 billion in FY90. **Table 4.12** shows that total assets of discount houses displayed a considerable variation over the period of analysis. The discounting activities also varied considerably along with the interest income. In spite of this erratic behavior, these institutions remained profitable. Discount houses are relatively new entrants in the market and still trying to position themselves. Their activities are likely to flourish with the passage of time.

Table 4.12 Discount Houses

million Rupees

	Assets	Discounting	Interest income	Net profit
FY90	929	11	74	4
FY91	1103	102	121	23
FY92	816	268	126	31
FY93	1276	691	162	49
FY94	778	344	126	56
FY95	812	445	63	26
FY96	976	568	152	57
FY97	1524	902	227	49
FY98	1603	808	270	94
FY99	1601	924	239	77
FY00	1312	713	218	78

4.1.8 Venture Capital Companies

Venture capital companies held less than one percent of total assets of NBFIs, being relatively new entrants in the market as compared to other NBFIs. Focused nature of their business activities, along with overall slower economic growth in late 1990s might have restricted the expansion of these institutions. Although VCCs could not increase their market activities as compared to investment banks and leasing companies, these institutions seemed to have performed prudently. Total assets of VCCs stood at Rs 105 million in FY92, which increased to Rs 1027 million in FY00, indicating healthy growth. **Table 4.13** depicts that investment activities of VCCs have also increased over the same period. However, net profit of these companies remained volatile from FY92 to FY00 indicating their vulnerabilities.

Table 4.13: Venture Capital Companies

million Rupees

	Assets	Investment	Net profit
FY92	105	70	-
FY93	121	105	11
FY94	137	86	26
FY95	134	97	0
FY96	133	106	5
FY97	629	570	20
FY98	1251	1036	9.2
FY99	1265	899	22
FY00	1027	743	-130

4.2 Performance of CDNS in 1990s

The National Savings Schemes (NSS) provided much needed receipts to bridge the gap between government expenditures and revenues (budget deficit), particularly from FY94. The receipts from NSS as percent of budget deficit ranged from 35.1 percent to 72.3 percent with an average of 43.6 percent[18], which implies that NSS were the major source of deficit financing (see **Table 4.14** and **Figure 4.17**). Higher reliance on NSS receipts for deficit financing is justified on grounds of being

[18] Data from FY94 to FY00 are used to calculate the average.

less inflationary compared with other sources.[19] The National Savings Schemes also played a crucial role in generating savings in the economy. The share of NSS in national savings ranged from 1.9 percent to 39.9 percent, with an average of 15.7 percent.

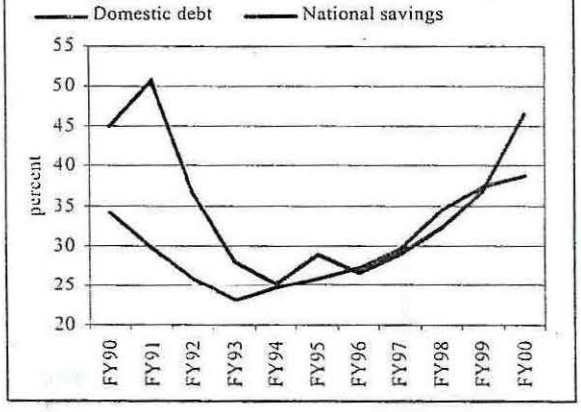
Table 4.14: National Saving Schemes

	As Percent of			
	Domestic debt	Budget deficit	National savings	GDP
FY90	37.5	31.8	14.6	15.4
FY91	4.0	3.1	1.9	13.2
FY92	5.3	4.7	2.1	11.5
FY93	6.4	5.0	2.9	10.8
FY94	34.1	35.1	13.2	11.2
FY95	35.1	32.4	12.6	11.2
FY96	37.8	30.5	16.8	11.8
FY97	43.8	37.6	20.6	12.7
FY98	74.0	49.4	25.8	15.4
FY99	51.7	72.3	39.9	18.5
FY00	48.6	44.8	21.9	19.9

4.2.1 Savings Mobilization

Total outstanding amount in NSS stood at Rs 633.8 billion as on end June 2000 compared with Rs131.9 billion in 1990, showing a compound annual average growth rate of over 15 percent. This massive growth in NSS, except in FY91 and FY00, was the upshot of policy changes during the decade under review. Amount received under NSS drastically declined in 1991 to Rs 2.8 billion as compared to Rs17.8 billion in 1990. This massive decline in NSS receipts was attributed to the discontinuation of Khas Deposit Certificates. Being the prime contributor to NSS receipts, Rs29.8billion maturity/ encashment of Khas Deposit Certificates in 1991 and in the following two years led to lower receipts in NSS in early 1990s. Furthermore, the receipts in newly introduced Special Saving Certificates (registered/bearer) could not offset the impact of the ban on Khas Deposit Certificates. In 1993, the CDNS introduced a new instrument named Regular Income Certificate to boost receipts from NSS. This newly launched instrument along with massive decline in maturity/encashment of Khas Deposit Certificates and better investment in SSCs contributed to upsurge in NSS receipts in 1994 (see **Table 4A.10** in **Annex 4**).[20] Besides, increased rate of profit also exerted a favorable impact on NSS. Later on, a substantial increase in NSS receipts in FY98 and onward was the result of increase in profit rates in FY97. However, increase in profit rates proved disastrous for domestic debt management as discussed in **Section 6.4**.

Figurte 4.17: Share of NSS in Domestic debt and National Savings



4.2.2 Yield Structure of National Savings Schemes

Yield structure of national savings schemes is reported in **Table 4.15**, which partially explains why people were investing more and more in these schemes. The profit rates on different savings schemes were totally administered and despite the efforts toward the end of decade to bring these rates in line with term structure of other interest rates, these remained very high. There was no mechanism to adjust these rates according to the determinants of overall interest rate structure in the economy. The intensity of high profit rates can be gauged from the fact that real profit rate (adjusted for inflation) on DSCs ranged from 2.9 percent to 11.4 percent, even higher than the weighted average lending rates on advances. The higher profit rates on NSS investment along with lower deposit rates in banking sector played a crucial role in diverting funds to NSS, which is known as the process of dis-intermediation.

[19] Other sources of financing include external and bank borrowing.
[20] Data on various National Saving Schemes are presented in Table 4A.10 in Annex 4.

The role of NSS in increasing national savings in the economy and in generating less inflationary receipts for deficit financing seemed impressive. However, NSS created tremendous problems for the rest of the economy. The first and foremost area of prime concern is the profit structure of NSS.

Table 4.15: Interest Rate Structure in Pakistan

percent as on end June

	Deposit rates*	Lending rates*	T-bill rate	DSC	SSC-R	RIC	Saving accounts	Mahana amdani accounts
Nominal interest rates								
FY90	8.2	10.6	6.0	15.6	-	-	10.0	14.9
FY91	6.0	10.8	6.0	15.6	-	-	10.0	14.9
FY92	6.4	13.2	11.3	15.6	13.6	-	10.0	14.9
FY93	6.1	13.3	12.3	15.6	13.6	13.8	10.0	14.9
FY94	6.2	13.7	12.4	16.0	13.7	13.8	11.0	14.9
FY95	6.3	13.7	11.7	16.0	14.9	14.6	11.0	14.9
FY96	6.4	14.4	12.8	16.0	15.8	14.6	11.0	14.9
FY97	6.8	14.6	15.5	18.0	16.9	18.0	13.0	14.9
FY98	6.8	15.6	15.0	18.0	16.9	18.0	13.0	14.9
FY99	6.5	14.8	12.9	16.0	14.7	16.0	11.0	14.9
FY00	5.5	14.5	8.7	15.0	12.6	14.0	8.8	14.9
Real interest rates								
FY90	2.2	4.6	0.0	9.6	-	-	4.0	8.9
FY91	-6.7	-1.9	-6.7	2.9	-	-	-2.7	2.2
FY92	-4.2	2.6	0.7	5.0	3.0	-	-0.6	4.3
FY93	-3.7	3.5	2.5	5.8	3.8	4.0	0.2	5.1
FY94	-5.1	2.4	1.1	4.7	2.4	2.5	-0.3	3.6
FY95	-6.8	0.7	-1.3	3.0	1.9	1.6	-2.0	1.9
FY96	-4.4	3.6	2.0	5.2	5.0	3.8	0.2	4.1
FY97	-5.0	2.8	3.7	6.2	5.1	6.2	1.2	3.1
FY98	-1.0	7.8	7.2	10.2	9.1	10.2	5.2	7.1
FY99	0.8	9.1	7.2	10.3	9.0	10.3	5.3	9.2
FY00	1.9	10.9	5.1	11.4	9.0	10.4	5.2	11.3

*: Weighted average

The higher profit rates on NSS have diverted deposits from banking sector to these lucrative instruments and resulted in lower deposit base of the banks, particularly in late 1990s. This was in fact a reinvigoration of financial repression and went against the basic objective of financial reforms. The administered nature of profit structure of NSS was mainly responsible for distortion in the term structure of interest rates. Nominal returns offered on any instrument should depend on maturity period, the frequency of interest payments, degree of anonymity of ownership of instrument, rate of inflation, tax on interest payments and credit worthiness of issuer. Therefore, the differentials between NSS profit rates and banks' deposit rates should not be very high. The need to rationalize the profit structure of NSS in line with the banking sector of the economy was therefore imperative.

Several steps were, consequently, initiated in this direction. Rates of returns on various certificates were reduced in FY99 and again in FY00. The most important step was the introduction of a new long-term bond (Pakistan Investment Bond) in December 2000. The resulting yields on ten year PIB are being used to price long-term NSS instruments (especially Defense Saving Certificates) from January 2001. Furthermore, the government also imposed a 10 percent withholding tax on profits from NSS with effect from July 1, 2001, to bring uniformity in tax treatment of government securities.

Higher profit rates on NSS had negative implications for domestic debt servicing as shown in **Section 6.4**. No doubt, NSS provided much needed receipts to bridge the gap between government revenues and expenditures, but at a very high cost. Moreover, the downward rigidity of government expenditures is also mainly attributed to increasing debt servicing, which has emerged as the major macroeconomic imbalance in the economy.

Another problem generated by NSS is the difficulty in management of public debt. The tap nature of NSS along with early encashment facility reduced the government's control over flow of funds in these schemes. For example, higher amount in NSS as compared to budget estimates results in unnecessary realization of higher public debt. Similarly, lower mobilization in NSS against budget target leaves the government with no option but to resort to short-term borrowing at high interest rates. Needless to say, the higher borrowing cost of the government and lower deposit base of the banking sector along with debt management problems are not beneficial for long-term growth of the economy. Therefore, this should be an area of prime concern for policy makers.

5 Transformation of Financial Markets During the Reform Process

Reforms initiated in late 1980s, which continued in the 1990s, started to transform the financial markets rapidly from FY91. Structure of a well functioning money market quickly developed with the introduction of auctioning process of short and long-term government securities. Capital market activities expanded very quickly in response to opening up of equity markets to foreigners. Activities in foreign exchange market also expanded rapidly after residents were allowed to open foreign currency accounts in addition to granting licenses to money changers.

5.1 Evolution of Money Market

The debt management reforms of early 1990s, in conjunction with monetary management measures (see **Sections 2.4** and **2.5**), resulted in establishment and development of a well functioning primary and secondary market for short-term government paper. The pre-reform sale of government securities was through tap system and banks could rediscount in case of any cash requirement. The rediscounting facility precluded the possibility of any secondary market activity. Only some sporadic trading was done in the long-term market loans for which premature retirement was not possible. The abolition and replacement of tap sale of government paper with auctioning of securities, and subsequent closure of rediscounting facility resulted in establishment of a robust secondary market and a network of efficient money market brokers.

5.1.1 Pre-reform Inter-Bank Money Market

As discussed in **Chapter 1**, the pre-reform money market consisted of primary market of treasury bills on tap and government treasury deposit receipts (GTDRs), call money market for borrowing and lending overnight or very short-term, and a market for sale and purchase of unutilized portion of credit ceilings. Segmentation in the short-term government debt market was maintained by disallowing banks to purchase GTDRs. Secondary market for treasury bills and GTDRs did not exist because of presence of discount window, which allowed early discharge of these bills. The secondary market activity was only confined to rare trading in market loans. Under the system of credit ceilings banks were, however, allowed to trade in the unutilized portions of their credit ceilings. Trading in credit ceilings did not involve any collateral. The rate was linked to the overnight call money rate, determined on the basis of demand and supply.

5.1.2 Primary Market of Treasury Bills

The reforms transformed the primary market from a non-market oriented to a competitive market oriented one; the previously fixed yield on T-bills was changed to an yield determined by the competitive bids of the players, thus compelling the government to borrow at market rates.[1] Further, the SBP could send interest rate signals to the market regarding the monetary stance. First auction of six-month T-bills was held on 3rd March 1991, and during the decade 208 successful auctions were conducted. The bidding pattern of the banks demonstrated a quick adjustment to market pricing mechanism in just four auctions. The bid spreads decreased sharply from over two thousand basis points in the first auction to 273 basis points in the fourth auction.[2] Unusually high spread in first auction reflected the initial lack of competitive pricing skills required to participate in auction. The average spread of 233 basis points for the decade showed the relative competitiveness and the efficiency of the market (see **Table 5.1**). The money market brokers contributed significantly in disseminating the crucial information that makes the market more efficient.

Wide participation was allowed in auctions through a system of approved dealers who were mainly banks and non-bank financial institutions. Individuals were also allowed to participate in auctions

[1] Under the tap system, three-month T-bills carried a fixed yield of 6 percent per annum.
[2] In the first auction, the spread between highest and lowest bid was 2929 basis points, presumably due to miscalculation by a bidder.

Table 5.1: Six-month T-bill Auction Summary

	Number of auctions		Number of bids		Spread (in percent)		Yield in percent (weighted average)
	Held	Scrapped	Received	Accepted	Simple	as % of yield	
FY91	9	-	574	330	6.93	78.62	8.81
FY92	28	3	1,293	726	2.44	21.49	11.34
FY93	24	3	1,942	969	2.44	19.80	12.35
FY94	25	-	2,816	1,222	2.64	21.24	12.45
FY95	26	-	1,880	1,008	1.90	16.27	11.69
FY96	24	1	545	332	0.53	4.15	12.78
FY97	24	-	766	541	1.07	6.88	15.53
FY98	22	2	2,493	1,094	2.13	14.22	14.97
FY99	24	7	1,532	410	1.96	15.52	12.66
FY00	26	8	758	251	1.25	14.06	8.87
Total/average	232	24	14,599	6,883	2.33	21.22	12.14

indirectly via approved dealers. Participation in T-bill auctions was, however, dominated by banks who had an active short-term portfolio of investment. Non-bank participation was minimal due to their preference for long-term investment. After the success of six-month paper, three and twelve-month treasury bills were introduced in June 1998 (see **Table 5.2**).

Table 5.2: Three and Twelve-month T-bill Auction Summary

Instrument	Year	Amount (million Rs)		Auctions		Spread	Yield in percent (weighted average)
		Offered	Accepted	Held	Scrapped	(in percent)	
Three-month	FY99	147,735.0	45,985.0	24	12	1.79	11.60
	FY00	82,245.0	21,085.0	26	8	1.40	7.82
Twelve-month	FY99	283,038.5	78,960.0	24	6	1.51	13.52
	FY00	168,391.5	51,199.7	26	3	1.36	9.29

As the market was already adept at the auctioning process, the bidding pattern showed lower bid spreads from the beginning of their auctions. First auction of three and twelve-month T-bills was held in June 1998 together with six-month bills. Overall 50 auctions of these maturities were conducted up to December 2000, out of which 20 and 9 were scrapped for three and twelve-month instruments respectively. The average spreads during the period under study for all tenors are relatively narrow, depicting the growing competitiveness and efficiency of the market. Six-month instrument stands out as the most effective one, as both the amount and the percentage acceptance is higher compared with the other two instruments (see **Table 5.1**).

5.1.3 Government Bond Market

There was no marketable long-term government paper in the pre-reform period. Federal and provincial governments mainly relied on 'Market Loans' to raise long-term finance from the financial sector. 'Market Loans' were essentially bonds of ten-year maturity offered through subscription to banks and non-banks, only at par, with a pre-determined rate of return fixed by the government. It was not a market-based bond, and trading was confined to a few instances of exchange among banks. In order to establish a proper government bond market, a new instrument, Federal Investment Bond (FIB) was introduced with maturities of three, five and ten years. Coupon rates for these bonds were fixed at 13, 14 and 15 percent respectively.

First auction of FIBs was conducted in March 1991 and the last in June 1998. **Table 5.4** shows that auctions during the first four years proved immensely successful as the number of bids received and accepted were on higher side. The ten-year FIB showed the best overall performance on the basis of amount offered and accepted, number of bids received and accepted, and the number of auctions scrapped (see **Table 5.3** and **Table 5.4**).

Table 5.3: Federal Investment Bond Auction Summary

million Rupees

Year	Amount offered	Amount accepted				Acceptance ratio (in percent)
		3 year	5 year	10 year	Total	
FY91	39,268	13,934	6,170	14,834	34,938	88.97
FY92	56,407	10,649	3,007	31,318	44,974	79.73
FY93	77,127	12,600	5,138	35,840	53,578	69.47
FY94	63,284	10,708	4,034	11,869	26,611	42.05
FY95	42,154	8,785	2,267	18,935	29,988	71.14
FY96	18,026	3,877	4,169	7,919	15,964	88.56
FY97	4,841	1,101	105	3,510	4,716	97.42
FY98	4,882	1,331	177	2,152	3,661	74.99
Total	305,989	62,986	25,066	126,378	214,430	70.08

In the initial years of introduction of FIBs, the bond was successful in attracting both bank and non-bank investments (see **Table 5.6**). The rates offered by FIBs were higher than the rates on T-bills in the beginning. However, during FY94, the yields on six-month T-bills rose significantly and surpassed those of three and five-year FIBs. In succeeding years, unwillingness of authorities to accept bids below par, or raise the coupon rates upwards, resulted in a weakening of participation by financial institutions. Participation of financial institutions almost came to a standstill during FY98 as T-bill yields rose up to 17.4 percent surpassing even the yield of a ten-year FIB. Auctions were subsequently suspended in June 1998.[3]

Table 5.4: FIB Auction Performance

number

Year	Bids		Auctions scrapped		
	Received	Accepted	3 year	5 year	10 year
FY91	542	430	-	-	-
FY92	893	633	3	1	-
FY93	1,321	969	-	-	-
FY94	1,287	608	1	1	1
FY95	557	374	-	3	1
FY96	257	209	1	1	-
FY97	88	84	3	8	1
FY98	60	52	1	9	1
Total	5,005	3,359	9	23	4

However, some banks had already piled up heavy stocks of FIBs due to much higher returns compared with those of T-bills in the initial years. This was against prudent asset-liability management and resulted in heavy losses to some of these banks when the short-term interest rates increased and even surpassed the FIB rates. In order to avoid recurrence of such pile up in future, SBP specified the limit of FIB holdings to a maximum of 15 percent of each bank's time and demand liabilities on any day or the amount of its holding of such bonds as on 22nd December 1994, whichever was higher.[4]

5.1.4 Post-reform Secondary Market

The inception of auctioning system coupled with subsequent closure of discount window paved the way for development of inter-bank money market. The banks in order to meet cash, liquidity and settlement requirements started to carry out repo and reverse repo transactions with each other. A

[3] After fresh issues of the Federal Investment Bonds (FIBs) were stopped, there were no long-term government securities that could meet the investment needs of banks, NBFIs, insurance companies, pension funds and corporate bodies. With the attractiveness of NSS rates and no bar on institutional investment, this vacuum was not even felt. However, in the interest of developing the longer end of the government debt market by creating a yield curve, and to boost the corporate debt market, the government decided to launch the Pakistan Investment Bonds (PIBs) in December 2000, sold through auctions.

[4] BSD Circular No. 19, 1994. It may be noted that the SLR was 30 percent at that time.

network of well functioning dealers also emerged to tap the opportunity thus created. Spreads in term repo market (see **Table 5.5**) were within the range of 27 to 81 basis points -- a narrow range implying a competitive market. Bid spreads ranged from 28 to 44 basis points while the offer spreads from 27 to 51 basis points. These ranges showed relative efficiency and competitiveness in the bid-offer quotation process. The bidding was relatively more efficient, as offers also included artificial quotes to lock in extra profits, if got through. The bid-offer spreads were relatively higher, ranging from 57

Table 5.5: Spreads in Term Repo Market

basis points

	Six-month repo market				Overnight repo market			
Years	Bid	Offer	Bid-offer	Rate (%)	Bid	Offer	Bid-offer	Rate (%)
FY95	38	42	68	11.63	214	234	137	9.92
FY96	41	43	59	12.55	329	333	110	10.77
FY97	44	51	81	14.69	391	409	87	12.62
FY98	37	41	67	13.84	338	343	71	12.30
FY99	42	43	80	11.5	200	218	62	7.62
FY00	28	27	57	8.35	204	195	54	8.41

Note: Spread is the difference between the highest and the lowest quote.

100 basis points = 1 percentage point

to 81 basis points, reflecting the possibility of mismatch of bids and offers, due to either artificially high offers or low bids for chance hits in a scenario of greater volatility in short-term rates.

The percentage share of FIB holdings for banks and non-banks continuously changed due to trading in the secondary market. The secondary market activity in FIBs was reflected in the difference between share of bank (non-bank) in auction sales and its actual holding (see **Table 5.6**). In the absence of data on trading volume, it can be used as an indicator of activity and development of secondary market. However, the higher yields in the earlier years prompted the players to adopt a buy-and-hold strategy. This behavior affected the development of secondary market for long-term paper adversely.

Table 5.6: Secondary Market Transactions and FIB Holdings

shares in percent

End June	Auction sales		Actual holdings	
	Bank	Non-bank	Bank	Non-bank
1992	77.46	22.54	75.98	24.02
1993	77.01	22.99	71.80	28.20
1994	73.92	26.08	58.49	41.51
1995	72.09	27.91	54.08	45.92
1996	67.99	32.01	44.09	55.91
1997	66.36	33.64	60.18	39.82
1998	65.87	34.13	68.68	31.32
1999	65.70	34.30	57.90	42.10
2000	66.74	33.26	70.20	29.80
Average/year	70.35	29.65	62.38	37.62

Activity in call money market, essentially a market for overnight funds, was linked to the overnight repo market. Overnight call rates usually prevailed above the overnight repo rates to cover the risk of clean lending. All scheduled banks are authorized to lend and borrow from the call market. **Figure 5.1** shows call rates prevailing during the decade under review. Money at call and short notice showed a stagnant trend till FY98; afterwards it rose sharply when SBP exempted money at call and short notice from cash and liquid assets requirement in May 1999 (see **Figure 5.2**).

5.1.5 SBP Repo Window

After the introduction of auctions for government securities, it was prudent to transform the SBP rediscounting facility. In February 1992, SBP decided to extend a 3-Day Repo Facility against T-bills to provide cash accommodation needed by the banks.[5] **Figure 5.3** shows the cash accommodation

[5] Banks were also allowed to use their FIBs, from April 1992, in case the cash requirement exceeded their T-bill holdings.

provided through this facility after discontinuation of discount window in February 1992.[6] **Figure 5.4** shows the SBP Repo Rates applicable on 3-Day Repo Facility.

Figure 5.1: Average Annual Call Rates

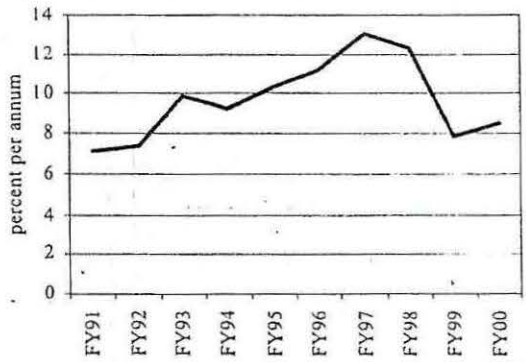
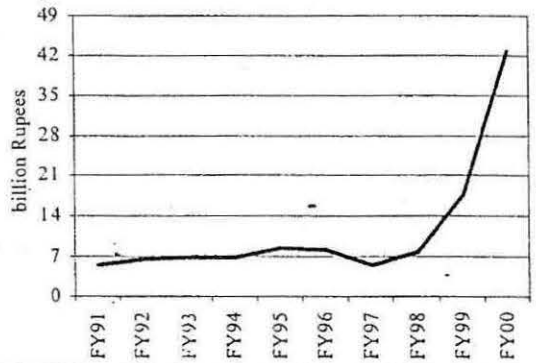


Figure 5.2: Money at Call and Short Notice



The 3-Day Repo rate is one of the main instruments of SBP; changes in it show the direction and stance of monetary policy. The rate is kept at higher levels than yields on T-bills in order to discourage banks to visit the window frequently. Further, to ensure that only the needy banks avail this facility, it is verified that the bank is not a deliberate net-lender in the overnight market. Cash accommodation is usually provided for overnight, however, transaction period can be extended to three days and exceptionally to four or five days to cover occasionally long weekends.

Figure 5.3: Cash Accommodation per Day
(on average)

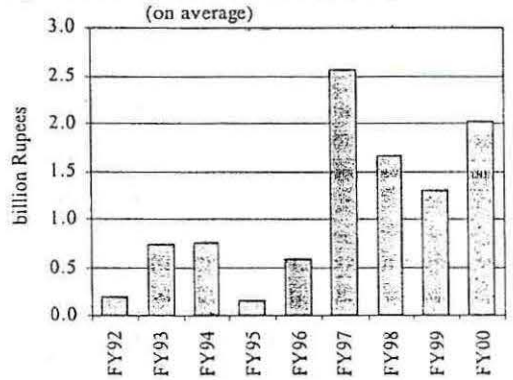
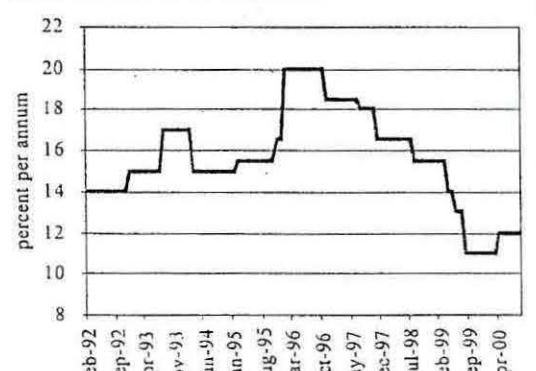


Figure 5.4: SBP 3-Day Repo Rate



5.1.6 Open Market Operations

After the abolition of credit-deposit ratio (CDR) in 1995, open market operations (OMOs) are being used as a major tool for the conduct of monetary policy. Regular OMOs are being conducted since January 1995, supplemented with special OMOs if liquidity conditions in the market require more intervention (see **Figure 5.5**). Initial few OMOs were unsuccessful as the rates quoted by the participants were not representative of the rates prevailing in the market. However, subsequent learning process enabled both SBP and the banks to adapt to the market mechanism. OMOs became the major instrument of monetary policy, after the abolition of CDR to contain the money supply within the limits set in the credit plan.

[6] The word 'discounting' is still used to indicate cash provided through SBP 3-Day Repo Window against T-bills. Likewise, 'discount rate' is also used to indicate SBP Repo Rate.

Initial OMOs were overly concerned with the objective of draining liquidity from commercial banks. This was understandable as after the abolishment of CDR, SBP lost its direct control over banks to restrain them from credit expansion. Furthermore, tight Credit Plans of FY95 and FY96, and quarterly targets under agreement with IMF, in the wake of continued excess borrowing by the government, left SBP with hardly any choice but to mop up aggressively through OMOs (see **Figure 5.5**). This focus on one-way OMOs continued till October 1997, when SBP started to inject funds for very short-term, in periods of liquidity crunch. Later years saw increasing use of OMOs by SBP for liquidity management, within the context of monetary management, relying more on short-term repos for mop-ups and even shorter-term reverse repos for injections (see **Table 5.7**). Operational objective remained the control of reserve money, rather than the overnight inter-bank rate.[7] Consequently, the issue of volatility in overnight rates has not yet been addressed.

Figure 5.5: Open Market Operations

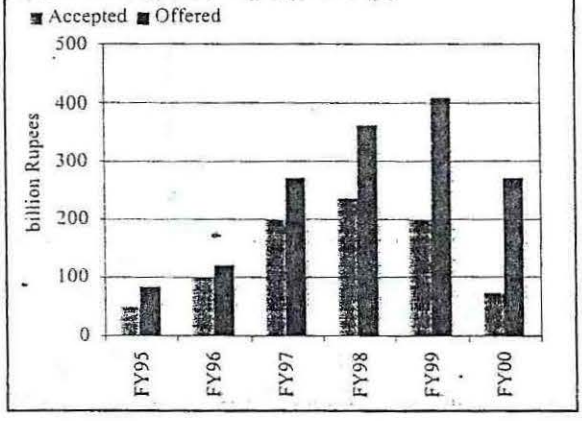


Table 5.7: OMO Injections
million Rupees

Year	Bid	Injected	% injected
FY98	16,425	4,550	27.70
FY99	32,585	10,860	33.33
FY00	282,300	137,870	48.84
Total	331,310	153,280	46.26

5.2 Development of Capital Market

One of the main objectives of the financial sector reforms was to do away with financial repression and encourage market-based allocation of financial resources. Capital market can play a crucial role in mobilizing domestic and foreign resources, and channeling them into productive medium and long-term uses.

At the beginning of 1989, the Government of Pakistan launched a broad based program of financial liberalization. These reforms had initiated a large mobilization of funds into the equity market, thus contributing to the growth of Stock Exchanges of the country. By the end of 1991, International Finance Corporation (IFC) ranked Pakistan as one of the leading emerging markets in the world. Financial reforms, specifically the permission granted to foreigners to repatriate their capital freely out of the country, resulted in a surge in capital market activity. The market capitalization increased from Rs 62 billion in 1990 to Rs 197 billion in 1992. This was due to a positive economic outlook and the increased interest in stock market as an attractive investment avenue. Increased interest of international investors also enabled Government of Pakistan to raise $150 million from Euro Dollar Market in FY95, through its first sovereign bond of 5-year maturity at 385 basis points above 5-year U.S. Treasury rate.

The boom period in Pakistan equity market meant increased returns for investors. However, market correction that followed this boom resulted in some losses to the investors. The most encouraging area, however, proved to be the development of corporate debt market. Since the launch of first Term

[7] The volatility was a consequence of changes in amount of liquidity available in the banking system. If the market was flooded with liquidity, the overnight rates tended to be very low and vice versa. There is a need to put in place a liquidity forecasting framework to improve the effectiveness of OMOs and reduce volatility in overnight rates.

Finance Certificate (TFC) by Packages Pakistan Limited in 1995, this market has come a long way. The reforms undertaken by the government at the end of the decade are expected to bear good fruits for this market.

5.2.1 Performance of Equity Market

Among the three stock exchanges, Karachi Stock Exchange (KSE) is the oldest and largest, followed by the Lahore Stock Exchange (LSE), set up in 1970, and the Islamabad Stock Exchange (ISE), which commenced its operation in 1992.

Karachi Stock Exchange

Equity market showed remarkable improvement after the introduction of exchange and payment reforms in early 1990s. These reforms allowed foreign investors and non-resident Pakistanis to trade in shares at the domestic stock exchanges and also to freely repatriate initial investments as well as profits. Furthermore, foreigners were allowed to own 100 percent equity in a venture. These steps gave much needed impetus to equity market in Pakistan. Consequently, a number of offshore funds were established in foreign countries and listed on foreign exchanges for investment either in Pakistan or in other emerging markets. For example, Citibank Hong Kong and Credit Lyonnais sponsored such funds of the size of $22 million and $35 million respectively. Similarly, the Pakistan Investment Fund (worth $60 million), listed on New York Stock Exchange was established by Asian Development Bank.

Interest of foreign brokerage houses developed very quickly. Morgan Stanley, Merrill Lynch, Bear Stearns International, Smith Barney Shearson, W.I.Carr. and Global Emerging Markets Europe entered Pakistani market and took up stakes with local partners or floated other offshore mutual funds. In addition, increased supply of securities due to the privatization of large state-owned enterprises (SOEs) such as the Pakistan Telecommunication Corporation (PTC) and the Muslim Commercial Bank (MCB) and the large issue of a power project HUBCO (Hub Power Company) had increased the depth of the market.

Notwithstanding these developments, the listed companies at KSE accounted for barely 1.8 percent of the registered companies by 2000. In terms of trading volumes, only four companies (PTCL, Hubco, PSO and ICI) accounted for 80 to 85 percent of total trading volume in KSE (during FY00). Supply of shares was limited as founding families or the government held a large segment of the listed shares at KSE. In addition, the institutional investors had the tendency of permanently holding a significant proportion of the shares of quality companies, which in turn reduced the activity in the market.

Political and economic instability of 1990s and institutional constraints of the equity market brought volatility in the KSE Index, which fell from a peak level of around 2661 in March 1994 to 1507.6 by the end December 2000. After the nuclear detonation of May 1998, market rode through the bumpiest path in its history, dropping to 765.7 on 14th July 1998. Nevertheless, market recovered and went through a boom during 2nd and 3rd quarter of FY00, reaching a peak on March 22, 2000 at 2054.4. However, these bullish sentiments proved to be short lived. Factors like Hubco-WAPDA dispute and slow privatization of SOEs proved to be an impediment in improvement of equity market during final quarter of the decade.

Table 5.8: Performance of Karachi Stock Exchange

amounts in billion Rupees

end period	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Number of listed companies	497	596	652	683	746	783	782	779	769	762
Listed capital	31.1	50.6	63.5	76.1	118.8	145.0	206.7	211.2	215.0	229.0
Market capitalization	90.0	218.4	214.4	404.6	293.3	365.2	496.1	259.4	289.2	391.9
KSE-100 index	1855	1545	1264	2333	1612	1703	1566	880	1055	1521
SBP general index	114.9	188.5	161.7	290.2	186.8	170.2	143.0	98.8	106.4	128.8
Trading volume (million)	361	725	894	1,831	2,293	5,232	8,023	15,004	25,533	48,109

As shown in **Table 5.8**, the number of listed companies grew from 497 in FY91 to 762 in FY00 showing an increase of 53 percent; in the latter half of the decade, the number of listed companies declined by about 3 percent. Listed capital showed a growth of 636 percent, from Rs 31.1 billion in FY91 to Rs 229.0 billion by FY00. Trade volumes also showed great improvement during 1990s mainly due to automation of the stock exchanges and establishment of Central Depository Company of Pakistan Ltd (CDC).

Lahore Stock Exchange

Companies listed at Lahore Stock Exchange (LSE) almost doubled from 332 in FY89 to 616 in FY00, as shown in **Table 5.9**. However, much of this progress occurred by FY95, when 617 companies got enlisted. Remaining half decade showed little progress on this front. In fact, few companies got themselves de-listed since FY97. Nevertheless, paid up capital rose consistently during the period under consideration. There was more than ten-fold rise in paid up capital (see **Table 5.9**).

Table 5.9: Performance of LSE and ISE

billion Rupees, shares in million

	LSE			ISE*		
	Listed companies	Turnover	Paid up capital	Listed companies	Turnover	Paid up capital
FY89	332	16.5	18.8	-	-	-
FY90	377	22.4	23.4	-	-	-
FY91	417	41.4	30.0	-	-	-
FY92	505	48.1	49.9	-	-	-
FY93	552	85.2	59.7	158	9.5	26.3
FY94	570	369.6	77.2	201	37.4	36.4
FY95	617	959.2	99.8	244	82.0	65.1
FY96	640	2564.8	119.4	272	154.0	84.1
FY97	645	2775.6	184.7	283	115.0	92.4
FY98	631	5848.2	186.9	285	478.0	149.4
FY99	621	9798.7	186.9	284	1,802.9	150.7
FY00	616	16356.9	207.7	283	3,139.8	162.2

*ISE commenced its operation in Aug-92

Islamabad Stock Exchange

Islamabad Stock Exchange (ISE) commenced its operation in August 1992. This exchange was established for catering investors' needs in northern region of the country. ISE, in comparison with the rest of the exchanges, is quite small and, in fact, follows the other exchanges. By FY00, 283 companies with a paid up capital of Rs 162.2 billion, were listed on this exchange (see **Table 5.9**).

5.2.2 Performance of Term Loan Market

DFIs and NBFIs continued to be marginalized during 1990s. This was mainly due to their inability to mobilize required funds, discontinuation of foreign credit lines, and fundamental structural weakness in most of these institutions, manifested in heavily infected portfolios and high level of NPLs. Sharp increase in NPLs forced DFIs to restrict their lending operations.

The performance of some selected DFIs during 1990s is shown in **Table 5.10**. It is evident that both the amount sanctioned and disbursed declined over the decade, former by almost 90 percent and latter by 78 percent. The diminishing role of DFIs and NBFIs highlights the need to broaden the term financing sources within financial system, rather than relying on specialized institutions that have proven to be inefficient and inherently unsustainable.

Table 5.10: Sanctions and Disbursement s by Selected DFIs and Specialized Banks

million Rupees

	FY90			FY95			FY00		
	Deposit	Sanctions	Disbursed	Deposit	Sanctions	Disbursed	Deposit	Sanctions	Disbursed
NDFC	12,422	5,123	2,272	19,297	8,007	2,435	28,338	127	225
RDFC	128	459	239	1,042	440	486	601	-	-
BEL	1,771	4,152	1,462	5,146	1,212	1,024	3,895	-	15
PICIC	1,191	8,591	1,239	5,303	394	747	3,263	988	193

5.2.3 Corporate Debt Market

A market for corporate paper began to develop after FY95 when private companies were allowed to issue Term Finance Certificates (TFCs) to raise resources. Establishment of the Pakistan Credit Rating Agency (PACRA),[8] also provided a supporting infrastructure in terms of rating process. Progress was slow in the beginning due to presence of bonds, with very high coupon rates, issued by some public sector enterprises carrying the guarantee of federal government.[9] Although the Federal Investment Bonds had an active market at that time, the presence of government guaranteed bonds with rates much steeper than those of FIBs made the pricing of new issues of TFCs very difficult. Discontinuation of further issues of these bonds proved conducive for the TFC issues.

Only five TFCs were issued upto 1998; however, after the decline in short-term interest rates, and consequently in long-term yields, market for TFCs picked up with four new issues in 1999 alone. Two important policy changes relating to National Savings Schemes (NSS) would go a long way in promoting TFC market. Firstly, NSS rates were reduced in mid-1999 and again in mid-2000. Secondly, institutional access to NSS was discontinued in April 2000. Since the institutional funds constitute a large part of long-term savings in Pakistan, these are likely to find TFCs a profitable avenue for investment. Five new issues of TFCs came to market in 2000 (see **Table 5.11**), and with the launching of Pakistan Investment Bonds (PIBs) in December 2000, it is expected that TFC market will flourish further as pricing becomes easier with PIB benchmarks.

Despite the issuance of several TFCs, their trading in secondary market is very thin as most investors still prefer to "buy and hold". Intermediaries also face difficulties in market participation, due to lack of short selling. Market makers are, therefore, unable to provide two-way quotes to develop a strong and deep secondary market. Furthermore, the volume of outstanding issues is also very small compared with those of long-term marketable government paper. Secondary market trading can only develop if investors get out of "buy and hold" mentality and sufficient volumes exist for meaningful trades.

Future outlook for TFC market looks bullish both from investor and issuer point of view. Companies that previously relied heavily on

Table 5.11: Corporate Debt

million Rupees

TFC	Issue Date	Maturity	Issue size	Coupon rate
Packages	Feb-95	Feb-00	232	18.5
Nishat tek	Jan-96	Jan-99	250	18.0
ICI	30-Sep-96	Sep-01	1,000	18.7
GATRON	17-Jun-98	Jun-03	274	18.0
Inter-Bank	1-Dec-98	Dec-03	300	17.5
SPLC	28-Jan-99	Jan-03	250	18.3
DSFL	24-May-99	May-04	863	19.0
NDLC	1-Dec-99	Dec-04	550	17.0
PILCORP	21-Dec-99	Jan-05	288	18.0
Sigma Lease	18-Jan-00	Jan-03	100	17.0
Paramount Lease	2-Aug-00	Aug-04	250	16.3
Atlas Lease	22-Sep-00	Sep-05	200	15.0
Network Lease	4-Oct-00	Oct-05	100	16.3
Al-Noor Sugar	31-Oct-00	Oct-05	204	DR+25 bps (16.5-18.5)

*: DR: SBP Discount Rate

[8] PACRA was established as a joint venture between International Finance Corporation (IFC), IBCA Limited of England and the Lahore Stock Exchange.

[9] For example, Wapda Bonds carried government guarantee besides offering coupon rates as high as 19 percent per annum.

Development Finance Institutions (DFIs) will have to utilize TFC funding in future. In the past, DFIs provided significant portions of term funding for leading Pakistani companies. These institutions, in turn, received considerable funding assistance from the multilateral development agencies. Lately, however, multilateral agencies have stopped funding the NBFIs, particularly to DFIs and leasing companies. These institutions have not been able to develop alternate sources of funding. This has adversely affected their lending and investment capabilities. Consequently, some major companies, particularly leasing companies, are forced to rely on TFCs for additional term debt funds.

On the investment side, commercial and investment banks are main investors in private sector TFCs. In 1997, listed TFCs became "approved securities" for the purpose of meeting statutory liquidity requirement (SLR) for non-bank financial institutions (NBFIs). Furthermore, in order to promote corporate debt, government has reduced stamp duties and taxation, including withholding tax on profits.[10] Nevertheless, retail investors lack confidence in the market, as they do not fully understand debt securities. Many are also concerned whether corporate borrowers will repay loans according to agreed terms. However, these sentiments are changing as more and more companies are relying on TFCs for their financing requirements. Although supply conditions are improving since FY00, institutional investors would welcome additional investment opportunities in TFC issues, subject to acceptable market profit rate.

5.2.4 Securities and Exchange Commission of Pakistan

Securities and Exchange Commission of Pakistan (SECP), having autonomous status, was established under the Securities and Exchange Commission of Pakistan Act, which was passed by the Parliament and promulgated in 1997. The main difference between the erstwhile Corporate Law Authority (CLA) and SECP is that while the former was an attached department of the Ministry of Finance, the latter is an autonomous body, within the framework of SECP Act, 1997. The Act clearly defines functions, powers and responsibilities of SECP that became operational from 1st January 1999. The erstwhile CLA stood dissolved simultaneously and all of its functions had been transferred to the SECP.

SECP has five to seven Commissioners including the Chairman who are appointed by the government. In order to increase the expertise within SECP, majority of the Commissioners are taken from the private sector. The tenure of the Chairman is three years and that of the Commissioners, two to three years. It has been vested with adequate operational, administrative and financial autonomy. Its functions include regulation of all aspects of capital market. The main functions can be divided into following three categories:

- Regulation of the securities market and related institutions like mutual funds, Central Depository Company and credit rating institutions.
- Administration of the Company Law.
- Regulation of some non-bank financial institutions like leasing and modaraba companies.

Since it became operational, SECP has implemented many laws for the betterment of capital market. Although stock exchanges in Pakistan are mostly self-regulating authorities, SECP is actively monitoring their activities and making amendments in regulations to create a level playing field for all investors. For this purpose SECP ordered some amendments in the Article of Association of the stock exchanges. This will amplify the transparency in stock exchanges' operations and in turn increase investors' confidence.

[10] Withholding tax on TFC profit was removed in 1995 but reinstated in March 1998. However, federal budget for 1999 again exempted payment of withholding tax to all persons, including companies.

5.3 Performance of Foreign Exchange Market

The process of liberalization in the external sector, initiated in 1991, was mainly concentrated in areas other than exchange rate regime (see **Section 2.7**). However, reforms specific to forex market were initiated in February 1998, when authorized dealers (ADs) were allowed to fix their buying and selling rates for currencies other than US dollar. Subsequently, fixation of exchange rate was further liberalized in March 1998, when SBP widened its buying/selling spread for US dollar from 0.5 percent to 1.0 percent of buying rate. At the same time, ADs were allowed to fix their own buying/selling rates for US dollar transactions with their customers within this band. Although the overall reform program went off-track following nuclear detonation, changes in exchange rate regime were expedited to address the external pressures. Major structural change came with the introduction of multiple exchange rate system in July 1998, which was gradually unified and transformed to one where the market forces determined the value of the Rupee.

This was a major achievement given the concerns over the viability of floating exchange rate regime due to thin foreign exchange and under-developed financial markets that increase the potential volatility of market determined rates and the cost of hedging against it.[11] Furthermore, floating the currency with serious balance of payments difficulties could lead to a steep fall in its value, which in turn adversely affects price stability and output in the short run and, therefore, undermines country's capacity to operate market-determined exchange rate.

A comparison of Pakistan's experience regarding floating rate system with other developing countries suggests a few common elements. First, most of these countries were facing severe balance of payments difficulties, reflected in sizeable external payments arrears. Second, in most of these countries, new mechanism was adopted in the context of Fund-supported programs. Third, the transition process involved a move from multiple exchange rate regime to unified and floating rate system. What is more interesting is the fact that Pakistan unified its exchange rate more swiftly. Generally, countries find it increasingly difficult to exit from multiple rate regime.

With this background, discussion on the performance of foreign exchange market has been divided into two periods -- setting 21st July 1998 as divider when multiple exchange rates regime was introduced.

5.3.1 Foreign Exchange Market Prior to 21st July 1998

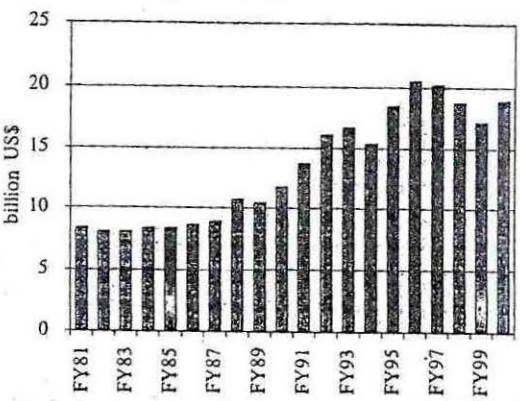
In terms of foreign exchange regime, overall structure of the forex market was not significantly different from what has already been described in **Section 1.3.3**. However, there are some specific issues regarding interbank forex market that need to be highlighted.

Inter-bank market had very limited role: Narrow spread, between buying and selling prices provided limited scope for the development of an active interbank market as participants were restricted in terms of their ability to take positions. Low margin of 0.1 percent, set by SBP for banks for selling US dollar to their customers, was also limiting spot foreign exchange trading operations. Foreign exchange flows were also restricted due to imposition of requirement on exporters to surrender their proceeds to ADs, who in turn were required to sell that foreign exchange to SBP on a daily basis after clearing their payment obligations. In effect, ADs' role was limited only to an intermediary between public and SBP. In overall terms, this resulted into a very shallow inter-bank forex market.

[11] Pakistan did not go for large devaluation supported by extensive exchange controls.

The market depth was also affected due to falling forex flows, which largely comprised of export proceeds, worker remittances and import payments. It is evident from **Figure 5.6** that the volume of merchandise trade, which expanded sharply following initiation of exchange and payment reforms in 1991, has started falling back after reaching peak in FY96 at US$20.5 billion. On the other hand, worker remittances, another major source of foreign exchange in the inter-bank market, also showed a generally declining trend (see **Figure 5.7**). This is mainly due to widening differential between official and kerb market rate, supported by efficient transfer channels of the hundi system.

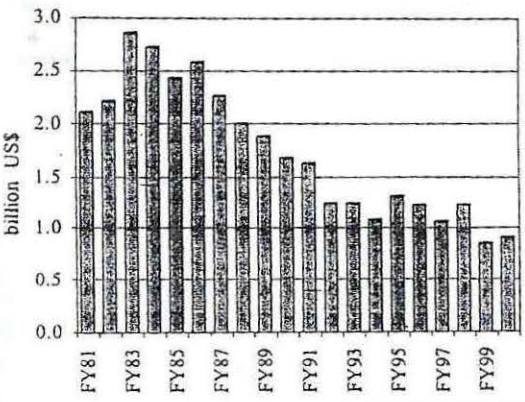
Figure 5.6: Merchandise Trade



Merchandise trade is sum of exports and imports based on FBS data

It is clear that despite Pakistan's comparative advantage in the export of semi-skilled labor, remittances are still far short of their desired level. In fact, throughout the 1990s, the authorities had not paid sufficient attention to the declining or stagnant flow of remittances. Instead, money changers, central player in hundi system, were granted licenses to operate. As a result, the hundi system was able to become established and is now clearly out-performing the banking system.

Figure 5.7: Home Remittances



Inter-bank activity was also restricted, as banks had set low trading limits for some of the ADs perceived to be weak. In addition, large banks, especially foreign banks, had a preference for direct dealings and while there are a few foreign exchange brokers, their role was limited. This had also resulted in a lack of depth in the market.

Forward market could not develop:

The forward cover facility was initially provided by the SBP to scheduled banks against forward cover provided by them to their customers in respect of imports, exports and repatriable loans. However, this facility was withdrawn on 30th June 1994 and banks were allowed, at their discretion, to continue providing such cover, provided their open positions permit them to do so. With a view to encouraging the banks to offer this facility without any major interruption, their combined Nostro limit was gradually raised from $50 million in June 1994 to $300 million in August 1994.

There were still some impediments to development of the forward market. For example, SBP required that all forward transactions be trade-related and that no forward coverage be extended by ADs for a period exceeding six months. In addition, ADs were restricted in terms of their ability to take on open position in excess of their nostro limits. This, viewed against large imbalances between exports and imports, meant higher premium paid by customers. Furthermore, paucity of forex flows did not always allow banks to square their position on a daily basis -- an essential condition for the development of a good forward market. In view of these limitations, the forward market was thin but

since SBP does not regulate the premium charged in that market, it seemed that banks compete aggressively in that segment.

Growing dependence on foreign currency accounts:
The introduction of foreign currency accounts, a driving force behind dollarization, had significant policy implications. The scheme, introduced in 1973, received a major boost in 1985 when banks were allowed to accept FCAs of a minimum amount of $10 million from overseas branches for a minimum maturity of one year.[12] This scheme was further broadened in 1991 when residents were also permitted to hold FCAs and again in 1992 when non-bank financial institutions were allowed to raise foreign currency funds from abroad.

In seven years since the liberalization in 1991; foreign currency deposits rose at a rate of 23 percent per annum to $10.9 billion in May 1998 -- when these were frozen. Growth in resident accounts accounted for more than two thirds of this increase, while non-bank financial institutions, which were allowed to accept such deposits in 1992, accounted for 20 percent. The amounts held by non-residents, outside of those held with the non-bank financial institutions, declined marginally over this period. The unusual growth in FCAs was the result of policy measures that included tax exemption and immunities and subsidized forward cover by SBP.[13] This was supported by persistently high rate of inflation in Pakistan and steady depreciation of the rupee. The growing gap between the official and the free market rate also added to the process of dollarization where the foreign currency was considered much more secure than the Rupee as a store of value.

The use of FCAs in the face of meager forex reserves and declining net medium and long-term concessionary capital inflows was considered a much easier source for financing large current account deficits. Consequently, the large and growing volume of short-term liability and the increased dependence of external sector on these deposits, was not only threatening to the economic stability but also posed severe difficulties for the conduct of macroeconomic policies.

More specifically, FCAs had implications for the monetary, fiscal and exchange rate policies. Resident FCAs permit greater substitutability between domestic and foreign assets and cause changes in the transmission of monetary policy. Overtime, volume of outstanding FCAs rose to a level where its reversal on account of any policy action was deemed as the most unwanted outcome. This binding was more evident in terms of monetary policy where T-bill rates could not be lowered, as this could have resulted into large-scale outflows of these deposits. The fiscal policy is affected due to erosion of the tax base and losses from the forward cover operations. The large build-up of these deposits was also creating self-fulfilling expectations for devaluation through false foreign exchange demand, thereby impeding the exchange rate management. Summing up, use of FCAs to finance external payments and consequent build-up of short-term liability, conflicted with the objective of sound economic management.

5.3.2 Foreign Exchange Market After 21st July 1998

In response to heightened uncertainty, particularly in terms of balance of payments viability, following nuclear detonation, SBP introduced a multiple exchange rate system in July 1998, comprising an official and a floating interbank rate (FIBR). Under this system, the official rate was fixed at Rs 46 per US Dollar whereas market forces determined FIBR, which was comparatively more devalued. The pre-specified ratio (originally being 50:50) of these two rates was known as composite rate. Subsequently, role of the market participants in determining the exchange rate was gradually

[12] In 1992, the minimum amount was reduced to US$ 5 million to encourage more inflows. In 1993, the minimum maturity was shortened to 6 month duration.
[13] Initially, SBP was providing the entire exchange rate risk on FCAs free of any charge. In 1992, in order to partly cover the mounting losses, SBP introduced a forward cover fee on FCAs; different fee rates were applicable on deposits denominated in various currencies to discourage currency substitution

enhanced by changing this ratio in favor of FIBR, first to 20:80 in December 1998, and then to 5:95 in March 1999.

Although the multiple exchange rate system was introduced under severe balance of payment pressures, it was very deftly converted into a market-based regime. On 19th May 1999, exchange rates were unified with FIBR covering all transactions; ADs were allowed to fix their own buying and selling rates. However, this attempt to liberalize the exchange rate was aborted after a few days and an unofficial band was imposed on banks. The band remained unchanged for almost a year, and after revising twice in June 2000, it was altogether abandoned on 20th July 2000 as a part of an IMF program. All through this period, the exchange rate system was tightly managed by SBP with the help of a number of restrictions placed on market participants. In particular, ADs were not allowed to provide cover to their clients for imports of less than one month. Furthermore, forex transactions in the interbank market by ADs were limited to sales and purchases backed by permissible (essentially trade) transactions.

These steps, which in effect curbed the ability of ADs to open speculative positions, were reflecting the notion that forex market was primarily based on trade and related transactions and, in the absence of genuine demand, no exchange could take place.[14] Although SBP continued to target exchange rate, the primary objective was to maintain an orderly condition in the forex market and to check destabilizing and self-fulfilling speculative activities.

Besides pure speculative forces, there were also mismatches in import demand and export proceeds, which could have a significant effect on exchange rate in the short run. Thus, while the relative absence of pure currency speculation in forex market due to SBP measures was helpful, it did not eliminate short-term pressures in the market by exporters/importers in anticipation of future value of the currency.[15]

Recognizing these "leads and lags" in foreign exchange transactions, SBP managed the foreign exchange flows by facilitating demand/supply matching in the interbank market. SBP also provided market support by directly meeting partially or fully the foreign exchange requirements for import of POL and debt payments, when considered necessary. This had the effect of reducing lumpy and panicky market demand for foreign exchange.

The turnaround in the exchange rate policy witnessed on 21st July 2000, when the Rupee was put to float with a view to achieve market-oriented and more flexible exchange rate policy, required a new mindset. Accordingly, the SBP role under the new paradigm became very different. Although measures aimed at discouraging pure speculative demand for foreign exchange were still effective, SBP's exchange rate management by facilitating demand/supply matching in the interbank market was completely abandoned and its market support was gradually reduced.

The forex market, still in the process of development, has certain features that need to be highlighted. First, the market has three distinct sets of participating banks: state-owned banks with a large merchant base; foreign banks mainly catering to multinational companies; and private banks having

[14] The need to impose requirement of commercial-based transactions also arise due to lack of liquid risk management tools. The risk management in an international forex market includes deep and diversified derivative market facilitating risk transfer, accounting and disclosure standards and a strong regulatory framework to develop an orderly market not driven by panic. Even then, strong speculative forces are often successful in changing the market sentiments. Lack of risk management tools necessitates commercial-based transactions.

[15] During periods of uncertainty, while importers tend to bunch their current and future requirements of foreign exchange, exporters may hold back export receipts in anticipation of further depreciation.

limited participation. Former two sets of banks play a significant role in influencing the market rate through active inter-bank participation. Second, the forex market is thin in terms of turnover. In view of curbs on speculative positions of ADs, the Rupee rate comes under pressure due to excess demand for the hard currency (a reflection of large trade gap), thereby leading to unidirectional expectations. However, a recent trend is witnessed of two-way movement. Third, the depth and liquidity that provides stability in times of volatility, are lacking in the forex market. Consequently, market exhibits tendencies of sharp overshooting and unidirectional trends and the SBP intervention becomes inevitable to stabilize the market.

5.3.3 The Kerb Market

The kerb market consists of authorized money changers (AMCs) who were granted formal license by SBP in 1991. Pakistani nationals or resident firms could obtain a license to work as AMCs after depositing the required capital according to regulations. Since then their number has increased to 427 as on June 2000. Although this seems large, there are only 4 or 5 money changers that are really important, with about 80 percent of turnover. Apart from AMCs, there are unlicensed money changers, who are much smaller and make up the black market.

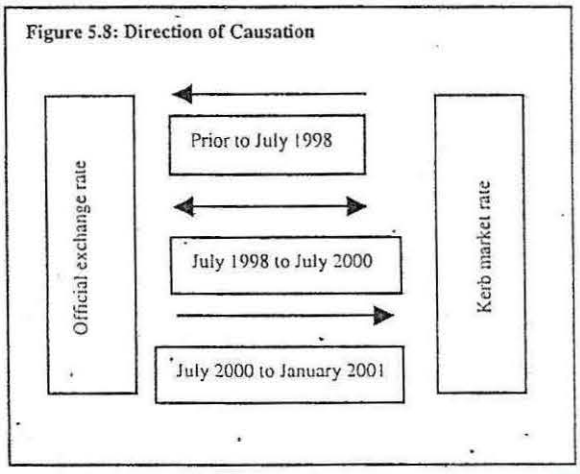
Traditionally, authorities have used different instruments to channel foreign currency flows from the kerb market to the banking system. In particular, FCA scheme for resident Pakistanis, introduced in 1991, was effectively providing a conduit to attract remittances flowing through the hundi into the banking system. Although the fall in domestic dollarization following freeze of FCAs in May 1998, had reduced the physical inflows of foreign exchange into the country, such hard currency balances have been building up abroad. Outright purchases by SBP, which simply tap into these balances at the existing kerb rate, have now become one of the major sources for financing the trade deficit. However, against general perception, these purchases as such do not have any significant relationship with kerb premium. In fact, kerb market maintains an almost fixed wedge over inter-bank rate irrespective of volumes purchased.

Deviations between the kerb and official rate are often used as proxy for the degree of misalignment of the official exchange rate. More specifically, the premium in the kerb market is taken as a reflection of the excess demand for foreign exchange resulting from certain restrictions that entail capital account controls. However, changes in the exchange rate regime following detonation have not only impacted the underlying relationship between the two rates, but also have implications for the validity of the kerb premium as an indicator of overvaluation. Prior to July 1998, the kerb rate was adjusting to market conditions whereas the official rate was announced on a daily basis by SBP. The overvaluation of the *pegged* exchange rate was directly on account of restrictions limiting only certain 'approved' transactions that could be executed at the official exchange rate. However, when the dual exchange rate mechanism was adopted, the official rate has been adjusting to market conditions.

According to a SBP study that attempts to determine the direction of causation between kerb and official rate, prior to July 1998, the official rate (as determined by SBP) followed the kerb rate.[16] This implied that a sustained upward movement in the kerb rate would preempt or lead to a devaluation of the exchange rate. This also meant that kerb market was able to correctly predict changes in the official rate, and the resulting activity in the open market would increase the kerb premium just before an official devaluation. During July 1998 to July 2000, on the other hand, when the Rupee was in a transitional stage towards free float, causation ran in both directions. To put simply, it was hard to determine one-sided causality. However, after the Rupee was fully floated, a stronger causation runs from the official to the kerb rate. This means that changes in the official rate now determine almost equivalent changes in the kerb rate. The main findings of the study are summarized in **Figure 5.8**. A

[16] See Second Quarterly Report 2000-2001

closer look at the two rates suggests that kerb market responds swiftly to changes in official rate when the latter depreciates, whereas it reacts with certain lags when the official rate appreciates. In other words, we can say that the kerb market rate is relatively rigid in downward direction.[17]



5.3.4 Crisis Management

Developments following the nuclear tests exposed Pakistan's external vulnerability and brought about a balance of payments crisis. Despite its intensity, Pakistan's economy survived the external shock fairly well, for several reasons: (1) economic linkages with international financial markets were not too strong— i.e. its external exposure was mainly in foreign currency accounts (FCAs), which were frozen without any delay; (2) proper crisis management, including a variety of actions to prevent overshooting of the exchange rate; (3) a relatively good food supply situation; (4) availability of Saudi Oil facility; and (5) presence of a large and robust informal sector which is not captured in the economic statistics.

In the face of immediate risk of massive withdrawals from FCAs against a very low level of foreign exchange reserves, the government suspended withdrawals in foreign exchange from FCAs and imposed certain restrictions on other foreign payments. This, together with the fact that Pakistan was building up substantial arrears on debt servicing and other forex obligations, adversely affected the confidence of investors. Downward revision by major credit rating agencies and imposition of economic sanctions led to a sharp fall in capital flows. Worker remittances also declined considerably due to widening differential between kerb and official market, thereby further aggravating external imbalances.

The government also imposed restrictions on certain hard currency payments in addition to debt servicing with a view to conserve foreign exchange reserves. It established a temporary dual exchange rate system to offset the loss of export competitiveness while easing the pressure on the official exchange rate. Furthermore, a 30 percent advance cash margin requirement was imposed to discourage imports. Cash reserve and statutory liquidity requirements were reduced to ease the anticipated squeeze on banks' liquidity resulting from withdrawals from FCAs. In order to accelerate the conversion of FCAs, Special US Dollar Bonds were introduced. These bonds were issued for a period of three, five and seven years. Since its inception, a total of US$ 1.95 billion bonds have been issued up to 30th June 2001. Of that, US$ 465 million have been converted into Rupees, thereby leaving US$ 1.5 billion outstanding liability in hard currency.

At the same time, government revived its 1997 reform program with strong up-front actions. Based on this reform program, the government also sought rescheduling from the Paris/London Club creditors. Subsequently, with the assistance from the World Bank, and refund of payments for F-16 planes by the USA, foreign exchange reserves increased from $ 415 million on November 12, 1998 (lowest level reached during the crisis) to $ 1,733 million on February 11, 1999. Reserves further increased to $ 1,838 million on March 31, 1999 after disbursement of $ 200 million by the Asian Development Bank (ADB) under the newly approved Trade, Export Promotion and Industry Loan. As the external financing position became relatively more comfortable, Pakistan removed most

[17] This behaviour changed completely in the aftermath of events of September 11, 2001. See **Second and Third Quarterly Reports 2001-2002** for details.

restrictions on current account transactions ahead of the schedule agreed upon under the ESAF/EFF program.

5.4 Credit Allocation System

Credit planning had a powerful role in the allocation of credit by the banking system till the initiation of financial sector reforms. After the abolition of credit controls, in the form of credit ceilings or mandatory credit, this role has been minimized to a tentative credit expansion plan during a fiscal year. It, however, still plays an important role in the integration of monetary expansion with the real sector growth targets set under the annual plan. Credit planning is done through a systematic and broad-based procedure, under the National Credit Consultative Council (NCCC), in which the views and suggestions of all stakeholders are duly considered and incorporated through consensus.

Under the NCCC, every year a credit plan is prepared to achieve a more focused and equitable distribution of credit, after a thorough regional and sectoral review of credit expansion during the past year, within safe limits defined after fixing of growth and inflation targets in the annual plan. Total domestic credit expansion is determined on the basis of foreign exchange inflows or outflows. In a situation of foreign inflows, the domestic credit is expanded by the overall monetary expansion less the foreign exchange inflows and vice versa. Within the domestic credit expansion limits, credit allocation to the government and non-government sectors are determined on the basis of government budgets, annual plan and capital requirements worked out on the basis of certain percentages of value added by different sectors. After a few dormant years, NCCC has once again been revitalized in FY00, to assess the credit requirements of the real sector and determination of safe limits of monetary expansion.

The credit allocation mechanism prevalent in FY00 was almost market-based except for the few subsidized credit schemes, like export finance and LMM schemes. Now that credit ceilings and mandatory credit do not bind the banks, they have also been freed from ceilings and floors on mark-up rates. Since July 1997, minimum and maximum bounds on mark-up rates on trade and investment related modes of financing have been abolished. Before the abolition of credit control regime, banks were penalized for not having achieved targets fixed for credit expansion to various sectors, after setting up of the overall monetary expansion targets. Now the credit plan is not followed by any kind of targets for banks. They are free to extend credit at their own choice of customer and mark-up rate. Since banks can avail the refinance facility for export finance and LMM schemes, it can be said that the lending by banks from their own resources is completely market based.

Although the government is enjoying bulk of the banking system resources, these are borrowed at market-based interest rates, mainly through auction of treasury bills. Only a small fraction of government borrowings is subsidized and that is for commodity operations. The credit to the private sector, however, has a significant part, in the form of export finance and LMM schemes, which is provided at subsidized rates.[18]

5.5 Transformation of Payment and Settlement System

The payment system comprises all those entities, which enable financial institutions, enterprises and individuals to transfer funds from one to another. An efficient and reliable payment system is of utmost importance for all users and participants. The types of payment instruments, clearing mechanism and final settlements represent key infrastructure for the financial sector and for the wider economy. In order to ensure efficiency and reliability in the growing cross-border payments and settlements during the last decade or so, a number of initiatives have been taken at international level to improve the payment systems. A considerable progress has been made also in Pakistan towards speedy clearance of checks and corporate securities during 1990s, especially in the later half.

[18] On average, 12.5 percent of the credit to the private sector is extended under export finance scheme.

At the beginning of 1990s, major components of the payment system in Pakistan were check clearing and settlement system, government securities settlement system and corporate securities settlement system. Before 1997, a clearinghouse at SBP was performing the function of check clearing through manual process. The clearinghouse used to prepare the net clearing position of each member bank and send it to Deposit Account Department (DAD) of Karachi Office of SBP for settlement. The DAD then, debited or credited, as the case may be, to the respective accounts of banks. However, since March 1997, the settlement remained structurally the same as before, but an automated system of clearing checks replaced the manual process of clearing through a private sector initiative.

National Institutional Facilitation Technology (NIFT) was launched in March 1997.[19] Since then, NIFT has entered in agreement with SBP to provide automated clearing services. Presently, all commercial banks have become participating members by signing a standard service agreement. So far, this modern imaging facility has been established at Karachi, Lahore and Islamabad and the process of conversion is on the move at Rawalpindi, Peshawar and other major cities.

In early 1990s, volumes of turnover were very small, given the predominance of currency-based transactions reflected in high currency to deposit ratio. On average, only 4 checks were used for every checkable deposit in 1992. Check clearing indicators are shown in **Table 5.12**. Turnover of checks relative to GDP remained stagnant around 1.27 times of GDP up to 1994. During the next four years, it fluctuated between 1.01 and 1.33 times of GDP. Only in the last two years, it has gone over 1.5 times of GDP.

Settlement of government securities was also performed at SBP. Before 1991, physical movement of the securities was routine of the day. In order to avoid unnecessary physical movement of the securities, the facility of Subsidiary General Ledger Account (SGLA) was extended to banks and NBFIs on March 7, 1991. Since then, transactions had been recorded through debits and credits in SGLA of banks and NBFIs. In this regard, two accounts were maintained, one for each institution as approved dealer for their own position, while the other was maintained at SBP to show the client's position. However, in case of client's request, physical movement still took place and remained a part of the system.[20]

Table 5.12: Indicators of Turnover in Clearing House

Year (Jan-Dec)	No of cheques cleared (millions nos)	Turnover in payment system (billion Rupees)	No of checkable deposits (millions nos)	Total no of deposits (millions nos)	Cheques to checkable deposits	Currency in Circulation to total deposits ratio(%)	Ratio of turnover to GDP
1990	13.2	1,083.3	3.6	26.8	3.7	51.4	1.3
1991	14.4	1,277.9	4.2	31.0	3.4	52.6	1.3
1992	16.0	1,544.3	4.0	27.1	4.0	43.3	1.3
1993	18.3	1,754.6	4.3	28.0	4.2	39.4	1.3
1994	16.9	1,978.8	4.7	29.5	3.6	36.0	1.3
1995	16.4	1,905.3	5.1	31.1	3.2	35.7	1.0
1996	22.2	2,824.7	5.2	31.7	4.3	33.6	1.3
1997	22.9	2,832.6	5.7	32.3	4.0	30.4	1.2
1998	24.7	3,508.8	5.6	29.8	4.4	29.4	1.3
1999	29.1	4,467.8	5.2	29.7	5.6	29.2	1.5
2000	29.6	5,357.6	4.8	28.8	6.2	34.3	1.7

Note: Total deposits include RFCD

[19] The private banks that participated in the establishment of NIFT included MCB, NBP, HBL, UBL, ABL and First Woman Bank Limited.

[20] The only exception is Pakistan Investment Bond, which is issued in book entry form without any scrip.

Corporate equities settlement system during 1990s, like check clearing system, had also experienced radical changes regarding efficiency and security of the settlement process. Since establishment of the Central Depository Company (CDC) in September 1997, electronic settlement process has replaced the physical transfer of shares from one party to other. Till March 2000, CDC had been settling about 97 percent of the securities traded at the stock exchanges. The CDC had also included Term Finance Certificates (TFCs) in its settlement process. Since its inception, CDC had also launched two major services that resulted in higher participation of investors in electronic settlement system. First, Investor Account Services (IAS) was started from August 16, 1999 that allowed investors to directly open and maintain accounts in CDC for electronic settlement system. Second, Delivery versus Payment (DvP) Service started on November 8, 2000, which allowed simultaneous transfer of cash and securities from one account to another in the CDC.

6 Impact Analysis of Financial Reforms

The objectives and nature of reforms in the financial sector during 1990s have been discussed in the first four chapters. How these changes have transformed the financial markets was also discussed in the previous chapter. This chapter assesses the impact of reforms on financial structure, deepening, intermediation, and efficiency by using macro-financial indicators. It also reviews developments in debt management, monetary transmission mechanism, and banking supervision. Sequencing issues have also been discussed briefly. The first section of this chapter gives a review of macroeconomic indicators of the economy and the subsequent sections appraise the reforms. The last section presents an evaluation of financial developments in peer countries.

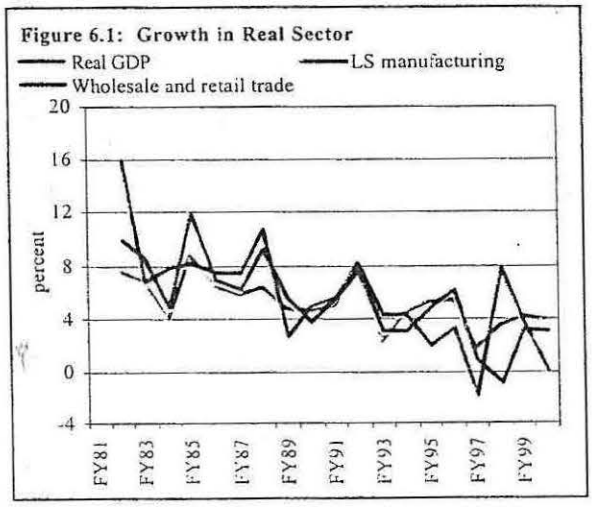
6.1 Role of Macroeconomic Factors

The extent of financial sector transformation depends not only on the quality of reforms and implementation process, but also on overall macroeconomic environment. A conducive growth environment is likely to provide a better support to the reform process, besides permeating the spirit of reforms across the entire financial sector. It is, therefore, important to examine the behavior of various macro economic variables during the decade, before assessing the impact of reforms.

6.1.1 Economic Growth

In 1990s the country witnessed real GDP growth rates lower than those of 1980s. Growth rate was 6.1 percent (on average) during 1980s, which fell to 4.4 percent in 1990s (see **Table 6.1** and **Figure 6.1**).[1] Low growth rates often weaken the debt-servicing capacity of the domestic borrowers, worsen the problem of loan defaults and increase credit risk. This was exactly the case in Pakistan where loan defaults grew tremendously during the last decade despite the process of financial reforms and liberalization.

Figure 6.1: Growth in Real Sector



Besides the aggregate growth rate, the sectoral performance of GDP is also very important for financial sector. A slump in sectors where financial institutions' loans and investment are concentrated, has an adverse impact on the soundness of the financial system. In Pakistan, large-scale manufacturing sector, mainly financed by banks' credit, slowed down during last decade. The sectoral slumps deteriorated the quality of financial institutions' portfolio and profitability margins, besides lowering their cash flows and reserves.

6.1.2 National Savings

Public and private savings are among the major sources of funds for the banking sector. During 1990s, average national savings in Pakistan declined significantly (see **Table 6.1**). National savings, which was 14.8 percent of GDP during 1980s, declined by one percentage point to 13.8 percent during 1990s. Major reduction was in private savings, by about one-half of a percentage point from 13.0 percent of GDP in 1980s to 12.4 percent in 1990s. Public savings also declined but with lesser extent. However, public savings witnessed a significant reduction during the second half of 1990s.

[1] Average growth rate of GDP during first half of 1990s was 3.7 percent against 6.5 percent in the first half of 1980s.

Table 6.1: Macroeconomic Factors Affecting the Financial Sector

	1980s	1990s	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Economic Growth (%)													
Real GDP	6.1	4.4	4.6	5.1	8.2	2.3	4.5	5.3	5.5	1.7	3.5	4.2	3.9
Major crops	3.3	4.0	-0.1	5.7	15.5	-15.6	1.2	8.7	6.0	-4.3	8.3	0.0	15.1
LS manufacturing	7.8	3.5	4.7	5.4	7.9	4.1	4.1	1.7	3.1	-2.1	7.6	3.6	-0.2
W & R trade	7.2	3.5	3.5	5.3	7.3	2.9	2.8	4.7	6.1	0.7	-1.1	3.0	2.9
National savings (% of GDP)													
Public	1.8	1.5	2.8	0.7	4.3	1.6	2.5	1.9	1.5	1.00	0.1	0.9	0.3
Private	13.0	12.4	11.4	13.5	12.8	12.0	13.2	12.5	10.3	10.8	14.5	10.8	13.5
Total	14.8	13.9	14.2	14.2	17.1	13.6	15.7	14.3	11.8	11.8	14.7	11.7	13.8
Inflation	7.3	9.7	6.0	12.7	10.6	9.8	11.3	13.0	10.8	11.8	7.8	5.7	3.6
Money supply (M_2 growth)	14.0	15.2	17.5	17.4	26.2	17.8	18.1	17.2	13.8	12.2	14.5	6.2	9.4
Fiscal sector													
Tax to GDP ratio	13.8	13.4	14.0	12.7	13.6	13.3	13.2	13.7	14.4	13.4	13.2	13.4	12.8
Budget deficit (% of GDP)	-7.0	-6.9	-6.5	-8.7	-7.4	-8.0	-5.9	-5.6	-6.5	-6.3	-7.7	-6.1	-6.4
External sector													
CAD (% of GDP)	-2.7	-3.9	-3.4	-3.0	-1.8	-6.4	-3.2	-3.5	-6.9	-5.6	-2.7	-3.8	-0.4
Liquid foreign exchange Reserves[1](billion US$)	0.8	1.2	0.4	0.4	0.5	0.8	1.2	2.6	1.6	1.0	1.3	1.2	1.5
Equivalent weeks of imports	7.3	6.2	2.9	2.4	2.9	4.2	7.1	13.2	7.2	4.5	6.7	6.6	7.6
External debt to GDP ratio	34.7	49.4	38.5	41.4	40.4	44.3	47.7	48.5	50.5	51.8	55.4	57.7	56.2
Portfolio investment/FPI[2] (%)	10.4	24.6	-2.2	-3.8	39.5	30.9	44.9	34.0[3]	15.7	28.2	26.9	5.5	13.5
Devaluation	-8.3	-8.2	-3.2	-10.3	-3.3	-7.5	-11.3	-1.3	-11.7	-13.2	-12.0	-10.5	-1.2

[1] 12-month end period average
[2] FPI: Foreign private investment
[3] Excluding PTC vouchers

6.1.3 Inflation

Inflation is one of the major factors affecting the performance of the financial system. High inflation reduces the demand for money, persuading people to prefer real assets over monetary assets. During 1990s, inflation was very high at around 10 percent on the average compared with 7 percent during a decade earlier. Although inflation was low during the last couple of years of 1990s, but the people remained reluctant to adjust their behavior accordingly, due to other economic and political factors.

6.1.4 Balance of Payments

Current Account Deficit

A rise in the ratio of current account deficit to GDP is generally associated with large external inflows that are intermediated by the domestic financial system and enhance turnover of banking services. However, a large current account deficit also signals vulnerability to a currency crisis with negative implications for the liquidity of the financial system, especially if this deficit is financed by short-term capital inflows. Financial crisis may occur if investors consider current account deficit to be unsustainably large. In Pakistan current account deficit (CAD) remained high during 1990s as compared with 1980s, which made the financial sector vulnerable to external shocks. At the same time, banks also enjoyed flow of foreign funds in this period, especially up to May 1998.

After the nuclear detonation and freezing of foreign currency accounts, financial institutions faced liquidity problems. CAD declined in FY98, due to imposition of dual exchange rate regime to tightly manage payments and receipts of foreign exchange. Later decline in CAD largely reflects the restructuring of external debt agreed with international financial and commercial institutions.

Foreign Exchange Reserves Position
A low level of international reserves is seen, particularly by investors, as a major indicator of vulnerability. The domestic financial system also comes under pressure due to possible actions taken by the central bank to contain external outflows and preserve foreign exchange reserves. Reserves position in Pakistan seldom remained satisfactory. Foreign exchange reserves could finance around six weeks of imports, on average, during the last two decades. Inadequate level of reserves has a bearing on the business of banks that may face restrictions and constraints on forex based activities.

A high external debt to GDP ratio indicates stress on the external sector of the economy. Increasing need for payments on account of debt servicing leaves a small amount with the domestic financial system for other transactions. External debt to GDP ratio also had an increasing trend in Pakistan. During 1980s, this ratio was 34.7 percent, which increased to 49.4 percent in 1990s. Another potential source of risk for the financial system is higher proportion of portfolio investment in total foreign investment. In Pakistan this share increased from 10.4 percent in 1980s to 24.6 percent in 1990s. Similarly, the volatility in the exchange rate can also increase the risk for the financial system. Volatility in the exchange rate could cause difficulties for financial institutions by creating currency mismatches between banks assets and liabilities and making decision process difficult. Exchange rate in Pakistan remained highly volatile during the last decade. The level of variance of monthly exchange rate during 1980s was 10.5, which increased to 95.5 during 1990s, indicating an increase in volatility after implementation of financial reforms.

6.1.5 Fiscal Position
A low tax to GDP ratio coupled with high budget deficit forces the government to take recourse to the banking system. High government borrowing from the central bank could lead to inflationary pressures and affect the financial system. However, government borrowing directly from the scheduled banks has a favorable implication for banks' asset quality and also for their profitability if it is done on market-based rates of return. Increased borrowing may, however, crowd out the private sector credit. During 1990s, both tax to GDP ratio and budget deficit were almost at the same level as during 1980s. But as rates of return on T-bills were liberalized during 1990s, the banking sector of Pakistan benefited from this development.

6.2 Impact on Financial Structure, Deepening and Intermediation

6.2.1 Impact on Financial Structure
Financial reforms that permitted private sector to establish banks, and the process that led to privatization of MCB and ABL in early 1990s (see **Section 2.1.1**) began to transform the structure of not only the banking sector but the overall financial system as well. Both the asset composition and deposit shares changed dramatically during the decade of 1990s. Within the banking sector, ownership structure changed radically. Asset share of banking institutions in the private sector jumped from 7.8 percent in 1990 to 46.0 percent in 2000.[2] Moreover, the pace of growth of assets and deposits in private sector banking institutions was even more dramatic. Compound annual growth rates of the assets and deposits in private sector were more than fourfold that of public sector. Consequently, the dominance of public sector was reduced from 92.2 percent in 1990 to 54.0 percent in 2000 as shown in **Table 6.2**. In terms of GDP, assets of private banking institutions leapt from only 3.9 percent in 1990 to 23.7 percent in 2000. Deposit structure also underwent a similarly remarkable transformation during the decade under review as shown in **Table 6.2**.

[2] Share of private sector banking assets is likely to go up to 55.5 percent after the envisaged privatization of UBL in 2002.

Overall financial system, including banks, NBFIs and CDNS also experienced a significant transformation in terms of ownership between private and public sector. Asset share of private sector financial institutions increased from 5.3 percent in 1990 to 30.0 percent in 2000 as shown in **Table 6.3.** Although the share of public sector financial institutions was reduced from 94.7 percent in 1990 to 70.0 percent in 2000, it is still high due to the dominant share of CDNS in resource mobilization (see **Tables 4A.10** in **Annex 4**).

Table 6.2: Dynamics of Banking Sector during 1990s

	Amt. (bln Rs)		CAGR (%)	Shares (%)		As % of GDP	
	1990	2000		1990	2000	1990	2000
Assets							
Private	33	755	36.6	7.8	46.0	3.9	23.7
Public	392	885	8.5	92.2	54.0	45.8	27.8
Total	*426*	*1641*	*14.4*	*100.0*	*100.0*	*49.7*	*51.5*
Deposits							
Private	25	579	37.0	7.0	43.8	2.9	18.2
Public	330	744	8.5	93.0	56.2	38.5	23.4
Total	*355*	*1323*	*14.1*	*100.0*	*100.0*	*41.4*	*41.6*

Notes: Private sector includes private banks, MCB, ABL and foreign banks; the public sector excludes MCB and ABL.
CAGR: Compound annual growth rate.

6.2.2 Financial Depth

The most commonly used indicator of financial sector deepening is the ratio of monetary assets (defined as M_2 in case of Pakistan) to Gross Domestic Product.[2] A higher M_2/GDP ratio represents a more developed and efficient financial sector. Clearly people will prefer to hold monetary assets only when they feel convenient to keep their wealth in monetary instruments with underlying nature of liquidity, risk, return and efficiency in payments. Such types of instruments are offered by a well-developed financial sector.

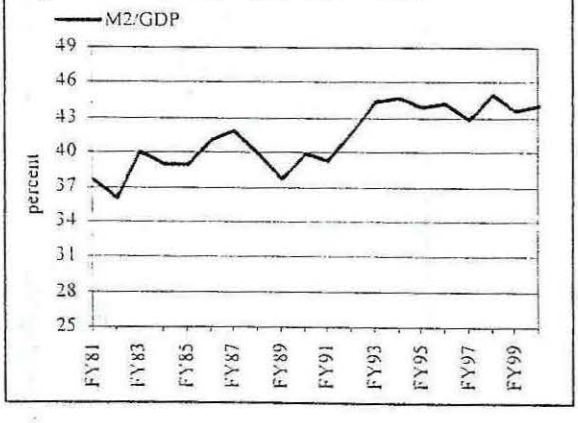
Table 6.3: Dynamics of Financial Sector during 1990s

	Amt. (bln Rs)		CAGR (%)	Shares (%)		As % of GDP	
	1990	2000		1990	2000	1990	2000
Assets							
Private	43	856	34.9	5.3	30.0	5.0	26.9
Public	649	1771	10.6	94.7	70.0	75.8	55.6
Total	*691*	*2626*	*14.3*	*100.0*	*100.0*	*80.8*	*82.5*
Deposits							
Private	27	614	36.7	6.2	32.6	3.2	19.3
Public	482	1436	11.5	93.8	67.4	56.3	45.1
Total	*509*	*2050*	*15.0*	*100.0*	*100.0*	*59.5*	*64.4*

Notes: Same as those of Table 6.2 a

In Pakistan, M_2/GDP ratio is not only low but also has remained stagnant for the last couple of decades. During the 1980s, monetary assets (on average) were around 40 percent of GDP while during 1990s, about 44 percent. There was only a one-time jump in the monetary assets from 41.7 to 44.4 percent of GDP, during FY93, mainly due to the introduction of resident foreign currency deposits in FY91. Signs of further improvement in M_2 to GDP ratio were not visible during the rest of the decade (see **Table 6.4 and Figure 6.2**). Things would be even worse if we consider the underground economy.[4] Thus, despite the process of liberalization and other reform measures, the financial sector of Pakistan was unable to strengthen and widen its scope in the economy. As a result, a large part of the economy is still non-monetized.

Figure 6.2: Monetary Assets to GDP Ratio



[1] M_2 = currency in circulation + demand deposits + time deposits + residence foreign currency deposits.
[4] If underground economy is taken into account then M_2/GDP ratio becomes 24.1%, 26.8%, and 29.7% during 1980-81, 1990-91 and 1999-00 respectively (Ref: "A Non-linear Model to Estimate the Underground Economy in Pakistan", an in-house study of Research Department by Aslam Khan, Farooq Arby, and Amin Lodhi).

Money Multiplier is another important indicator of financial sector deepening. High but stable multiplier indicates a well-developed and active financial sector. A low money multiplier, on the other hand, indicates a shallow and passive financial sector, having low responsiveness to central bank policy changes. An unstable money multiplier renders the results of monetary policy measures unpredictable and thus makes monetary management more difficult. Low and unstable multiplier, therefore, indicates a weak mechanism of monetary policy transmission.

Table 6.4: Indicators of Financial Sector Deepening (percent)

	M_2/GDP	MM	CC/TD	CC/RD
FY81	37.6	2.5	50.1	50.1
FY82	35.9	2.5	48.1	48.1
FY83	40.1	2.6	45.9	45.9
FY84	38.9	2.6	47.1	47.1
FY85	39.0	2.6	44.5	44.5
FY86	41.0	2.7	43.1	43.1
FY87	41.9	2.4	45.5	45.5
FY88	39.9	2.5	48.6	48.6
FY89	37.7	2.4	51.4	51.4
FY90	39.9	2.4	51.4	51.4
FY91	39.3	2.4	52.6	54.6
FY92	41.7	2.4	43.3	49.4
FY93	41.4	2.8	39.3	46.0
FY94	44.7	2.9	36.0	43.9
FY95	43.8	2.7	35.7	43.2
FY96	44.3	3.0	33.6	42.4
FY97	42.9	3.2	30.4	42.2
FY98	45.1	3.3	29.4	42.1
FY99	43.6	3.2	29.2	33.2
FY00	44.0	2.8	34.3	38.5
Averages				
1981-85	38.3	2.6	47.1	47.1
1986-90	40.1	2.5	48.0	48.0
1991-95	42.8	2.6	41.2	47.4
1996-00	44.2	3.1	31.4	39.7

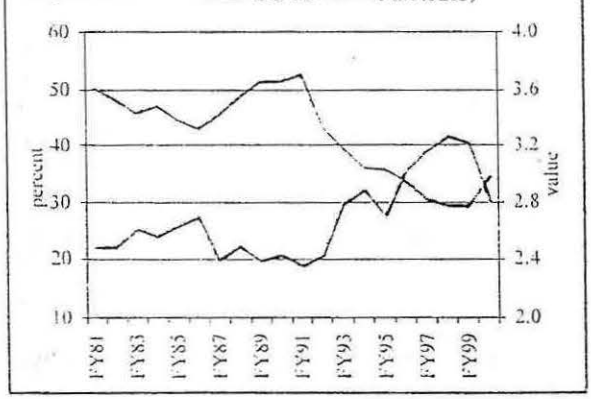
MM = Money Multiplier, CC/TD = Currency in Circulation to Total Deposit Ratio, CC/RD = Currency in Circulation to Rupee Deposit Ratio

Value of money multiplier showed rising trend during last two decades (see **Table 6.4**). A significant jump in the money multiplier may be noted during mid 1990s (see **Figure 6.3**) because of frequent devaluation of domestic currency during this period, which made holding of Pak Rupee less attractive; as a result currency to deposit ratio declined and money multiplier increased. This could also be due to the removal of caps on maximum lending rates of banks and NBFIs, together with the elimination of credit to deposit ratio that resulted in quicker expansions in domestic credit. As far as stability of money multiplier is concerned, it witnessed high fluctuation during the 1990s compared with the 1980s. Variance of monthly money multiplier was 0.1261 during 1990s compared with 0.0915 during 1980s. These fluctuations were mainly due to frequent policy changes undertaken during the decade of 1990s.

6.2.3 Financial Intermediation

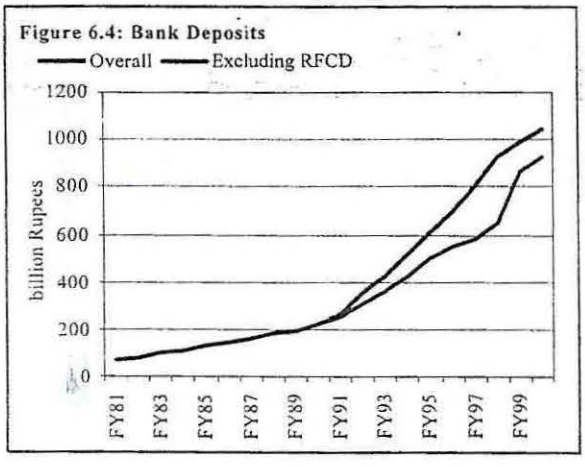
The extent of financial intermediation can be assessed by the currency to deposit ratio. Currency and bank deposits are two competing financial assets. People like to keep both currency and deposits in a certain proportion depending upon their taste, spending habits, cost of holding currency in terms of interest rates and inflation, quality of financial services, and efficiency of payment system. A low currency to deposit ratio indicates public preference towards bank deposits and vice versa. In Pakistan, currency to deposit ratio generally had a declining trend during 1990s (see **Table 6.4** and **Figure 6.3**). It declined from 50.1 percent in FY81 to 29.2 percent in FY99. If resident foreign currency deposits are excluded, then currency to rupee deposit ratio declined to 33.2 percent in FY99. However, during

Figure 6.3: Money Multiplier and Currency to Deposits Ratio



FY00, both the ratios -- currency to total deposit as well as currency to rupee deposits -- increased significantly.

The reversal of trend in currency to deposit ratio is witnessed despite high real interest rates on deposits in recent years. The whole decade of 1990s, except the last two years, witnessed negative real interest rates due to high inflation. During the last two years, real interest rates were positive. It seems puzzling that when real interest rates were negative, currency to deposit ratio was declining, but as the real rates of returns became positive, it has gone up. The solution of this puzzle may be linked to other macroeconomic, social and political developments in the economy. Some of the possible factors behind this phenomenon may include: (1) the fall in inflation in FY00, which reduced the opportunity cost of hoarding money; and (2) the accountability drive launched in October 1999 created a clear incentive to hide personal wealth, and cash is clearly the most convenient and untraceable avenue for this purpose.



Deposits of commercial banks increased steadily during 1990s, although growth slowed down after FY98 (see **Figure 6.4**). Introduction of resident foreign currency account scheme went a long way in boosting the deposit base of commercial banks. Rupee deposits also grew with generally increasing rate during the period, except for some sluggishness in FY97 and FY00. The growth in deposits also benefited from entrance of new banks in the banking industry. However, the thrust of deposit growth came from RFCDs and the dollarization. Nevertheless, deposit growth was only marginally ahead of the nominal growth in GDP during the decade. Consequently, the ratio of deposits to GDP has gone up from 29.5 percent in FY90 to 33.8 percent in FY00.[5]

6.2.4 Financial Savings

Financial savings can be defined as the amount of deposits and other savings held by the financial institutions for the households, business organizations and other institutions. Four major components of financial savings are deposits of scheduled banks, deposits of NBFIs, investment in government debt instruments by non-bank, and currency in circulation. Greater availability of savings and checking deposits and other financial instruments contribute to the expansion of financial savings. However, the structure of financial savings shown in **Table 6.5** depicts a falling share of banks deposit in total financial savings in the second half of 1990s. The same trend was witnessed in terms of deposits of NBFIs. Although the share of currency in circulation declined during 1990s, this healthy development was countered by an intense pressure of financial dis-intermediation, which caused the share of government debt instruments (non-bank investment, mostly in CDNS schemes) in financial savings to increase from 25.8 percent in 1995 to 35.1 percent in 2000.

The alarming strength of dis-intermediation during 1990s was also visible clearly in terms of trends in growth rates of components of financial savings, as well as their ratios to GDP. Investment in government securities by non-banks showed an increasing trend at the expense of deposits of both banks and NBFIs that showed a declining trend in growth. These trends not only resulted in a virtually stagnant ratio of stocks of financial savings in term of GDP, but a markedly declining trend in the

[5] The value of deposit to GDP ratio reported here will not tally with those in other sections. Deposits used here are part of M_2 and exclude deposits of government and non-residents.

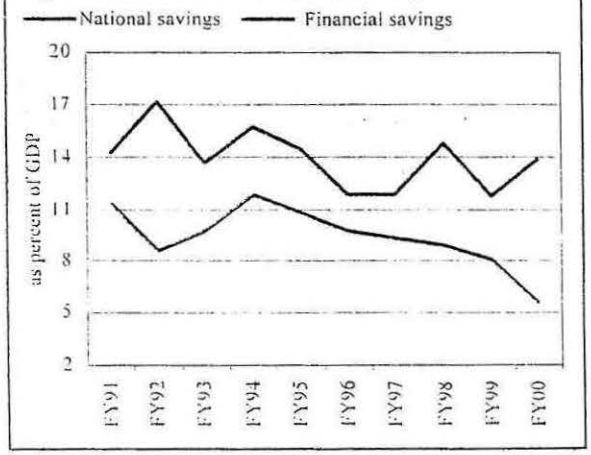
yearly flows of financial savings to GDP. Financial savings, being a subset of national savings (see **Figure 6.5**), therefore, caused the latter to decline as well.

Table 6.5: Components of Financial Savings

	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Financial savings (billion Rupees)	724	828	958	1143	1346	1552	1777	2016	2251	2427
Stocks as percent of financial savings										
Deposits of schedule banks	47.5	50.3	51.2	51.9	53.0	53.3	52.9	52.1	49.4	47.0
Deposits of NBFIs	3.5	4.0	5.2	5.6	5.3	5.4	6.6	5.0	4.1	3.2
Govt. debt instruments (non-bank)	30.1	27.3	26.1	26.4	25.8	26.2	26.8	29.4	33.6	35.1
Currency in circulation	18.9	18.3	17.4	16.2	16.0	15.1	13.7	13.5	12.8	14.7
Financial savings	100	100	100	100	100	100	100	100	100	100
Stocks as percent of GDP										
Deposits of schedule banks	33.8	34.4	36.6	37.7	37.9	39.0	38.7	39.2	37.9	35.8
Deposits of NBFIs	2.5	2.7	3.7	4.0	3.8	4.0	4.9	3.7	3.2	2.4
Govt. debt instruments (non-bank)	21.5	18.7	18.6	19.2	18.4	19.2	19.6	22.1	25.8	26.8
Currency in circulation	13.5	12.5	12.4	11.7	11.5	11.0	10.1	10.2	9.8	11.2
Financial savings	71.3	68.3	71.4	72.7	71.5	73.2	73.2	75.3	76.6	76.2
Flows as percent of GDP										
Deposits of schedule banks	6.4	6.0	5.5	6.5	6.4	5.4	4.6	4.2	2.1	0.9
Deposits of NBFIs	0.6	0.7	1.3	0.9	0.4	0.6	1.4	-0.7	-0.2	-0.5
Govt. debt instruments (by non-bank)	2.2	0.6	1.8	3.3	2.4	2.8	2.8	4.3	5.6	3.0
Currency in circulation	2.1	1.2	1.1	1.1	1.6	0.9	0.4	1.1	0.5	2.1
Financial savings	11.3	8.5	9.7	11.8	10.8	9.7	9.3	8.9	8.0	5.5
National savings	14.2	17.1	13.6	15.7	14.3	11.8	11.8	14.7	11.7	13.8

The process of dis-intermediation was fuelled by the increasing distortions in the term structure of interest rates, as a result of introduction of new costly schemes by CDNS in 1993 and drastic upward revision in profit rates of its main certificates. For example, compound annual average rate of profit of DSCs was revised upward from 15.6 percent set in June 1981 to 16.0 percent in November 1993, and then again to 18.0 percent in November 1996. It was only in May 1999 that a process of rationalization of profit rates of NSS was started that reduced the DSC rate first to 15.9 percent, and then to 14.0 percent in July 2000. Unfortunately, the rate was again revised upwards to 15.0 percent in July 2001, and later reduced to 14.1 percent after linking it to the yield of ten-year PIB from January 2001.

Figure 6.5: National and Financial Savings



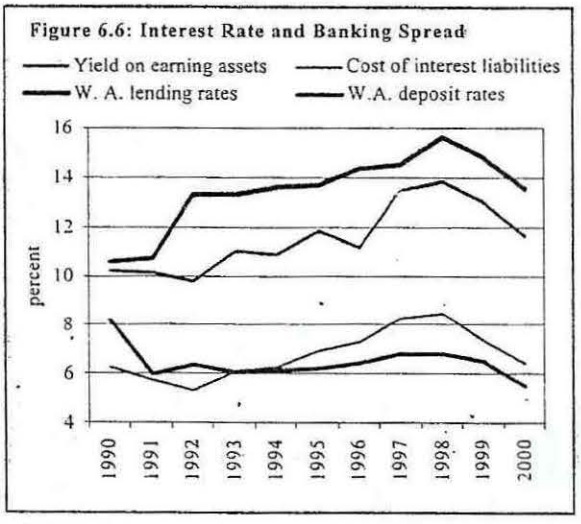
6.3 Impact on Financial Efficiency

The efficiency of the financial system can be measured by two important indicators: (1) interest rate spread; and (2) distribution of bank credit among various sectors. The trend in both of these indicators is discussed below.

6.3.1 Interest Rate Spread

The spread between lending and deposit rates (the banking spread) is the measure of intermediation cost of banks, which has increased over time in case of scheduled banks in Pakistan (see **Table 6.6** and **Figure 6.6**). It was 2.4 percentage points in FY90, which increased sharply to 7.9 and then to 8.1 percentage points in FY96 and FY00 respectively. Although during 1990s lending rates increased significantly, the banks were unable to pass on their interest earnings to depositors to the same extent. The increase in spread between lending and deposit rates can be linked to high administrative cost, overstaffing, higher risk of business default, increasing volume of bad loans of financial institutions, and to a lesser extent the volatility of interest rate.

Figure 6.6: Interest Rate and Banking Spread



Increase in banking spread should, however, be interpreted with caution. In pre-reform period, interest rates were controlled from both sides, with the floors on deposit rates and ceilings on lending rates. Their widening after the reforms largely indicated the change from a repressed to a liberalized interest rate regime. In addition, computed weighted average lending rates do not reflect the true market rate and have downward bias. Since the share of this concessional credit in total credit to private sector has gone down substantially from 44.2 percent in the beginning of 1990s to 31.4 percent at end June 00, the simple comparison of weighted average lending rates over the decade might be misleading.

Interest rate spread is comparatively a better measure than the banking spread, because the former takes into account lending as well as investment whereas the latter does not (see **Section 3.2.3**). Nevertheless, interest rate spread also widened from 4.0 percent in 1990 to 4.5 percent in 2000, showing that the reforms did not succeed in increasing the efficiency of banking sector.

Table 6.6: Indicators of Financial Efficiency

	Banking spread	Concessionary credit as % of total credit
FY90	2.4	44.2
FY91	4.8	45.5
FY92	6.9	44.8
FY93	7.2	47.5
FY94	7.5	45.9
FY95	7.5	43.9
FY96	7.9	40.8
FY97	7.8	38.1
FY98	8.8	34.8
FY99	8.3	33.4
FY00	8.1	31.4
Averages		
1980-85	4.7	58.7
1985-90	2.7	48.9
1990-95	6.8	45.5
1995-00	8.2	35.7

6.3.2 Credit Allocative Efficiency

The credit allocative efficiency can be assessed by the share of concessional and mandatory credit in the private sector credit, and diversification of asset portfolio. There are two dimensions of portfolio diversification: (1) by economic sectors like industry, agriculture, etc.; and (2) by different economic agents like government, public sector enterprises, private sector, etc.

Concessional and Mandatory Credit

An increase in the share of concessionary and mandatory credit leads to an increase in the shadow cost of intermediation to banks. The mandatory credit discourages market forces to determine the

allocation of resources while concessionary credit deprives the banking institutions of earning market rates of return. Thus in both cases, distortions in the market mechanism are created and efficiency is lost. A decline in the share of concessionary and mandatory credit, on the other hand, indicates improvement in the allocative efficiency of credit. It shows that the banks are giving more loans to those sectors, which offer competitive rates of returns. The average share of concessionary and mandatory credit in the total private sector credit declined from 58.7 percent during 1980-85 to 35.7 during 1995-00 (see **Table 6.6**). Although the performance of banking system in Pakistan is admirable in this regard, share of concessional credit is still too high.

Sectoral Distribution of Credit

Efficient allocation of credit also requires diversification of asset portfolio. Concentration of credit in few sectors of the economy makes the financial sector vulnerable to the performance of these sectors. Financial reforms in Pakistan did not appropriately address this problem. In total credit, the share of large-scale manufacturing sector, which was highest in the pre-reform period, further increased during later half of 1990s (see **Table 6.7**). It is worth noting that the share of manufacturing in real GDP is less than that of agriculture but its share in banks' credit is more than twice compared with the credit share of agriculture. Declining share of agriculture in banks' credit also has unfavorable implications for the health of overall economy.

Table 6.7: Allocation of Credit Among Different Sectors and their Share in GDP

A. Percentage share in total credit - 5 year average	1980-85	1985-90	1990-95	1995-00
Agriculture, forestry, &	13.2	22.2	20.4	14.7
Mining & quarrying	1.4	1.0	1.2	1.9
Manufacturing	47.9	42.0	42.5	50.9
o/w				
Textile	34.2	33.4	39.7	41.5
Chemical products	3.3	4.9	5.4	6.9
Construction	2.6	3.3	2.4	1.8
Electricity, gas & sanitary services	2.2	2.1	2.1	2.2
Commerce	21.4	20.7	19.4	14.9
Transport, storage & communications	1.8	1.3	2.9	4.5
Services	3.8	1.1	1.2	1.2
Others	5.8	6.3	8.0	8.0
B. Percentage shares of sectors in real GDP - 5 year averages				
Agriculture, forestry, &	28.9	26.3	25.0	25.8
Mining & quarrying	0.4	0.5	0.5	0.5
Manufacturing	16.0	17.2	18.1	16.8
Construction	4.3	4.2	4.1	3.7
Electricity, gas & sanitary services	2.3	2.8	3.6	4.2
Commerce	18.2	18.9	18.7	18.1
Transport, storage & communications	9.9	9.8	10.0	10.0
Others	19.9	20.1	20.1	20.8

During the pre-reform period, agriculture sector was receiving mandatory and concessional credit to fulfill its needs. However, after the introduction of reforms, banks failed to substitute the concessionary and mandatory credit with the credit on commercial basis. It was largely due to: (1) inability of commercial banks to introduce new financial instruments for the agriculture sector where credit risk management required a different type of approach vis-à-vis industry and commerce; (2) lack of commercialism and competitiveness on the part of agriculturalists; (3) legal impediments such as a clear land title and difficulties in collateral enforcement; and (4) presence of sizeable informal financial markets in the agriculture sector.

Looking at **Table 6.7**, construction seemed to be an underserved sector, as its credit share remained significantly lower than its share in GDP. Since construction sector includes loans and advances for buildings, roads, harbors, water channels etc., declining share of credit may have adverse implications for the economy as a whole. Within construction, it is difficult to specify the share of housing sector, as it is merged with loans and advances for buildings. However, besides the banking sector HBFC is also catering to the credit needs of this sector.

User Distribution of Credit

There was only a nominal change in the share of users, in the credit of scheduled banks during the past decade (see **Table 6.8**). In terms of allocation of resources, it can be argued that larger the share

of private sector in credit, more efficient will be the allocation. The financial reforms of 1990s did not succeed in this regard as no noteworthy reallocation of resources took place during this period.

Table 6.8: Allocation of Gross Domestic Credit among Different user Groups (Shares)

	Scheduled banks credit			SBP credit		Gross domestic credit		
	Government	PSEs	Private sector	Government	Private *	Government	PSEs	Private sector
FY82	33.5	11.3	55.3	81.9	18.1	46.6	8.2	45.2
FY83	33.2	12.6	54.2	85.0	15.0	48.4	8.9	42.7
FY84	26.8	11.5	61.7	85.3	14.7	44.9	7.9	47.2
FY85	25.1	11.4	63.5	85.5	14.5	45.0	7.6	47.4
FY86	23.0	11.3	65.7	83.2	16.8	40.8	7.9	51.3
FY87	23.2	8.0	68.8	80.2	19.8	38.8	5.8	55.4
FY88	29.6	6.8	63.6	81.0	19.0	43.8	4.9	51.3
FY89	27.8	5.3	66.9	80.5	19.5	42.6	3.8	53.6
FY90	24.4	5.0	70.6	82.1	17.9	41.5	3.5	55.0
FY91	27.6	4.3	68.1	82.9	17.1	43.5	3.1	53.4
FY92	31.8	4.4	63.8	92.6	7.4	48.6	3.2	48.2
FY93	34.0	3.4	62.6	92.2	7.8	49.8	2.5	47.7
FY94	36.3	3.1	60.6	90.3	9.7	48.6	2.4	49.0
FY95	34.4	3.5	62.0	89.7	10.3	47.2	2.7	50.1
FY96	36.2	3.7	60.1	90.1	9.9	48.8	2.9	48.3
FY97	35.6	4.6	59.7	92.0	8.0	49.2	3.5	47.3
FY98	38.1	5.2	56.8	91.1	8.9	48.3	4.2	47.6
FY99	33.7	5.1	61.3	89.8	10.2	48.3	3.7	48.0
FY00	29.3	6.2	64.5	93.1	6.9	51.6	4.0	44.4
Averages								
FY80-85	29.6	11.7	58.7	84.4	15.6	46.2	8.2	45.6
FY85-90	25.6	7.3	67.1	81.4	18.6	41.5	5.2	53.3
FY90-95	32.8	3.8	63.4	89.5	10.5	47.5	2.8	49.7
FY95-00	34.6	5.0	60.5	91.2	8.8	49.2	3.7	47.1

* credit to NBFIs

6.4 Impact on Domestic Debt Management

Objectives of the debt management reforms, undertaken from the beginning of 1990s, were to rationalize the cost of domestic debt servicing over the long run, eliminate segmentation in government debt market, establish a market based rate of return structure for government securities, and provide a supporting environment for reorientation of monetary policy from direct towards indirect monetary control.

In order to achieve the aforementioned objectives, important steps undertaken included: (1) replacing the tap system of sale of government securities with that of auction; (2) establishment of 3-Day repo window in lieu of discount window; (3) introduction of six-month market treasury bills and a long-term auctionable government paper; (4) introduction of SBP purchase of T-bills at market determined rates in lieu of adhoc T-bills at only 0.5 percent; and (5) discontinuation of highly expensive Khas Deposit Certificates (KDCs).[6]

6.4.1 Impact on Cost and Sustainability of Debt

At the start of reforms in the beginning of 1990s, both the level and cost of servicing were quite high, a legacy that started in mid 70s due to introduction of costly national saving schemes and subsequent

[6] For a comprehensive coverage of debt management reform measures, see section 2.2 of Chapter 2.

unabated flow of resources in these. It was expected that various measures would help in stabilization of domestic debt to a sustainable level in the long run. However, interest costs as well as debt levels continued to rise at a fast pace in post-reform decade, albeit at a pace lower than that observed in pre-reform decade. Some of the measures taken in the early years of reform did succeed in decelerating the interest costs, but others worked in opposite direction resulting in an unchecked increase in domestic debt and servicing burden. Increasing burden of domestic debt from the pre to post-reform decade is shown in **Table 6.9.**

Table 6.9: Burden of Domestic Debt

	Pre-reform		Beginning	Post-reform	
	FY80	**FY85**	**FY90**	**FY95**	**FY00**
Outstanding debt levels	59.7	153.0	381.3	807.67	1641.4
end period, billion Rupees					
As percent of GDP					
Domestic debt	25.5	32.4	44.5	42.9	51.6
Permanent debt	5.6	7.8	11.5	15.4	10.2
Floating debt	15.0	15.5	16.9	15.6	20.4
Unfunded debt	4.9	9.1	16.1	11.9	21.0
As % of total revenue					
Domestic debt	155.2	197.6	240.1	254.0	305.8
Permanent debt	34.4	47.6	62.1	91.3	60.5
Floating debt	91.1	94.4	91.3	92.5	120.6
Unfunded debt	29.7	55.6	86.7	70.2	124.7

Burden in terms of GDP, which was 44.5 percent in FY90, rose to 51.6 percent in FY00. Burden in terms of revenue reveals a still more worrisome picture. It was about two and a half times the revenue in FY90 and grew to over three times the total revenue in FY00. However, it must be acknowledged at the outset, that the domestic debt burden was already very high when reforms started, and the rates of increase in debt levels were extremely high in pre-reform decade as shown in **Table 6.10.**

Reforms had a favorable impact in decelerating the nominal as well as real debt levels. The pre-reform decade of 1980s witnessed a per annum growth rate of 20.4 percent, whereas post-reform decade of 1990s registered 15.7 percent per annum increase in domestic debt.

If we look at growth rates of components of domestic debt in **Table 6.10**, and compare first half of post-reform decade with second half of pre-reform decade, a significant decline can be seen in the growth rate of unfunded debt from 26.2 percent to 10.2 percent.[7] This was due to the discontinuation of Khas Deposit Certificates (KDCs) from February 1990, which accounted for about 68 percent of unfunded debt as on end June 1989. However, this deceleration could not be sustained in the second half of post-reform decade due to introduction of Special Saving Certificates and Accounts in FY91 and Regular Income Certificates in FY94, and upward revision in rates of return on these and other saving schemes in second half of post-reform decade. Failure of reforms, as far as unfunded debt is concerned, was due more to their effective reversal just after the successful measure of discontinuation of KDCs.[8]

Indicators of the servicing burden of domestic debt are shown in **Table 6.11**. At the start of reforms in FY90, servicing burden was 4.3 percent of GDP and 23.2 percent of revenue, which could hardly be labeled as sustainable. After five years of reform process, servicing burden increased to 4.8 percent and further five years down the road to almost 7.0 percent in FY00. In terms of debt components and burden on GDP, a success could be discerned, again in unfunded debt, whose servicing burden declined from 2.0 percent to 1.3 percent during first five years, due to the reasons described above, but later increased to 2.8 percent of GDP in FY00 because of effective reversal of reforms in national saving schemes.

[7] Domestic debt is categorized in Pakistan into permanent, floating and unfunded. Permanent debt can also be labeled as long-term debt; floating debt as short-term debt; and unfunded can also be labeled under another name. The word 'unfunded' seems superfluous, but used traditionally.

[8] The possibility that ceiling on government borrowing from the banking system, under IMF conditionality, might have forced the government to reverse these measures, can not be ignored.

Table 6.10: Expansion Rates of Domestic Debt
percent per annum

	Pre-reform period			Post-reform period		
	1st half 1980-85	2nd half 1985-90	1980-90	1st half 1990-95	2nd half 1995-00	1990-00
Nominal debt						
Domestic debt	20.7	20.0	20.4	16.2	15.2	15.7
Permanent debt	22.7	21.8	22.2	24.1	2.3	12.6
Floating debt	15.8	14.7	15.2	15.2	17.1	16.1
Unfunded debt	30.4	26.2	28.3	10.2	24.6	17.1
Real debt						
Domestic debt	11.3	12.9	12.1	4.5	6.8	5.6
Permanent debt	13.1	14.5	13.8	11.6	-5.2	2.8
Floating debt	6.8	7.8	7.3	3.6	8.5	6.0
Unfunded debt	20.3	18.6	19.4	-0.9	15.4	6.9

Although a part of negative impact on burden and servicing of unfunded debt could be attributed to effective reversal of measures related to NSS, rest of the measures did contribute negatively. Reform measures taken in respect of permanent debt and floating debt played an important role in worsening the servicing debt burden (see **Table 6.11**). Servicing burden in terms of GDP, for permanent debt rose from 1.3 percent in FY90 to 1.9 percent in FY00 due to introduction of Federal Investment Bonds at very high coupon rates, which contributed to increase the effective interest rate on permanent debt from 11.5 percent in FY90 to 18.6 percent in FY00.[9] It may be noted that comparable 10-year Federal Government Market Loans were being issued through subscription at around 10.5 percent per annum before the introduction of FIBs.

Table 6.11: Servicing Burden of Domestic Debt

	Pre-reform years		Beginning	Post-reform years	
	FY80	FY85	FY90	FY95	FY00
Nominal debt costs					
As percent of GDP					
Domestic debt	1.1	2.3	4.3	4.8	7.0
Permanent debt	0.4	0.7	1.3	1.8	1.9
Floating debt	0.3	0.4	0.7	0.8	1.5
Unfunded debt	0.3	1.0	2.0	1.3	2.8
As percent of total revenue					
Domestic debt	7.0	13.8	23.2	28.6	41.3
Permanent debt	2.4	4.2	7.1	10.6	11.2
Floating debt	2.1	2.5	3.5	5.0	9.2
Unfunded debt	1.6	6.0	10.7	7.9	16.8
As percent of debt level					
Domestic debt	4.5	7.1	9.6	11.3	13.5
Permanent debt	7.0	9.0	11.5	11.6	18.6
Floating debt	2.3	2.9	3.9	5.4	7.6
Unfunded debt	5.4	11.6	12.3	11.3	13.5

Note: Domestic debt includes interest payments on provincial and other obligations.

Similar is the case in respect of servicing burden for floating debt in terms of GDP, which rose from 0.7 percent in FY90 to 1.5 percent in FY00 due mainly to the replacement of tap T-bills (with yield of 6 percent), to auction T-bills (with yields ranging from 8 to 17 percent), and also due to replacement of adhoc T-bills held by SBP (at a yield of only 0.5 percent) to auction determined yields. Effective

[9] FIBs carried coupon rates of 13, 14 and 15 percent respectively for bonds of three, five and ten-year maturities.

interest rate on floating debt rose from 3.9 percent in FY90 to 7.6 percent in FY00. Expansion rates of domestic debt servicing are shown in **Table 6.12**.

Table 6.12: Expansion Rates of Domestic Debt Servicing

percent per annum

	Pre-reform decade			Post-reform decade		
	1st half	2nd half	Full	1st half	2nd half	Full
	1980-85	1985-90	1980-90	1990-95	1995-00	1990-00
Nominal debt costs						
Domestic debt	31.7	28.1	29.9	19.8	19.5	19.7
Permanent debt	28.2	28.5	28.3	24.3	12.4	18.2
Floating debt	19.1	23.6	21.3	23.0	25.5	24.3
Unfunded debt	49.6	29.5	39.2	8.3	29.0	18.2
Real Debt Costs						
Domestic debt	21.4	20.4	20.9	7.8	10.8	9.3
Permanent debt	18.2	20.8	19.5	11.8	4.2	7.9
Floating debt	9.8	16.2	13.0	10.6	16.3	13.4
Unfunded debt	38.0	21.8	29.6	-2.6	19.6	7.9

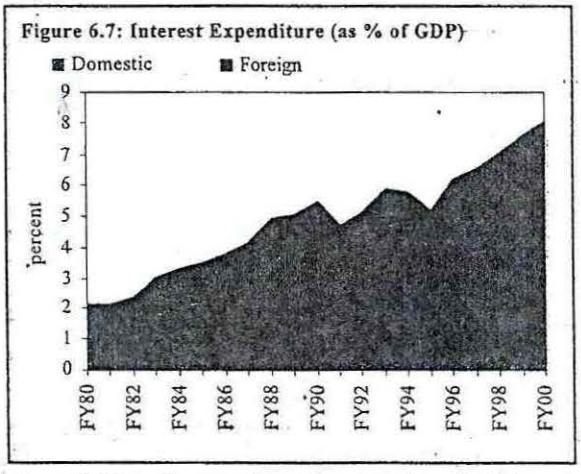
A decline is visible both in expansion rates of nominal and real domestic debt servicing, from pre-reform decade to post-reform decade. However, in case of floating debt, rates of expansion for nominal as well as real cost went up from pre-reform to post-reform period.[10] Increasing burden of domestic debt and its servicing in the post-reform decade affected the fiscal account adversely. **Table 6.13** presents fiscal indicators for selected pre-reform and post-reform years. It is difficult to spot any improvements except for the appearance of surplus in primary balance.

All other indicators, both as percentage of GDP and revenue, show either a continuous deterioration, or at best no improvement at all. Budget deficit in terms of GDP in FY00 stood almost at the same level as that of the beginning of reforms. In terms of revenue it had deteriorated a little. Revenue deficit has worsened, indicating the increasing reliance of government to finance its current expenditure. A declining trend is alarmingly visible in development expenditure, and a perverse increasing trend in interest expenditure. Government was spending a little over one-third of its revenues on development, and a little less than that on interest payments at the beginning of reforms. However, in FY00, it ended up paying almost one-half of revenues as interest on accumulated debt and less than one-fifth on development expenditure. Interest expenditure rose to 8.3 percent of GDP in FY00 from 5.5 percent of GDP in FY90, which forced the government to reduce development expenditure. Revenue effort did not improve, due to difficulty in implementing fiscal reforms, and debt management reforms pushed interest expenditure on upward direction, with disastrous consequences amply, reflected in various fiscal indicators.

Interest expenditure on total public debt as percent of GDP has shown phenomenal growth over the period FY80 to FY00 increasing from 2.1 percent to 8.3 percent of GDP (see **Table 6.13** and **Figure 6.7**). However, it is important to take notice of the fact that almost all of the increase in interest expenditure is brought about by increase in interest payment on domestic debt, which shot from 1.1 percent in FY80 up to 6.7 percent in FY00. Contrary to the popular view, interest expenditure on external debt has shown little increase during the same period, from 1 percent to 1.4 percent of GDP. During the decade of 1980s as well as 1990s, comparatively higher rates of return on domestic debt were mainly responsible for the growing trend in total public debt. Furthermore, during 1990s as the

[10] High government borrowing from the banking system through T-bills was mainly responsible for acceleration in floating debt.

sources of concessional external borrowing dried up, a heavier reliance on domestic debt sources was witnessed.



We can draw two conclusions from the above discussion. Firstly, the reform measures related to permanent and floating debt resulted in rapidly surging servicing burden, which, in the absence of major restraint over current expenditures, severely affected the government's ability to undertake development expenditures. And secondly, the initial measures related to unfunded debt which could have contributed to lessening of servicing burden, were reversed quickly resulting in further mounting pressure on domestic debt servicing. Pakistan's experience is not unique in this respect. Cole and Slade (1999) have shown that premature liberalization of government debt markets in less developed countries does not lead to fiscal restraint, rather it becomes easier for these countries to get into trouble through rapidly rising interest expense on domestic debt.[11]

Table 6.13: Fiscal Indicators

	Pre-reform Years		Beginning	Post-reform Years	
	FY80	FY85	FY90	FY95	FY00
As percent of GDP					
Total revenue	16.2	16.4	18.6	16.9	16.9
Total expenditure	23.0	24.7	25.9	22.8	23.4
Interest expenditure	2.1	3.5	5.5	5.2	8.3
Non-interest expenditure	20.9	21.2	20.4	17.6	15.0
Current expenditure	13.8	17.7	19.3	18.4	20.4
Development expenditure	9.2	7.0	6.5	4.4	3.0
Budget deficit	6.2	7.8	6.5	5.6	6.5
Revenue deficit	(2.4)	1.3	0.8	1.5	3.3
Primary deficit	4.0	4.3	1.1	0.4	(1.9)
As percent of total revenue					
Total expenditure	141.9	150.9	139.6	134.7	138.5
Interest expenditure	13.2	21.4	29.4	30.6	49.5
Non-interest expenditure	128.7	129.6	110.2	104.1	89.0
Current expenditure	85.3	108.2	104.3	108.8	120.7
Development expenditure	56.6	42.7	35.3	25.9	17.8
Budget deficit	38.1	47.5	35.3	33.1	38.5
Revenue deficit	(14.7)	8.2	4.3	8.8	19.8
Primary deficit	24.9	26.2	5.9	2.5	(11.0)

Note: 1. Figures in parentheses indicate a surplus in the corresponding year.
2. Net lending to PSEs has been included in Current Expenditure.

Mounting of domestic debt and rising servicing burden can be attributed to the improper sequencing followed in design and implementation of economic reforms. Within the broader set of economic reforms encompassing the real, financial, fiscal and trade sectors, the supply side reforms may

[11] Cole, David C. and Betty F. Slade, "Premature Liberalization of Government Debt Markets", Conference paper for Research workshop "Financial Liberalization: How Far? How Fast?", World Bank, March, 1999.

precede others (as was witnessed in case of Pakistan in early 1980s) and the fiscal reforms should precede financial reforms. However, opposite sequencing was followed in case of Pakistan with regard to the latter. Among the financial and fiscal reforms, and within the financial sector reforms, liberalization of domestic debt is, perhaps, the easiest to implement. Main and direct stakeholders of domestic debt reforms are only four -- government, central bank, commercial banks, and non-bank financial institutions, with the latter three as beneficiaries. Government is the loser, so is the private sector, which is only an indirect stakeholder, but also deeply affected by the reform process. Fiscal reforms are the hardest to implement affecting almost every agent in the economy. Neglect of fiscal reforms in the initial stages of financial reforms proved disastrous for fiscal deficits and domestic debt.[12]

Administrative exigencies; and implementation of conditionalities under various agreements with IFIs, rather than a carefully chalked out plan of reforms, were perhaps the overriding factors that resulted in the implementation of debt management reforms. These reforms failed in almost every objective except that of providing supporting environment for reorientation of monetary policy from direct to indirect control. Cost of domestic debt seemed to have been escalated instead of being rationalized. Segmentation from government debt market could not be eliminated, although reforms did succeed in establishing a market-based yield structure of government securities.

6.5 Impact on Reorientation of Monetary Policy

One of the objectives of debt management reforms, supported by various institutional and monetary management measures was the reorientation of monetary policy away from direct control, towards indirect control through market-based instruments. This reorientation triggered two important changes. First is the increasing assertiveness of the SBP in initiating and implementing its monetary policy, albeit within the framework of Annual Credit Plans, and second is the significant alteration in monetary policy transmission mechanism.

6.5.1 Impact on SBP's Conduct of Monetary Policy

Effectiveness of a central bank depends on its professional competence and independence in the conduct of monetary policy. Professional competence largely depends on quality of its human resources in the areas of banking, finance, economics and management. Independence can be in goal setting, or target independence, if central bank fixes for itself the monetary policy target, which is usually inflation; or it can be operationally independent, if central bank is free to use its instruments independently to achieve a target set outside central bank. Independence in decision-making can come from law, practice, or both. A central bank can be de facto independent, because of tradition, without being de jure independent. On the other hand, it is possible for a central bank to be de jure independent but def acto not independent. This situation can arise because of three interrelated issues: first relates to operational independence in managing its own currency, second to operational independence in managing its foreign exchange reserves, and third, to financing arrangement between itself and the exchequer.

Independence encompassing above three issues can come from a combination of legislative as well as extra legislative processes. In the post-reform period, State Bank of Pakistan has made tremendous strides in the first two. In the pre-reform period, monetary policy was largely subservient to government's objectives of directed credit to priority sectors, with the highest priority given to the government sector itself. Important monetary policy changes, like those in SLR or CRR were communicated to the SBP by Finance Division with SROs rather than initiated and implemented through SBP Circulars. SBP was empowered to change these instruments only after its legislative

[12] For further detail see Yaqub, Muhammad, "Financial Sector Reforms in the Emerging Market-based Economies", Opening Remakes at the symposium of SEANZA Central Banks' Governors in Karachi, November 1994. Reprinted in "Major Policy Issues in Pakistan", State Bank of Pakistan, 1998.

independence in 1994, through amendments in SBP Act, 1956. In the beginning of 1995, another important step, which strengthened the independence of SBP in its conduct of monetary policy was that the auction cut-off decision was given to SBP. By that time, a supporting infrastructure in terms of a well developed primary market of T-bills and a fairly developed repo market in these bills and FIBs was well in place. Monetary policy objectives, since then, are being achieved through changes in SBP Repo Rate (discount rate), auctions of T-bills, open market operations and less frequent use of CRR or SLR. SBP is now instrument independent in the area of managing its currency.

It is also important to keep in mind that the exchange rate policy was exercised by the Government of Pakistan through Foreign Exchange Regulation Act, 1947, both in pre-reform and post-reform period. It was only in July 1999 when an amendment in the State Bank of Pakistan Act enabled it to purchase foreign exchange from any entity in Pakistan, and after the unification of exchange rate in May 1999, that SBP got the effective power to intervene in the interbank market of foreign exchange. After removal of the cap imposed in floating inter-bank market, link of money market and forex market was established and put SBP under pressure to defend Pak-Rupee through monetary policy measures. Government can still take independent measures legally under Foreign Exchange Regulation Act, 1947; however, the practice has already been changed and SBP is taking all the measures to control foreign exchange reserves. Therefore, SBP is now de facto independent in managing its forex reserves.

Third area of independence, which relates to direct financing arrangements between SBP and Ministry of Finance, has not changed significantly in the post-reform period. An automatic system of replenishment of federal government account is still in place, practically without any limits, through the creation of treasury bills. Direct financing arrangements can weaken the independence easily. It should also be kept in mind that for countries having perennial budget deficits, direct financing arrangements can not change in the short-term. Until and unless revenues of the government become commensurate with its expenditure, legislative measures to control direct financing may prove fruitless.

In sum, SBP is now operationally independent, both de jure and de facto, in managing its currency and operationally independent,(de facto but not de jure) in managing its foreign exchange reserves. Moreover, level of professional competence, which is required to assert independence in an effective and useful manner, has also increased in the post-reform period through restructuring of its departments, merit based recruitment and training of its existing human resources.

6.5.2 Pre-reform Transmission Mechanism

Monetary transmission mechanism (see **Box 6.1**), prior to reforms, was largely determined by the instruments of direct control. Statutory liquidity requirement determined the allocation of credit between the government and private sector supported by the system of bank-by-bank credit ceilings. Monetary policy set in Annual Credit Plans worked its way mainly through availability of credit, while interest rates played a secondary role because of various controls on lending as well as deposit rates. Indirect instruments like discount rate, cash reserve requirement and open market operations were not relied upon because of lack of a well-functioning market for government securities. Directed and subsidized credits were used to promote various activities in agriculture, industry and export.

The result of these direct control measures was that although sectors like agriculture and manufacturing were given priority, the distribution of credit within them was not commensurate with their demand. Thus, the scope of monetary policy had been limited and made ineffective in stimulating activities in all sectors of the economy. The priority sectors became more and more

Box 6.1

Monetary Transmission Mechanism

One of the most important objectives of any central bank is to maintain price stability without jeopardizing the growth and employment prospects for the economy. The effectiveness of a monetary policy requires the impact of policy changes to be felt on macroeconomic variables like consumption, investment and net exports. Implementation of monetary policy, through any or a combination of its instruments triggers a chain of reactions, or impacts, in various sectors of the economy. These impacts can be felt only if a robust transmission mechanism is present. Immediate impacts become visible in the financial markets, especially in money market. Later reactions work through banks, non-bank financial institutions, firms and households and end with an effect on the price level, after having transient effects on growth and employment. This chain of reactions, or impacts, is known as the transmission mechanism of monetary policy.

Various channels have been explored and discussed by the economists both theoretically and empirically, mainly in the context of developed countries. These channels can be divided into four groups, namely, money channel, credit channel, exchange rate channel and asset price channel.

Money channel

It is also known as the interest rate channel, as a chain of reactions is stimulated after a change in the interest rates. Major components of GDP, i.e., investment and consumption expenditures are affected by a change in interest rates. A strong interest rate channel, with significant interest rates effects on consumer spending and investment is empirically found to be present in industrial countries.[1] This channel is usually weak in developing countries with shallow financial sectors.

Credit Channel

The credit channel works through the bank lending operations and balance sheet effects.[2] It is suggested that open market sales by a central bank drain reserves and, hence, limit their ability to make loans and vice versa. A fall in loans from banks reduces the credit availability in the market, thereby reducing investment expenditure and aggregate demand. The balance sheet effect, on the other hand, is the result of direct and indirect influence of monetary policy on the balance sheet of a borrower. Both the direct and indirect effects lead to two results. First, a decline in net cash flow of a firm, as a result of an increase in outstanding short-term debt ensuing from an increase in interest rates. Second, an increase in interest rates shrinks the asset prices, thereby reducing the value of the collateral. The credit channel, however, is not supposed to be a distinct channel but is regarded as a set of factors shoring up the interest rate effects.

Exchange Rate Channel

Exchange rate channel is the standard effect of a change in monetary policy through interest rates on exchange rate and, therefore, on net exports and aggregate demand. An increase in money supply lowers the interest rates and depreciates the domestic currency. The lower value of domestic currency makes foreign goods more expensive, thereby promoting domestic production. This increases net exports and aggregate output leads to increase in average price level.

Asset Price Channel

This works through two channels: first, the Tobin's *q* theory of investment and second, the wealth effects on consumption. Tobin's *q* theory provides a mechanism through which monetary policy affects the economy via its effect on the valuation of equities. The wealth effect, on the other hand, is based on Modigliani's famous life cycle consumption model. This model suggests that the lifetime resources of consumers, which are made up of human capital, real capital and financial wealth, determine consumption spending. A major component of financial wealth is common stocks. When stock prices fall, the value of financial wealth decreases, thus decreasing the lifetime resources of consumers, and consumption should, accordingly, fall.

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[1] See John B. Taylor, "The Monetary Transmission Mechanism: An Empirical Framework." The Journal of Economic Perspective, Vol. 9, No. 4, Fall 1995.

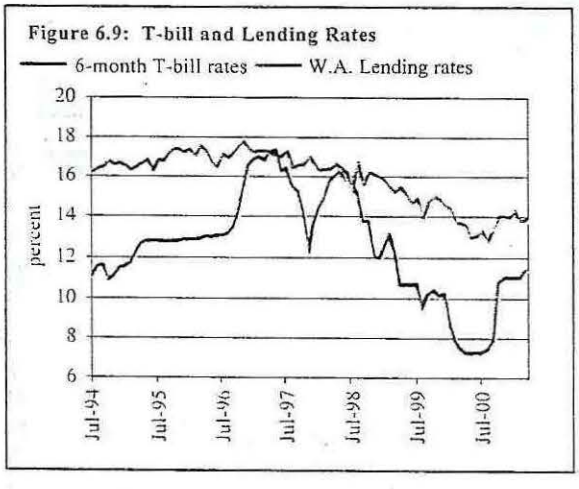
[2] See Ben Bernanke and Mark Gertler, "Inside the Black Box: The Credit Channel of Monetary Policy Transmission." The Journal of Economic Perspective, Vol.9, No.4, Fall 1995.

dependent on concessionary financing, and lethargic in generating their own resources. These concessional funds tried to make them artificially competitive and hence hindered improvement in their efficiency. Any change in the concessional rates or the availability of credit through such direct measures had a direct bearing on the economic activity through changes in direct investment expenditures or net exports. Since the economy was not open for foreign portfolio investment and domestic portfolio investment was limited, credit controls had little effect on portfolio investment. On the other hand, banks were also tied up for lending to specific sectors, which limited their efforts to achieve optimal credit allocation and compromised their carefulness in credit distribution, resulting in increasing bad loans.

In short, pre-reform transmission of monetary policy was taking place primarily through credit channel but without the efficacy of interest rates, which were controlled. Exchange rate channel was also working, but not through interest rates. Impact on net exports was coming through the changes made in the exchange rate independently of interest rates. Money channel and asset price channel were almost non-existent. **Figure 6.8** shows the pre and post-reform transmission mechanism.

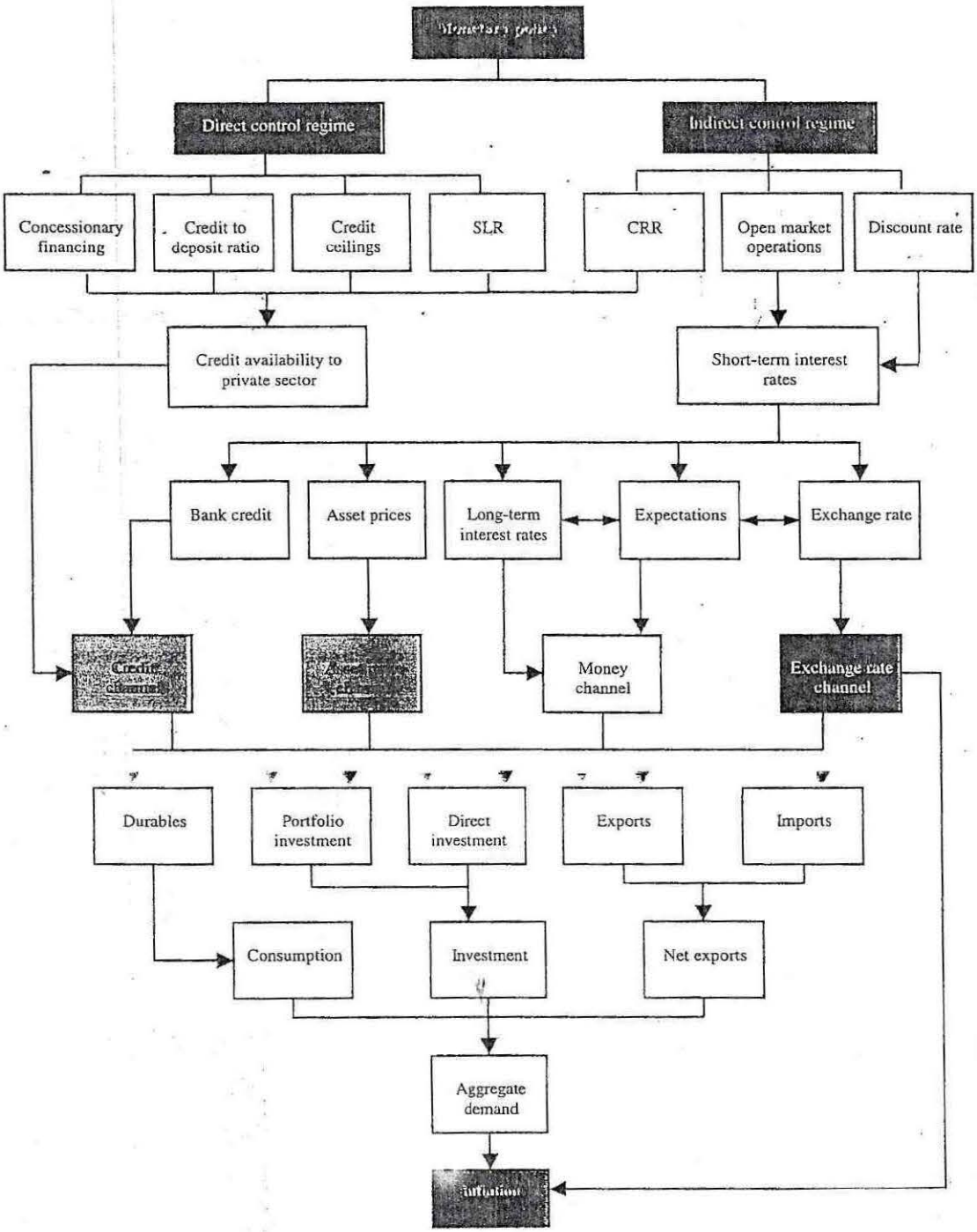
6.5.3 Post-reform Transmission Mechanism

The financial sector reforms initiated in FY90 with the objective of transforming the existing financial structure from a controlled regime to a market-based system, has had a deep impact on the transmission mechanism of monetary policy. A diversion from direct to indirect control, alongwith the opening up of the external sector and a market-based exchange rate regime, has made the task of monetary policy all the more complicated, especially given the volatility in exchange rates. However, the distribution of resources is becoming more realistic and banks are becoming more independent in their credit allocation decisions. After the introduction of financial sector reforms, the effects of monetary policy changes through interest rates were not so visible since the credit market was controlled through the ceilings and then credit-deposit ratio (CDR) till September 1995 while the exchange rate was on managed float.



After the removal of caps on maximum lending rates of banks and NBFIs for trade related modes of financing in March 1995, and for project financing in October 1995 along with the abolition of CDR, the changes in interest rates have become all the more important. Consequently, the earlier mode of transmission through credit channel underwent a transformation to reflect increasing efficacy of interest rates in influencing volume of bank lending. In this context, the effects of changes in SBP 3-Day Repo Rate and the T-bill rates are being increasingly reflected in corresponding induced changes in lending rates of commercial banks -- albeit, with lags and diluted by the perceived notions of the market about persistence of these changes. **Figure 6.9** shows that despite a sharp hike in T-bill rates during the first half of the 1990s, commercial lending rates did not change much. In the second half, however, fall in T-bill rates have been followed more vigorously by the commercial lending rates. **Figure 6.9** also shows that it is the persistent or durable changes in interest rates that are transmitted to lending rates.

Figure 6.8: Transmission Mechanism of Monetary Policy in Pakistan



The change in exchange rate regime to a free float in July 2000 also defined a new chain of transmission. A change in short-term interest rates began to affect the exchange rate and vice versa, creating additional volatility in exchange rate induced by variability in very short-term interest rates. Consequently, during the recent episodes of exchange rate volatility, monetary operations have been extensively used to bring stability in foreign exchange market. Exchange rate channel is, therefore, fully functional now via the interest rates, although the inflation pass-through effects and net export effects were, of course, strongly present earlier.

In developed countries, monetary policy has a strong influence on the capital markets. A change in the interest rates is keenly followed by a change in stock prices. This relationship, however, is not so strong in the developing countries. This is due to the reason that equity markets are not yet well entrenched in the domestic investment culture. In Pakistan, the capital market is accessible, largely, to big companies, and to a small fraction of the population living in big cities. Moreover, people have little knowledge about capital markets. Although monetary policy changes are not reflected directly on the stock prices, they do have a weak relationship through the *badla* rates.[13]

Other avenues of investment for public include real estate, gold, and government securities. Government paper is an attractive option for general public and is considered to be the safest investment with high returns. Since the differential between return on government paper and bank deposits is quite high, a small change in interest rates hardly initiates a substitution of government paper with bank deposits and vice versa. As a result, government expenditures are rarely affected through this channel. Similarly, other assets like real estate or gold also have a weak relationship with the interest rates.

With the increasing trend in consumer banking, banks have been moving towards financing of consumption expenditures especially of durables. Housing finance, credit cards and personal loans are becoming more popular and, quite obviously, these financing activities are affected by changes in the interest rates. So far, banks have been offering such finances at relatively higher rates and only a negligible fraction of the population is having benefit of these credit schemes. Still, other sources like personal savings and loans from close relatives or friends are used for the purpose of durable purchases. Therefore, it is believed that the effect of changes in interest rates on such expenditures is not so significant.

To reap the full benefits of a market-based financial sector in stimulating growth in the economy, we still have to go a long way. Financial sector deepening is the only way to achieve this, but it will require a change of mindset of the public in favor of financial savings, and expansion and modernization of the financial services.

6.6 Impact on Banking Supervision

A crucial set of reforms that started to have a significant impact on banking industry, was initiated quite late in 1997 in the reform process. Impact of many of these is yet to be realized due to the medium to long-term nature of their objectives on the one hand, and inherent complexities and dynamics of institutional reforms, on the other. These reforms encompassed not only the institutional strengthening and restructuring of banks and DFIs, but also those of supervisory authorities (see **chapter 2**).

After the regulatory and supervisory powers of SBP were consolidated by dissolving the Pakistan Banking Council in May 1997, disclosure standards for banks and NBFIs were revised by SBP in August 1997 to bring them in conformity with International Accounting Standards, and consequently

[13] Badla is an informal source of financing, widely used in Pakistan's stock exchanges. For detail see page 109, **Annual Report** 2000-2001, SBP.

Box: 6.2: Core Principles for Effective Banking Supervision[1]

Basel Committee on Banking Supervision has prepared a set of twenty-five core principles, after years of consultations and deliberations with banking supervisors in every part of the world. These principles were released in September 1997 and the Basel Committee encouraged the supervisory authorities throughout the world to endorse the Basel Core Principles. These principles set out minimum requirements that need to be complied by a supervisory system to be effective. In many cases, minimum requirements may need to be supplemented by other measures designed to address particular conditions and risks in the financial systems of individual countries. The twenty-five Core Principles are categorized into seven major areas.

Preconditions For Effective Banking Supervision – Principle 1
The first principle emphasizes the need for having clear objectives and responsibilities for every supervising agency of banking organizations. It further highlights the need for having a suitable legal framework and arrangements for sharing information between supervisors. Operational independence for supervising agencies has also been highlighted in the first principle.

Licensing and Structure – Principles 2 to 5
These principles delineate the importance of having a standard licensing process by the authorities for establishment of banks and limiting the use of word 'bank' to prevent confusion amongst depositors. The licensing process must include an assessment of ownership structure, management, operating plan and projected financial condition. Supervisors must have the authority to review major acquisitions or investments by a bank.

Prudential Regulations and Requirements – Principles 6 to 15
Focus of these principles is on the need for establishing a comprehensive system of risk management for banks. Principles highlight the necessity of developing and enforcing prudential regulations to monitor and minimize the risks confronted by banks. Regulations relate to capital adequacy, asset quality, loan loss provisioning, portfolio concentration, connected lending, risk management and internal controls.

Methods of Ongoing Banking Supervision – Principles 16 to 20
These principles emphasise the necessity of adopting both on-site and off-site supervision, with the latter based on analysis of reports and return from banks, and the former on independent validation through on-site inspection and regular contact with bank management. Supervisors must also be able to supervise the banking group on a consolidated basis.

Information Requirements – Principle 21
This principle points to the need for banks to maintain adequate records with consistent accounting policies and disclose regular statements that truly reflect their financial conditions and profitability.

Formal Powers of Supervisors – Principle 22
This principle states that banking supervisors must have adequate enforcement and corrective action powers including recommendation to, or revoking of banking license.

Cross-border Banking – Principles 23 to 25
These principles highlight the need for supervising banks, both their domestic and international operations, on global consolidated basis through cooperation of home and host supervisors.

[1] Complete list of these principles is reproduced in Annex 6.1.

a CAMELS framework was adopted by SBP to assess their performance on the basis of off-site surveillance and on-site inspection. Furthermore, SBP moved very quickly to implement the core principles of effective banking supervision, or the Basel core principles (see **Box 6.2**).

Implementation status of these principles is shown in **Table 6.14**. Banks were also asked to comply with the core principles of banking, in addition to applying the system of risk-weighted capital prescribed by the Basel Committee.

Foreclosure standards of banks have considerably improved since then. All four nationalized commercial banks are now largely compliant in terms of having reliable financial statements and evaluating asset quality; three are largely compliant in managing country and transfer risk; and two in managing market and all material risk, having adequacy of internal controls and MIS to identify

concentration, and in knowing their customer rules. Two privatized banks are in compliance with all of the above core principles, so do a greater part of private banks. Only three, out of 39 banks had lower than 8 percent capital to risk-weighted assets ratio by the end of 2000. Banks and NBFIs were also asked to get themselves credit rated by 30th June 2001 and by now, out of 80 financial institutions, ratings of some 50 banks/NBFIs have been completed.

Table 6.14: Basel Core Principles: Implementation Status

Status*	Core Principles													
Compliant	1	2	4	7	10	16	17	18	19	21	22	23	24	25
Largely compliant	3	5	6	8	9	12	14	15						
Materially non-compliant	11	13	20											
Non-compliant	Nil													

* Compliant– essential criteria met without any significant deficiencies; Largely compliant– essential criteria met with minor shortcomings; Materially non-compliant– sufficient short comings but substantive progress towards compliance; Non compliant– No substantive progress towards compliance.

With the adoption of CAMELS framework by SBP in December 1997, and strengthening of its on-site inspection and off-site surveillance capabilities, SBP had become more adept in finding the weaknesses of banks and NBFIs, besides becoming proactive in taking concrete actions for their resolution. Capabilities of SBP in problem bank management have significantly improved after 1997. For example, the board of directors and management of Bankers Equity Limited (BEL) were removed in August 1999 by SBP under section 41-A and 41-B of Banking Companies Ordinance, 1962, after it was found guilty of mismanagement, concealment of information, falsification of the balance sheet, mis-reporting of data to SBP, provision of loan without proper securities, writing-off of loans without adhering to the due process, failure to comply with instructions of SBP etc.

SBP made interim arrangements for prudent management of BEL during its petition in Sindh High Court and subsequent order for winding-up of BEL and appointment of an official liquidator in April 2001. Depositors of BEL were allowed to withdraw a maximum of Rs.100,000 against their investment from October 1999. In February 2000, it was decided that depositors be paid principal amount in phases on the basis of recoveries in each quarter. Subsequently, principal amount was paid to all such depositors whose total investment with BEL did not exceed Rs 10 million, and only 33 depositors with larger balances remained unpaid.

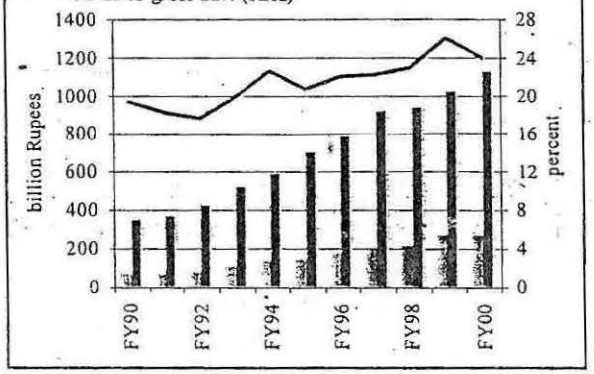
Similarly, quick resolution action was taken with regard to Indus Bank Limited (IBL) after on-site and off-site surveillance system of SBP reported unsatisfactory state of affairs. The license of IBL was cancelled on September 21, 2000 and it is now in the process of liquidation. Supervision system of SBP also found Prudential Commercial Bank Limited (PCBL) operating in a highly questionable and non-transparent manner. In view of this imprudent management, the federal government issued 180 days moratorium order against the bank on SBP's request, which was effected from March 19, 2001. After successful negotiations, management and control of PCBL was handed over to Saudi-Pak group, which commenced operation with a new name "Saudi-Pak Commercial Bank" on 20th September 2001.

Above examples elucidate the increasing quality of off-site surveillance by SBP supplemented with in-depth probing through on-site inspection. Human resource quality of SBP inspectors has considerably been improved through extensive training. With the creation of a subsidiary -- State Bank of Pakistan Banking Services Corporation (SBPBSC) -- SBP will be able to concentrate more on its core functions of banking supervision and regulation, monetary policy and research, and foreign exchange and debt management. Capacity of SBP is likely to further improve in near future with regard to its core functions.

6.7 Impact on Non-performing Loans

Non-performing loans (NPLs) of financial institutions continued to mount throughout the decade, from Rs 66.1 billion in December 1990 to Rs 271.4 billion in December 2000. However, their annual average rate of increase has come down from 17.4 percent during the first seven years of the decade to 10.1 percent during January 1998 to December 2000. As shown in **Figure 6.10** the ratio of NPLs to gross advances has also been gradually increasing, except for a temporary fall in 1995, and a decline towards the end of 1990s that is likely to be sustained in near future in view of the reasons discussed below.

Figure 6.10: Non-performing Loans



Reform process up to 1996 did not really address the banking sector problems, although the attempts to streamline the loan recovery process were started in 1992. It was only in July 1997 that the focus of reforms shifted to arrest the weakening health of public sector financial institutions, with the implementation of the most crucial set of reforms as already explained in **Section 6.6**. Adoption of a vigorous standard of loan classification in 1997, and their strict enforcement by SBP first caused a temporary rise in the volume of NPLs in FY99. Prior to that, some of the public sector banks and DFIs were reporting only default or overdue position of their

Table 6.15: Volume and Concentration of NPLs [1]

billion Rupees

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
All banks & NBFIs	**66.1**	**67.3**	**74.9**	**101.1**	**130.5**	**142.6**	**172.3**	**203.4**	**213.5**	**263.7**	**271.4**
All banks	*41.1*	*46.8*	*50.3*	*71.2*	*86.5*	*94.9*	*106.7*	*130.9*	*134.3*	*170.0*	*173.6*
State-owned banks	39.0	44.8	46.6	67.2	82.8	89.3	98.7	120.0	122.1	152.3	153.0
Private banks	-	-	1.8	1.5	1.7	2.4	3.1	4.7	5.6	11.1	13.6
Foreign banks	2.1	2.0	1.9	2.5	1.9	3.2	4.9	6.2	6.7	6.6	7.0
NBFIs[2]	*25.0*	*20.5*	*24.6*	*29.9*	*44.1*	*47.7*	*65.6*	*72.4*	*79.1*	*93.7*	*97.8*
DFIs	22.8	17.5	20.9	25.2	38.2	39.6	56.5	62.3	68.0	80.0	83.4
HFC	0.6	1.4	2.0	2.7	3.4	4.3	5.3	6.3	7.6	8.6	9.3
Others	1.6	1.5	1.7	2.0	2.3	3.7	3.5	2.9	2.8	3.4	3.0
Share in NPLs (percent)											
All banks & NBFIs	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
All banks	*62.1*	*69.6*	*67.1*	*70.5*	*66.2*	*66.5*	*61.9*	*64.4*	*62.9*	*64.5*	*64.0*
State-owned banks	59.0	66.7	62.2	66.5	63.5	62.6	57.3	59.0	57.2	57.7	56.4
Private banks	-	-	2.4	1.5	1.3	1.7	1.8	2.3	2.6	4.2	5.0
Foreign banks	3.1	2.9	2.6	2.5	1.5	2.3	2.8	3.1	3.1	2.5	2.6
NBFIs	*37.9*	*30.4*	*32.9*	*29.5*	*33.8*	*33.5*	*38.1*	*35.6*	*37.1*	*35.5*	*36.0*
DFIs	34.6	26.1	28.0	24.9	29.3	27.8	32.8	30.6	31.9	30.4	30.7
HFC	1.0	2.0	2.7	2.7	2.6	3.0	3.1	3.1	3.6	3.3	3.4
Others	*2.4*	*2.3*	*2.2*	*1.9*	*1.9*	*2.7*	*2.2*	*1.9*	*1.6*	*1.9*	*1.9*
memorandum item:											
State-owned Institutions	96.9	97.1	95.0	96.0	97.1	96.0	95.2	94.2	93.9	92.6	91.6

[1]: Data for Schedule banks and NBFIs are of end calendar and fiscal year respectively while banks and NBFIs are of end calendar and fiscal year.
[2]: *Leasing, Modaraba* and *Venture Capital Companies* are excluded due to non-availability of data. *Capital Companies* are excluded.

NPLs instead of total outstanding amounts of such loans. This adjustment alone has added to the volume of non-performing loans.

Although credit culture is changing very slowly, nevertheless, decrease in growth of NPLs and ratio of NPLs to gross advances in the last two years is encouraging. This trend shows that new loans are being disbursed relatively more prudently; leading us to conclude that perhaps the ratio of NPLs to gross advances has reached a plateau and thus likely to decline in future--albeit slowly. However, the volume of NPLs may continue to rise in near future because the credit culture is unlikely to change dramatically in a short period of time.

Another reason that points to the likely continuation of decline in the ratio of NPLs to gross advances is the structure of concentration of NPLs. As shown in **Table 6.15**, state-owned banks and DFIs together held 87.1 percent of total NPLs in FY00. With the merger of the largest DFI, i.e., NDFC with NBP, liquidation of BEL and restructuring plan of rest of public sector DFIs, new project loaning is less likely to turn into bad loans. Capital adequacy of state-owned banks is now much better than earlier even after incorporation of full provisioning. Therefore, these banks are also likely to show substantial improvement in their ratios of NPLs to gross advances in near future.

6.8 Financial Development in Peer Countries

Many of the problems in the financial sector of Pakistan were common to other countries of comparable development and financial structure like India, Bangladesh, Sri Lanka, Philippines, Malaysia and Turkey. This section provides a short comparative evaluation of transformation in their macro-financial landscapes during 1990s. Comparison is based on two points in that period -- 1990 and 2000. Their macroeconomic environment is discussed first, followed by a comparison of financial deepening and intermediation indicators.

6.8.1 Macroeconomic Environment

At the beginning of the decade, except for Malaysia, inflation was a serious challenge for all countries of this group with Turkey having anomalously higher inflation of about 60 percent per annum (see **Table 6.16**). Fiscal deficit was high in South Asian Countries. Philippines and Pakistan had severe problems of current account imbalances compared with other countries. Foreign exchange reserves positions were also not very encouraging in most of the countries. Only Malaysia and Turkey had high reserve positions among this group.

Table 6.16: Macroeconomic Indicators

	Pakistan	India	Bangladesh	Sri Lanka	Philippines	Malaysia	Turkey
1990							
GDP per capita (US$)	351.6	389.1	194.4	472.7	720.7	2,478.8	2,682.2
Inflation	9.1	9.0	6.1	21.5	13.2	2.6	60.3
Fiscal deficit *	-5.4	-7.6	n.a	-7.8	-3.5	-2.9	-3.0
Current account balance *	-4.2	-2.2	-1.9	-3.7	-6.1	-2.0	-1.7
Foreign exchange reserves **	0.3	1.2	0.6	0.4	0.9	9.3	6.0
Exchange rate (per US$)	21.8	18.1	35.8	40.2	28.0	2.7	2,930.0
2000							
GDP per capita (US$)	437.0	460.7#	264.9	842.2	979.2	3,840.1	3,024.7
Inflation	4.4	4.0	2.3	6.2	4.4	1.5	54.9
Fiscal deficit *	-5.9	-4.2#	-	-6.9#	-4.1	-3.2#	-12.2#
Current account balance *	-0.4	-0.7#	-0.8	-6.5	12.2	16.0#	-4.8
Foreign exchange reserves **	1.5	3.7	1.5	1.0	12.9	28.6	22.3
Exchange rate (per US$)	58.0	46.8	54.0	82.6	50.0	3.8	673,385.0

* % of GDP; ** Billion US$, # for 1999, (Source: IFS year book 2001)

At the end of 1990s, the macroeconomic indicators of these countries gave a mixed picture of their economies. Except for Turkey, inflation in all other countries was under control. Current account balances were also at sustainable levels. However fiscal deficits remained high and deteriorated over the decade for most of the countries, especially in Turkey.

6.8.2 Financial Deepening and Intermediation

At the beginning of reforms in Pakistan, all countries in the group, except for Malaysia, had shallow financial sectors with a low M_2 to GDP ratio. Pakistan was close to the level of financial depth as that of India, but better than that of Philippines, Turkey, Sri Lanka and Bangladesh (**Table 6.17**). However, even after a decade of far-reaching reforms, financial depth, in terms of M_2 to GDP ratio in Pakistan improved only marginally from 39.2 percent in 1990 to 46.5 percent in 2000 and its relative position within the peer group worsened.

One of the factors that limited the deepening of financial markets in Pakistan seems to be the large size of informal financial and non-financial markets, which has not yet been addressed directly by the financial sector reforms. Currency to GDP ratio is indicative of the size of informal economy. Pakistan was the only country in 1990, which had this ratio at double-digit level (i.e., 14.7 percent). After a decade of reforms, the ratio has gone down only to 12.9 percent, still indicative of fairly large size of informal economic sector. Interestingly, this ratio for India has gone up from 8.8 to 9.9 percent during this period, again indicating the presence of a large informal financial and non-financial sector in India.

Table 6.17: Indicators of Financial Depth and Efficiency

percent

	Pakistan	India	Bangladesh	Sri Lanka	Philippines	Malaysia	Turkey	Median	
1990								Value	Country
M_2 / GDP*	39.2	42.7	31.8	28.5	34.2	64.4	23.9	34.2	Philippines
Currency / M_2	37.6	20.7	12.8	24.1	16.8	14.6	12.1	16.8	Philippines
Currency / GDP	14.7	8.8	4.1	6.9	5.7	9.4	2.9	6.9	Sri Lanka
Money multiplier	2.2	3	3.9	2.8	2.6	4.2	3.3	3	India
Demand deposits[1]	61.3	17.6	17.5	25.4	8.9	21.6	31.1	21.6	Malaysia
Time deposits[1]	38.7	82.4	82.5	74.6	91.1	78.4	68.9	78.4	Malaysia
Credit to government[2]	48.5	49.4	10.6	41.3	1.7	4.5	1.7	10.6	Bangladesh
Credit to private sector[2]	51.5	50.6	89.4	58.7	98.3	95.5	98.3	89.4	Bangladesh
2000									
M_2 / GDP	46.5	56.9#	43.3	38.2	62.5	102.6	44.6	46.5	Pakistan
Currency / M_2	27.8	17.5	14.2	13	9.3	6.4	5.6	13	Sri Lanka
Currency / GDP	12.9	9.9#	6.2	5	5.8	6.6	2.5	6.2	Bangladesh
Money multiplier	3.2	4.1	4.6	4.7	4.7	4.1	5.6	4.6	Bangladesh
Demand deposit[1]	43.2	14.9	14.5	13.3	10.6	17.4	12	14.5	Bangladesh
Time deposit[1]	56.8	85.1	85.5	86.7	89.4	82.6	88	85.5	Bangladesh
Credit to government[2]	41.8	44.5	22.2	27.8	23.4	-2.2	52.7	27.8	Sri Lanka
Credit to private sector[2]	58.2	55.5	77.8	72.2	76.6	102.2	47.3	72.2	Sri Lanka

* M_2 is money plus quasi money; [1] percent of total deposits; [2] percent of total credit; # for 1999 (Source: IFS Year Book 2001)

Comparison of money multiplier reveals a contrasting picture in terms of values, but similar in terms of deepening. Value of money multiplier for Pakistan although marginally increased from 2.2 in 1990

to 3.2 in 2000, but had remained the lowest vis-à-vis other six countries, indicating the shallowest financial system.

In terms of one of the intermediation indicators, share of demand deposits to total deposits, Pakistan again stood out as the cdd country with the highest share both in 1990 and 2000. Not only these shares were highest in Pakistan, but also the difference from peer country average (excluding Pakistan) was huge. Preference for demand deposits over time deposits in Pakistan is extremely pronounced, although it has decreased from 61.3 percent in 1990 to 43.2 percent in 2000.

While the above ratio describes a qualitative characteristic of mobilization side of intermediation, share of credit to private sector indicates the crowding out phenomenon from the credit extension side. This ratio is again on the lower side among peer countries, both in the beginning and at the end of reform decade. However, a minor improvement was witnessed from 51.5 percent in 1990 to 58.2 percent in 2000. Malaysia, in terms of this share stands out as the best performer. **Table 6.18** summarizes the qualitative change during the decade in financial deepening and efficiencies in Pakistan in absolute term as well as in relation to the group of peer countries.

Table 6.18: Financial Deepening and Efficiency in Pakistan vis-à-vis Peer Countries

	Qualitative change during 1990s		Rank*	
	Absolute	Relative to group	1990	2000
M_2 / GDP	Improvement	Deterioration	3	4
Currency / M_2	Improvement	No change	7	7
Currency / GDP	Improvement	No change	7	7
Money multiplier	Improvement	No change	7	7
Demand deposits	Improvement	No change	7	7
Time deposits	Improvement	No change	7	7
Credit to government	Improvement	Improvement	6	5
Credit to private sector	Improvement	Improvement	6	5

* 1 is for best and 7 is for worst

Above evaluation shows that although the level of financial development in Pakistan is much lower in comparison with most of peer group of countries, financial reforms nevertheless had a measurable, though small improvement on financial deepening and intermediation. Needless to say that not only much remains to be done, but keeping the reform process going is also necessary.

7 Future Direction of Reforms

The country has made a significant progress in implementing financial sector reforms and achieved a more competitive market structure with the expanding market share of private and foreign banks, and the privatization of two nationalized commercials banks. There are also significant gains in the form of better supervision and regulation of financial market and institutions. Nevertheless, there are still some major weaknesses in the financial sector, particularly with respect to efficiency of the banking sector. Thus, further reforms in main areas are required to achieve an efficient, sound and competitive banking system. The subsequent sections discuss the future direction of financial sector reforms in Pakistan that has emerged from the analysis provided in earlier chapters.

Future direction should be focused to achieve four broad medium to long-term objectives: improvement in soundness of financial system; strengthening the efficiency of supervision; increasing the effectiveness of monetary policy; and deepening the financial system and services.[1]

7.1 Soundness of Financial System

Soundness of financial system requires its constituent institutions to be efficient, having an optimal size and relatively healthy portfolio; and the financial system itself of being the optimal size. These requirements call for renewed efforts for privatization, drastic restructuring of DFIs, a more effective tackling of the problem of bad debts, and the elimination of fragmentation, and thereby consolidation of financial system.

7.1.1 Remaining Agenda for Privatization

Chapter 3 shows that the state-owned banks continue to dominate the financial sector, despite the entry of new private and foreign banks during 1990s. The commercial banking system is still dominated by the three nationalized commercial and two partially privatized banks. The deteriorating governance and credit discipline, especially in the state-owned banking sector had eroded their capital, which has largely been compensated through capital injections by SBP. Privatization of the nationalized commercial banks (NCBs) and large development finance institutions is the key to overcome these structural problems. These banks should be sold, as being done currently, through competitive bidding and through listing on Stock Exchanges. This would bring in transparency in the process, fetch a realistic price to the government exchequer and enhance sale proceeds, which should be used for high priority purposes such as national debt retirement and poverty reduction. In addition, it would also deepen the strength of the capital market.

It must be realized that the size of these institutions, given the absorbing capacity of the private sector, demands a carefully designed process of privatization with absolute transparency. A vigilant restructuring of these institutions, making them a manageable and profitable avenue to attract the hitherto lukewarm attention of the foreign investors, is required. In addition, the high tax rate on banks' profits is also perceived negatively by the potential buyers of state-owned banks. Though a reduction in tax rate from 58 percent to 50 percent for banks has been made in FY02, a further reduction is also required so that the general corporate tax rate is applied to banks as well. Moreover, the current drive to recover the defaulted loans also needs to be accelerated. The privatization of NCBs could be further promoted by staff reduction and branch rationalization.

7.1.2 Restructuring of DFIs

Although the government implemented various reforms to improve the efficiency of the financial sector, but only a little attention has been given to reform the development finance institutions (DFIs).

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[1] This chapter draws extensively from " Financial Sector in Pakistan: Future Strategic Direction" by Dr. Ishrat Husain, Governor, State Bank of Pakistan.

Current distressed state of DFIs is clearly described in chapter 4. These institutions are characterized by a common set of problems, which includes a very high ratio of non-performing loans and infected portfolios, serious shortage of new financial resources, a low level of institutional efficiency and overstaffing with a high level of demoralization. The distressed state of DFIs is an outcome of political intervention by different governments in the 1980s and 1990s, which has perverted the credit allocation and loan recovery decision. DFIs in Pakistan have failed not only in reaching the targeted sectors but also in achieving sustainability mainly because of large defaults.

Thus, attention should be paid to reform and restructure the DFIs. The ultimate objective of reforms should be: (a) to provide diversified variety of financial products and services at economical costs to the various segments of the economy including micro and small enterprises/individuals; (b) to contribute to enhancing the domestic savings rates; and (c) to allocate resources on the basis of economic merits of investment proposals. In this respect, restructuring of DFIs may be done with the objective of making them operationally efficient, financially viable and sustainable. To achieve these objectives, the DFIs' institutional structure needs to be rationalized, streamlined and consolidated with a view to minimizing the number of public sector DFIs, attaining economies of scale, enhancing clarity in their roles and promoting efficient delivery of services to targeted sectors.

DFIs account for about 11 percent of the total assets of the financial sectors. They are mainly owned by the government with mandate to provide directed and subsidized long-term financing to industry, credit to the agricultural sector and loans for house building. Although government intervention has created distortions in the market, a calculated government intervention is justified in view of the fact that the financial market in Pakistan is not yet well developed to meet the long-term financing needs of the economy. Keeping this in view, the government has already started restructuring of DFIs in 2000. Bankers Equity Limited (BEL) has already been liquidated, while National Development Finance Corporation (NDFC) amalgamated with National Bank of Pakistan (NBP). The Small Business Finance Corporation (SBFC) and Regional Development Finance Corporation (RDFC) have already been merged into a new entity--the SME Bank--to cater to the needs of the small and medium scale enterprises. Public sector shares (46 percent) of Pakistan Industrial Credit and Investment Corporation (PICIC) are to be sold to the private sector. The NIT and ICP mutual funds management has been proposed to be contracted out to the private sector through the Privatization Commission under the Capital Market Development Program with the assistance of Asian Development Bank. ADBP will be retained, with institutional strengthening so as to make it more effective. Federal Bank for Cooperatives (FBC) is in the process of liquidation and its financing functions will be transferred to ADBP. House Building Finance Corporation (HBFC) is being restructured and its institutional capabilities are being upgraded substantially to provide housing finance.

7.1.3 Arresting Bad Debts

Chapter 3 and 4 show that although, a number of prudential measures have been taken to arrest the bad debts, the non-performing loans as percent of total advances increased from 21 percent in 1993 to 25 percent in 2000, which clearly reflects that earlier efforts to arrest the bad debts were not enough. To address the problem in a more systemic way, the government has established the Corporate & Industrial Restructuring Corporation (CIRC) in September 2000 to assume non-performing loans and assets of state-owned institutions (HBL, UBL, NBP, NDFC, IDBP and ADBP) with the aim of promoting revitalization of the economy by reviving sick industrial units. The corporation has been empowered to take over the non-performing loans of Rs 30 million or more of the nationalized commercial banks (NCBs) and development finance institutions (DFIs), make arrangements to revive the sick units and ultimately liquidate non-performing loans and stuck up loans. The Corporation has so far resolved outstanding loans of Rs 3.2 billion by selling 30 non-performing loans, while 138 non-performing loans with outstanding amount of Rs 33 billion are under resolution.

While progress of CIRC has been limited so far in arresting the bad debts, a comprehensive strategy is needed to address the issue, which requires rationalization of the whole financial sector and considering bad debts as a subset of a larger issue. Any comprehensive program of arresting bad debt will have to cover the following areas: (a) a well functioning legal framework without any loop-holes; (b) strengthening and improving regulatory framework; (c) strengthening and widening the scope of Corporate and Industrial Restructuring Corporation; (d) strengthening the role of Credit information Bureau and credit rating agencies; (e) improving the quality of project evaluation by institutions before disbursing loans, and (f) privatization of nationalized institutions, and reduction in the number of banks and DFIs through merger/amalgamation. It is noteworthy that while the first four steps are of continuous nature, the time frame for last one is necessary to avoid the moral hazard problem.

7.1.4 Consolidation of Financial Sector

Chapter 3 and 4 also show that there are too many small and under-capitalized private financial institutions in different categories, resulting in fragmentation and smallness mainly due to the legal and regulatory framework that sets the limits of the business areas and minimum capital requirements. Absence of economies of scale and scope, failure to upgrade technology, and lack of quality human resource base do not allow these institutions to compete effectively with large banks. Consolidation of smaller institutions into bigger units is required to enhance competition and efficiency. This can be done by focusing on the legal and regulatory framework, the mode of funding by institutions, and deregulating their business operations. The aims should be to integrate the market as much as possible from the viewpoint of customers of financial services.

The following actions should be taken to trigger the consolidation in a smooth manner: (a) raising the capital required for each type of institution to a certain level; (b) facilitating consolidation deals; and (c) in case of commercial banks, further liberalizing branch opening and closing to promote natural growth and mergers. In fact, all scheduled banks have already been required by SBP to raise their capital to Rs 1,000 million by 1st January 2003, in a graduated manner by first enhancing it from Rs 500 million to Rs 750 million by 1st January 2002.

In the long-term, the financial system should be well served by a three-tier structure. Top tier would consist of strong universal banks providing credit and financial services to large-scale industries and other corporate clients; catering to consumer financing needs; and having a global network. This tier would be mainly private sector owned and also encouraged to reach out to small and medium enterprises.

Second tier would consist of specialized and other private sector banks, in addition to microfinance institutions in public and private sector. The focus of this tier would be to provide credit and financial services to micro, small and medium enterprises, besides meeting specialized credit requirements for exports, agriculture and rural sectors.

The third tier is envisaged to consist of private non-bank financial companies resulting from the consolidation of existing fragmented NBFIs. These institutions would rely on borrowing and contributions funding their asset growth. They would undertake equity underwriting, merger and acquisition, asset management, corporate bond issues, securities trading, leasing, venture capital etc. This tier would be governed and supervised by the Securities and Exchange Commission of Pakistan (SECP).

7.2 Efficacy of Supervision

Strengthening of supervisory and regulatory capabilities of governing institutions (SBP and SECP) not only requires enhancement of their own skills but also those of institutions being supervised. This requires instillation of good governance, placement of effective legal infrastructure, and clear demarcation of supervisory responsibilities in case of multiplicity of supervisors.

7.2.1 Improving Corporate Governance

For good corporate governance a four tier structure is desirable, viz management, board, external auditors and self-regulation. A good progress in this respect has been made towards the end of 1990s. The banks/NBFIs incorporated in Pakistan have been mandated to get the clearance of the State Bank prior to appointment of their Chairman, Chief Executive and members of the Board. The management of public sector banks has already been drawn from private sector, and their boards have been re-constituted and appropriate persons of repute from private sector have been inducted. Under the provisions of Banks (Nationalization) Act, 1974 the appointments of Chief Executive of public sector banks/DFIs have to be made out of a panel of professional bankers maintained by SBP. The SBP requires not only a continuous strict scrutiny but also strict adherence to the defined criteria in this regard to prevent intervention by the government and politicians.

Good corporate governance is also aided by a system of external auditing. In this respect, SBP has recently revised the appointment criteria for selecting panel of auditors to make it more realistic, transparent and according to international standard. The criteria will also help SBP to determine the professional capability and competence of external auditor. The guidelines for submission of special report to State Bank by the external auditors are also being revised. A vigilant monitoring and updating of these issues will be required by the State Bank to improve the corporate governance.

Self-regulatory bodies like Financial Markets Association of Pakistan (FMAP) and Pakistan Banks Association (PBA) also have to become more active to enforce ethical and sound market practices. The need for close liaison between self-regulatory bodies and supervisory authorities will also increase in future and likely result in better regulation and supervision.

7.2.2 Strengthen Legal Infrastructure

Although legal and judicial reforms have facilitated financial contract dispute resolution, implementation of court judgments is still ineffective, partly due to remaining weaknesses in the law and its enforcement. The law could be further strengthened by enabling financial institutions to foreclose on collateral without the intervention of courts. Financial institutions could be facilitated by providing required resources of the state to implement out-of-court foreclosure. Simultaneously, the implementation of court judgment could be facilitated by providing courts with adequate resources to effect loan recovery. Furthermore, SBP Act, Banking Companies Ordinance 1962, Banking Nationalization Act and DFI Act could be revised to enable the operation of these institutions on commercial considerations without bureaucratic and political influences.

7.2.3 Enhance Capabilities of Supervision

State Bank of Pakistan has already taken important initiatives to strengthen off-site surveillance and on-site inspection. A set of manuals was developed for on-site examinations, off-site surveillance, early warning system, and problem bank management. On-site examination process was modernized to provide reliable, clear and timely information regarding banks' financial conditions, performance and future prospects; and serves as the basis for effective corrective action. In this respect, development of sustainable practical training programs for supervisory staff are essential not only to enhance the quality of SBP inspectors but also to keep pace with modernization of financial institutions.

7.2.4 Demarcation of Supervision and Regulation Responsibilities

The proposed three tier financial system, requires a clear demarcation of supervision and regulation responsibilities for strengthening the efficacy. SBP and SECP have redesigned the non-bank financial institutions (NBFIs) to offer a whole variety and range of financial products, tailored to the needs of customers through one window operation; these institutions will be called as Non-bank Financial Companies (NBFCs). Duality in supervisory role for NBFIs between SBP and SECP will no longer

exist as supervisory/regulatory functions of NBFIs are going to be transferred to SECP after making necessary amendments in Banking Companies Ordinance 1962 and a framework containing rules for supervision of NBFCs. Continuous coordination is envisaged between SECP and SBP to ensure consistent and effective supervision over the entire financial sector.

Redesigned NBFCs will bring together all non-banking services such as leasing, investment banking, housing finance, venture capital, asset management, discounting services and investment advisory services under one umbrella. This consolidation will not only help in greater cost effectiveness for customers, but also improve the effectiveness of supervision stemming solely from SECP.

7.3 Effectiveness of Monetary Policy

Independence of central bank is a sine qua non for effectiveness of monetary policy. It further requires existence of deep and efficient financial markets. In addition, a market based term structure of interest rates is a precondition for the realization of an active money and government securities market. Furthermore, monetary policy changes are transmitted more effectively if both money and foreign exchange markets are free of segmentation.

Proper signaling of monetary stance also plays a vital role in the effectiveness of monetary policy, which necessitates the signals to be interpreted by market players in the direction intended by the central bank. This requires not only a clear enunciation of dissemination of Annual Credit Plan but also an enhanced communication with the market. SBP has already started a detailed explanation of its monetary stance in its Quarterly Reports. This practice will be further strengthened in future.

7.3.1 Ensuring Autonomy of SBP

The SBP was granted autonomy in 1997 in the management of monetary policy but it remained an institution devoted to the financial need of the government, although in recent years fiscal prudence was broadly observed. Ensuring SBP full autonomy in devising and applying its monetary policy requires establishing legal limits to the amount, established in terms of clause (b) of Section 9A of SBP Act, 1956, that it can advance to the government.

7.3.2 Rationalization of Interest Rate Structure

Government has created distortions in resource mobilization through the national saving schemes (NSS) by setting very high yields on medium and long-term saving certificates. As shown in section 6.4, these high rates have put pressure on public finances as the domestic debt servicing costs have risen disproportionately, thus widening the fiscal deficit. On the other hand, they have diverted deposits from banking sector to non-banking sector and resulted in lower deposit base for banks. As a result, the NSS instruments have grown at twice the rate of bank deposits and now equal half of bank deposits. Thus, government has crowded out the private sector from the long-term markets through the NSS.

Although in the recent past, the profit rates on NSS have been rationalized to avert the diversion of banks deposits to non-banking sector, the government financing mechanism needs to be made more conducive to overall financial sector development. To achieve this goal, it is important to set the rates on NSS marginally lower than those of government securities available to banking sector. This is necessary in view of premature encashment facilities available on various certificates of NSS. Consequently, it will require the strengthening of existing weak link between the return on a ten-year DSC with that of market determined Pakistan Investment Bond (PIB). Unless this happens, dis-intermediation episodes will continue to haunt the financial system.

7.3.3 Unification of Foreign Exchange Market

Present foreign exchange market is segmented into an official inter-bank foreign exchange market, fed by export receipts, official remittances and other inflows for ultimate use by imports and other payments, and a kerb market fed by unofficial remittances for ultimate use by any buyer. Kerb market has been increasingly used by SBP for purchasing hard currency to enhance reserves. The premium between the two markets has remained within a range of 4 to 5 percent over an extended period of time. Merging of these markets will remove the segmentation and increase the efficiency. Merger is proposed to take place by 1st July 2002 through transformation of existing licensed money changers into Exchange Companies with enhanced regulation. This unification is expected to significantly increase the inflow of foreign exchange in the country through official channels.

7.3.4 Development of Secondary Market for Long-term Government Paper

Although the secondary market for short-term government paper is active and efficient, the market for long-term government papers is yet to be developed. Initial steps in this regard have already been taken through the selection of primary dealers (PDs) and the introduction of PIBs. The PDs were chosen on the basis of their treasury expertise and infrastructure, past performance as market players, and capital adequacy. These players are given the explicit responsibility of developing an active secondary market by supplying non-PDs and institutional investors with PIBs. The resulting shortlist of PDs include: (1) ABN-AMRO Bank, (2) American Express, (3) Citibank, (4) Habib Bank Limited, (5) National Bank of Pakistan, (6) Standard Chartered Grindlays, and (7) Union Bank.

It is imperative to give the long-term instruments a more conducive environment through a shift in mindset of players from a buy-and-hold strategy to a strategy of active participation in secondary market trading. This will depend mainly on how effective the PDs are in undertaking their obligations that will lead to effective market making.

7.4 Deepening of Financial System and Services

Financial depth requires that financial transactions should encompass a broader range of economic and financial agents. This in turn calls for limiting the role of government and promoting that of the private sector. Furthermore, outreach of financial institutions should not be confined to the large few, but also touch micro level enterprises. An outdated and inefficient payment system can result in promotion of informal financial activities and constrain the system to remain shallow. Moreover, in the age of globalization, enhancement of financial services will go a long way in attracting global capital.

7.4.1 Minimizing the Role of Government

As shown in peer country comparison (**section 6.8**), larger shares of banking sector credit to government are associated with shallowness of financial sectors. Therefore, it is necessary to reduce the role of government and public sector institutions through curtailment of its borrowing from the banking system. This can only be done if not only the ownership of government in financial institutions is reduced through privatization, but a meaningful restructuring of public sector enterprises is undertaken as well.

7.4.2 Promote Micro-finance Institutions

Low level of financial depth indicated in high currency and low M2 to GDP ratios is largely due to the inability of present formal financial structure to cater to the needs of micro, small and medium enterprises, which are currently outside the formal sector, and as such unable to expand the scope of their economic activities. As discussed earlier, proposed three-tier structure of financial system is expected to go a long way in deepening and widening of financial activities.

7.4.3 Modernization of Payment System

Considerable progress has been made during 1990s towards achieving speedy and automated clearing of cheques. However, progress on modernization of government securities settlement system was limited to establishment of a book-based manual system for only three government securities (T-bills, FIBs and PIBs). Nevertheless, a landmark achievement was the establishment of Central Depository Company for automated settlement of corporate securities.

Establishment of an automated and efficient payment settlement system is necessary not only to increase the volume of financial transactions within the country, but also to tap the international capital searching for viable financial investment. Growing cross-border interdependence between payment and settlement systems has led to a number of international initiatives to develop the payment systems in accordance with the Core Principles for Systematically Important Payment Systems (SIPS). The SBP is examining various options to implement a Real Time Gross Settlement System (RTGS). Once operational, it will significantly enhance the volume of financial transactions in the country. Furthermore, in order to curtail the delay in foreign currency transfers within the country, establishment of a non-Rupee clearing house is also under consideration.

7.4.4 Enhancing Financial Services

The financial sector around the world is opening to the foreign markets. Globalization brings in both opportunities and threats. Economies that want to get benefit from this trend must be proactive in adopting the optimal policies. World Trade Organization is an important forum for promoting international trade in goods and services and Pakistan is a member of WTO and a participant in GATS (General Agreement of Trading in Services). State Bank will be actively involved in promoting policies and strategies to export financial services. Presently, Pakistan's commitments in financial services address important issues of branch licensing, ownership of banks and financial institutions, asset management and financial advisory services, employment of foreign nationals, setting up of locally incorporated subsidiaries by foreign institutions, and commitments related to leasing and insurance. Further liberalization of financial services has to be undertaken under TRIMs (Trade Related Investment Measures) agreement with WTO. Therefore, the State Bank as a regulatory authority will have to reposition itself to cope with these challenges.

7.5 Conclusion

State-owned banks and DFIs are still faced with the problems of large non-performing loans, high administrative costs and low efficiency reflected in high spread between lending and deposit rates. Thus, key to solution lies in the privatization of state-owned banks and DFIs. To privatize these institutions, a watchful restructuring is required to make these institutions manageable and profitable avenue to attract the attention of foreign investors. To remove distortions in resource mobilization, the government financing mechanism needs to be made more conducive to overall financial sector development. To arrest the bad debts a comprehensive strategy should be envisaged, which requires rationalization of the whole financial sector along with a well functioning legal framework without any loop-holes; strengthening and improving regulatory framework; strengthening and widening the scope of Corporate and Industrial Restructuring Corporation; privatization of nationalized banks; and merger of small banks and reduction in the number of DFIs. Consolidation of smaller institutions into bigger units is also required to enhance efficiency and promote competition. Implementation of these reforms would result in self-sustained and commercially viable financial institutions.

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Annex 1

Annex 1.1: List of Scheduled Banks Operating in Pakistan

As on 30th June 1990

State-owned Banks

1 Allied Bank of Pakistan Ltd.
2 First Women Bank Ltd.
3 Habib Bank Ltd.
4 Muslim Commercial Bank Ltd.
5 National Bank of Pakistan
6 The Bank of Punjab.
7 United Bank Ltd.

Foreign Banks

1 Algemene Bank Netherland N.V.
2 American Express Bank Ltd.
3 ANZ Grindlays Bank p.l.c.
4 Bank of America
5 Banque Indosuez
6 Bank of Tokyo
7 Citibank N.A.
8 Deutsche Bank A.G.
9 Doha Bank
10 Emirates Bank International Ltd.
11 Habib Bank A.G. Zurich
12 International Finance Investment and Commerce Bank Ltd.
13 Mashreq Bank Ltd.
14 Massraf Faysal Al-Islami of Bahrain
15 Rupali Bank Ltd.
16 Standard Chartered Bank
17 The Hong Kong and Shanghai Banking Corporation Ltd.

Private Banks

Nil

As on 30th June 2000

State-owned Banks

1 Allied Bank of Pakistan Ltd.
2 First Women Bank Ltd.
3 Habib Bank Ltd.
4 Muslim Commercial Bank Ltd.
5 National Bank of Pakistan
6 The Bank of Khyber
7 The Bank of Punjab
8 United Bank Ltd.

Foreign Banks

1 ABN AMRO Bank N.V.
2 Al- Baraka Islamic Bank B.S.C. (E.C.)
3 American Express Bank Ltd.
4 Bank of Ceylon
5 Citibank N.A.
6 Credit Agricole Indosuez
7 Deutsche Bank A.G.
8 Doha Bank
9 Emirates Bank International Ltd. PJSC
10 Habib Bank AG Zurich
11 International Finance Investment and Commerce Bank Ltd.
12 Mashreq Bank PSC
13 Oman International Bank S.A.O.G.
14 Rupali Bank Ltd.
15 Societe Generale, The French and International Bank
16 Standard Chartered Bank
17 Standard Chartered Grindlays Bank Ltd.
18 The Bank of Tokyo-Mitsubishi Ltd.
19 The Hong Kong and Shanghai Banking Corporation Ltd.

Private Banks

1 Askari Commercial Bank Ltd.
2 Bank Al-Falah Ltd.
3 Bank Al-Habib Ltd.
4 Bolan Bank Ltd.
5 Faysal Bank Ltd.
6 Gulf Commercial Bank Ltd.
7 Metropolitan Bank Ltd.
8 Platinum Commercial Bank Ltd.
9 Prime Commercial Bank Ltd.
10 Prudential Commercial Bank Ltd.
11 Soneri Bank Ltd.
12 Union Bank Ltd.

Annex 1.2: List of NBFIs Operating in Pakistan

As on 30th June 1990

Development Finance Institutions

1 Agricultural Development Bank of Pakistan
2 Bankers Equity Ltd.
3 Federal Bank for Cooperatives
4 Industrial Development Bank of Pakistan
5 National Development Finance Corporation
6 Pakistan Industrial Credit & Investment Corporation Ltd.
7 Pakistan Kuwait Investment Company (Pvt) Ltd.
8 Pak-Libya Holding Co. (Pvt) Ltd.
9 Punjab Provincial Cooperative Bank
10 Regional Development Finance Corporation
11 Saudi Pak Industrial & Agricultural Inv. Co. (Pvt) Ltd.
12 Small Business Finance Corporation (SBFC)

Investment Banks

1 Al-Towfeek Investment Bank Ltd.
2 Asset Investment Bank Ltd.
3 Crescent Investment Bank Ltd.
4 Fidelity Investment Bank Ltd.
5 Islamic Investment Bank Ltd.

Leasing Companies

1 Asian Leasing Corporation Ltd.
2 Atlas BOT Lease
3 Orient Leasing
4 Orix Leasing Pakistan Ltd.
5 Pakistan Industrial Leasing Corporation Ltd.

As on 30th June 2000

Development Finance Institutions

1 Agricultural Development Bank of Pakistan
2 Bankers Equity Ltd.
3 Federal Cooperative Bank
4 Industrial Development Bank of Pakistan
5 National Development Finance Corporation
6 Pakistan Industrial Credit & Investment Corporation Ltd
7 Pakistan Kuwait Investment Company (Pvt) Ltd.
8 Pak-Libya Holding Co. (Pvt) Ltd.
9 Punjab Provincial Cooperative Bank
10 Regional Development Finance Corporation
11 Saudi Pak Industrial & Agricultural Inv. Co. (Pvt) Ltd.
12 Small Business Finance Corporation (SBFC)

Investment Banks

1 Al - Meezan Investment Bank Ltd.
2 Al-Faysal Investment Bank Ltd.
3 Al-Towfeek Investment Bank Ltd.
4 Asset Investment Bank Ltd.
5 Atlas BOT Investment Bank Ltd.
6 Crescent Investment Bank Ltd.
7 Escorts Investment Bank Ltd.
8 Fidelity Investment Bank Ltd.
9 First international Investment Bank Ltd.
10 Franklin Investment Bank Ltd.
11 Islamic Investment Bank Ltd.
12 Jahangir Siddiqui Investment bank Ltd.
13 Orix Investment Bank Ltd.
14 Prudential Investment Bank Ltd.
15 Security Investment Bank Ltd.
16 Trust Investment Bank Ltd.

Leasing Companies

1 Asian Leasing Corporation Ltd.
2 Askari Leasing Company Ltd.
3 Atlas Lease Ltd.
4 Capital Assets Leasing Corporation Ltd.
5 Crescent Leasing Company Ltd.
6 Dadabhoy Leasing Company Ltd.
7 Dawood Leasing Company Ltd.
8 English Leasing Ltd.
9 First Leasing Corporation
10 Ghandhara Leasing Company Ltd.
11 Grays Leasing Ltd.
12 Ibrahim Leasing Ltd.
13 Inter Asia Leasing Company Ltd.
14 International Multi Leasing Corporation Ltd.
15 Lease Pak Ltd.
16 Mercantile Leasing Company Ltd.
17 National Assets Leasing Corporation Ltd.
18 National Development Leasing Corporation Ltd.
19 Natover Lease & Refinance Ltd.

Annex 1.2: List of NBFIs Operating in Pakistan (Cont.)

As on 30th June 1990

Modaraba Companies

1 B.F. Modaraba
2 B.R.R. Capital Modaraba
3 B.R.R. Second Modaraba
4 First Grindlays Modaraba
5 First Habib Modaraba
6 First National Modaraba
7 First Sanaulah Modarba
8 First Prudential Modaraba
9 LTV Capital Modaraba
10 Modaraba Al-Mali

As on 30th June 2000

20 Network Leasing Corporation Ltd.
21 Orix Leasing Pakistan Ltd.
22 Pacific Leasing Corporation Ltd.
23 Pak-Apex Leasing Company Ltd.
24 Pak-Gulf Leasing Ltd.
25 Pakistan Industrial & Commercial Leasing Ltd.
26 Pakistan Industrial Leasing Corporation Ltd.
27 Paramount Leasing Ltd.
28 Saudi Pak Leasing Company Ltd.
29 Security Leasing Company Ltd.
30 Sigma Leasing Corporation Ltd.
31 Trust Leasing Corporation Ltd.
32 Union Leasing Ltd.
33 Universal Leasing Corporation Ltd.

Modaraba Companies [1]

1 Al-Noor Modaraba
2 Allied bank Modaraba 1st
3 Al-Zamin Modaraba
4 B.F. Modaraba
5 B.R.R. International Modaraba
6 Confidence Modaraba 1st
7 Constellation Modaraba 1st
8 Crescent Modaraba 1st
9 Custodian Modaraba 1st
10 Dadabhoy Modaraba 1st
11 Elite Capital Modaraba 1st
12 Equity Modaraba 1st
13 Fidelity Leasing Modaraba 1st
14 Financial Link Modaraba
15 General leasing Modaraba 1st
16 Grindlays Modaraba 1st
17 Guardian Leasing Modaraba
18 Habib Bank Modaraba 1st
19 Habib Modaraba 1st
20 Hajveri Modaraba 1st
21 IBL Modaraba 1st
22 Ibrahim Modaraba 1st
23 Imrooz Modaraba 1st
24 Industrial Capital Modaraba 1st
25 Interfund Modaraba 1st
26 Islamic Modaraba 1st
27 LTV Capital Modaraba
28 Mehran Modaraba 1st
29 Modaraba Al Tijarah
30 Modaraba Al-Mali
31 National Modaraba 1st
32 Pak Modaraba 1st
33 Paramount Modaraba 1st
34 Professional Modaraba 1st
35 Providence Modaraba 1st
36 Prudential Modaraba 1st
37 Prudential Modaraba 2nd
38 Prudential Modaraba 3rd

Annex 1.2: List of NBFIs Operating in Pakistan (Cont.)

As on 30th June 1990	As on 30th June 2000
	39 Punjab Modaraba 1st
	40 Tri-Star Modaraba 1st
	41 Tri-Star Modaraba 2nd
	42 Trust Modaraba
	43 UDL Modaraba 1st
	44 Unicap Modaraba
	45 Unity Modaraba
Housing Finance Companies	*Housing Finance Companies*
1 House Building Finance Corporation	1 Citibank Housing Finance Co. Ltd.
	2 House Building Finance Corporation
	3 International Housing Finance Ltd.
	4 LTV Housing Finance Ltd.
Mutual Funds	*Mutual Funds*
1 Investment Corporation Of Pakistan	1 Golden Arrow Selected Stock Fund
2 National Investment Trust Ltd.	2 1st ICP Mutual Fund
	3 2nd ICP Mutual Fund
	4 3rd ICP Mutual Fund
	5 4th ICP Mutual Fund
	6 5th ICP Mutual Fund
	7 6th ICP Mutual Fund
	8 7th ICP Mutual Fund
	9 8th ICP Mutual Fund
	10 9th ICP Mutual Fund
	11 10th ICP Mutual Fund
	12 11th ICP Mutual Fund
	13 12th ICP Mutual Fund
	14 13th ICP Mutual Fund
	15 14th ICP Mutual Fund
	16 15th ICP Mutual Fund
	17 16th ICP Mutual Fund
	18 17th ICP Mutual Fund
	19 18th ICP Mutual Fund
	20 19th ICP Mutual Fund
	21 20th ICP Mutual Fund
	22 21st ICP Mutual Fund
	23 22nd ICP Mutual Fund
	24 23rd ICP Mutual Fund
	25 24th ICP Mutual Fund
	26 25th ICP Mutual Fund
	27 ICP SEMF
	28 Tri-Star Mutual Fund
	29 Growth Mutual Fund
	30 Security Stock Fund
	31 Asian Stock Fund
	32 Prudential Stock Fund
	33 KASB Premier Fund
	34 Safeway Mutual Fund
	35 First Capital Mutual Fund
	36 Confidence Mutual Fund
	37 Dominion Stock Fund
	38 Al-Meezan Mutual Fund

Annex 1.2: List of NBFIs Operating in Pakistan (Cont.)

As on 30th June 1990	As on 30th June 2000
	39 BSJS Balance Fund
	40 NIT
	41 UTP
Discount Houses	*Discount Houses*
1 First Credit & Discount Corporation (Pvt) Ltd.	1 First Credit and Discount Corporation (Pvt) Ltd.
	2 National Discounting Services Ltd.
	3 Prudential Discount & Guarantee House Ltd.
Venture Capital Companies	*Venture Capital Companies*
Nil	1 Pakistan Emerging Ventures Ltd.
	2 Pakistan Venture Capital Ltd.

[1] These 45 modarabas are handled by 41 management companies, of which three are handling more than one modaraba (Prudential Capital Management Ltd. is handling three modarabas, Al-Mal Corporation Ltd. is handling two, and Tri-Star modaraba 1st and 2nd are handled by one company).

Annex 1.3: Exchange Market Participants (Pre-reform)

Foreign exchange market comprised of suppliers (exporters, remitters and tourists), and users of foreign exchange (importers and government sector organizations). To manage the transactions between suppliers and users of foreign exchange, a system of Authorized Dealers (ADs) and Authorized Money Changers (AMCs) was in place.

1.1 Foreign Exchange Suppliers

Exporters, Pakistani nationals working abroad and foreign visitors spending foreign exchange in Pakistan make up a major source of hard currency in the foreign exchange market. Exporters were obliged to surrender export proceeds to ADs within four months of shipment of visible exports, and within three months of invisible exports (SBP authorized extensions of this period at its discretion). Proceeds from exports to Afghanistan were, however, exempted from surrender requirement.

Worker remittances were also surrendered to ADs in exchange for the Rupee equivalent, which in turn was sold to SBP at prescribed rates. Foreign visitors could convert their foreign currency holdings into Rupee at hotels and other licensed organizations dealing with tourists. These licensed dealers operated within prescribed limits on the volume of transactions and were also required to surrender all foreign exchange to SBP.

1.2 Foreign Exchange Users

Importers and those making invisible payments such as students, travelers and foreign companies remitting dividends, etc. comprised the users of foreign exchange. Invisible payments and remittances were subject to stringent controls by SBP, whilst importers' foreign exchange requirements were met by ADs. All imports, except goods imported by the government and other specified categories, required a license issued by the Chief Controller of Imports and Exports (CCI&E) who was also responsible for implementing import and export policies. These licenses, together with requirement of letters of credit, were effectively a means to regulate payments and overall import demand in the foreign exchange market.

Trade related invisible payments were treated according to the underlying trade transactions, and in many cases required prior approval of SBP. Limits on commissions, brokerage and other charges applied as a percentage of the value of the import shipments. Other invisible payments included payments for private travel, education and remittance of dividends, etc. The Private Travel Exchange Quota (PTEQ) was US$ 1,000 per person, every two years. Allowances were made for pilgrims traveling to Saudi Arabia, as well as for exporters (earning above a given threshold annually) on account of business trips abroad. Additional exchange for business travel, medical treatment, education, and sponsored cultural trips were granted on individual basis. Student maintenance and book allowances for study abroad were allowed up to US$ 8,200 a year. Allowances for professional training abroad were also made. Unrestricted remittance of dividends by foreign shareholders was allowed where the underlying investment had been made with government approval. Foreigners exiting the country within six months of their arrival in Pakistan were permitted to take out foreign currency equivalent to the amount they brought in, whilst those living in Pakistan could make family remittances of up to 50 percent of net income or US$ 750 per month.

Government departments and public sector organizations were indirect participants, with an important role in the foreign exchange market. The Ministry of Finance prepared an annual foreign exchange budget, outlining requirements for individual public sector departments during a year, which were met by ADs. In 1989-90, certain public sector organizations were heavily involved in foreign trade transactions, for example, State Cement Corporation, Trading Corporation of Pakistan, Cotton Export Corporation and Rice Export Corporation. These agencies were required to surrender their earnings to ADs, whilst their foreign exchange needs were also fulfilled by ADs. Furthermore, foreign

currency loans contracted by the government were surrendered to SBP against their Rupee equivalent, deposited in government's account with the SBP.

1.3 Authorized Dealers

These comprised of all commercial banks designated by the SBP to deal in foreign exchange, acting as the main intermediary between suppliers, users and the SBP. They were required to surrender all foreign exchange holdings to SBP on a daily basis after clearing their payment obligations. At the same time, SBP was also ready to meet any excess demand of foreign exchange over and above their holdings. However, given the large current account deficit, SBP was more likely to be regular seller in the interbank market. ADs also dealt in foreign currency debt instruments certified by the SBP.

1.4 Authorized Money Changers[1]

This category was restricted to hotels and other organizations dealing with foreign tourists. They had Ltd. authorization to purchase foreign currency notes, coins and travelers checks at rates prescribed by SBP, subject to the condition that they surrender all collections to an authorized dealer. AMCs were, therefore, essentially involved only in meeting domestic currency demands of tourists through conversion of foreign exchange.

[1] According to Foreign Exchange Regulation Act, 1947 "authorized money changer means a person for the time being authorized under section 3A to deal in foreign currency notes, bank notes, coins and travelers cheques.

Annex 2

Annex 2.1: Reform Matrix

Area of reform	Date of reform	Reform description
Privatization		
Amendment in The Banks (Nationalization) Act 1974.	1990	The Act was amended to pave the way for privatization of the nationalized commercial banks (NCBs).
Privatization of NCBs	Apr-1991	On April 2, 1991, 26 percent shares of MCB were disinvested to private sector. Another 49 percent shares were disinvested in two steps in February 1992 and January 1993.
	Sep-1991	On September 9, 1991, 26 percent shares of ABL were sold to private sector. In August 1993, further 25 percent of its shares were sold to the private sector.
Opening of new banks	Aug-1991	Permission was granted to open 10 private domestic banks and licenses were granted to 3 foreign banks to operate in Pakistan. In later years, further 8 domestic and 3 foreign banks were established.
Scheduling of provincial banks	Sep-1994	Two Provincial banks namely Bank of Punjab and Bank of Khyber were scheduled.
Institutional Strengthening		
Setting up of Credit Information Bureau (CIB)	Jan-1990	CIB was set up in SBP to compile data pertaining to borrowers from the lending institutions in the country and disseminating it to banks and financial institutions.
National Credit Commission (NCC)	Aug-1991	National Credit Commission was set up in August 1991 to review the existing policy and institutional arrangements for the allocation and flow of credit in the economy.
Expansion in supervisory jurisdiction of SBP	Jan-1992	The government extended supervisory jurisdiction of the SBP to the NBFIs including leasing companies, investment banks and housing finance companies etc.
Setting up of NBFIs Regulation & Supervision Department	Jan-1992	The said department became functional from January 1, 1992. In the organizational restructuring process of SBP in FY97, the then two Banking Inspection Departments (BIDs) and this department were restructured as three Banking Supervision Departments (BSDs).
Rules of business for NBFIs	Dec-1991	SBP framed and issued Rules of Business for NBFIs. These rules became effective from January 1, 1992.
Issuance of prudential regulations for banks	Jan-1992	SBP issued prudential regulations for banks. These regulations covered various aspects of operations of commercial banks and became mandatory w.e.f July 1, 1992.
Amendment in Banking Companies Ordinance, 1962	Feb-1993	Section 27B was inserted to curtail disruptive union activities, and section 83A was inserted to make punishable dishonest removal or disposal of goods pledged as security for payment of debt or loan. Amendments also empowered SBP to frame guidelines for facilitating recovery of bad and doubtful loans.
Grant of autonomy to the SBP	Feb-1994	State Bank was granted autonomy in February 1994. Issuance of three more ordinances on January 21, 1997, which were approved by the parliament in May 1997, further strengthened this autonomy.
Establishment of Monetary and Fiscal Policies Coordination Board	Feb-1994	This Board was constituted for maintaining coordination between the SBP and federal government on fiscal, monetary and exchange rate policies.

Credit ratings for NBFIs & banks	Apr-1995 Jun-2000	Effective from April 20, 1995, all NBFIs were required to have themselves credit rated by a SBP approved rating agency. The same became applicable for all commercial banks from June 2000.
Fund management and investment advisory companies	Jan-1997	Banks meeting assets requirement and other credit disciplines during the immediately preceding 52 weeks would be eligible to offer fund management and other investment advisory services only if they form exclusive subsidiary companies for the purpose.
Dissolution of Pakistan Banking Council (PBC)	May-1997	PBC, which was established to look after the affairs of the NCBs, was dissolved through an amendment in the Banks (Nationalization) Act, 1974.
International Accounting Standards (IAS)	Aug-1997	State Bank issued directives to banks to prepare accounts for the year ending December 31, 1997, in conformity with IAS.
Basel Accord Minimum paid up capital CAMELS framework BASEL core principles	Dec-1997	Banks were instructed to apply the system of risk-weighted capital, in line with the Basle Accord. From December 31,1997, all banks were required to maintain capital and unencumbered general reserves of not less than 8% of their risk-weighted assets. Effective from December 31, 1997, no banking company in Pakistan would carry on business unless it has a minimum paid up capital of Rs 500 million. This minimum paid up requirement for banks was doubled in December 2000 to Rs 1,000 million with half of the increase i.e. upto Rs 750 million to be achieved by December 2002. CAMELS framework was adopted to ascertain the performance of banks and NBFIs on the basis of off-site and on-site surveillance. Out of twenty-five core principles, SBP is compliant in fourteen, largely compliant in eight, and materially non-compliant in three of these principles.
Equity support to UBL and HBL	May-1998	In terms of its bail-out package, the State Bank made equity support to UBL amounting to Rs 21 billion on May 4, 1998, and Rs 9.7 billion to HBL on June 27, 1998.
Downsizing and restructuring of banks and DFIs	1997-98	Public sector banks and DFIs were asked to prepare action plans for restructuring and downsizing of their organizations in order to reduce the financial intermediation cost. Accordingly, through various incentive schemes from 1997 to 1999, work force of these institutions was reduced from 99,954 to 81,079, while 815 loss-making branches were closed.
Establishment of Corporate & Industrial Restructuring Corporation (CIRC)	Sep-2000	The CIRC was established on September 22, 2000 to promote revitalization of the economy by reviving sick industrial units. It will take over the NPLs of NCBs and DFIs.
Non Performing Loans (NPLs)		
Classification of loans	Aug-1992	Directives were issued to banks for provisioning and classification of NPLs. Loans were to be classified as other assets especially mentioned (OAEM), substandard, doubtful or loss, depending on whether interest or principal is overdue. Provisioning against substandard, doubtful and loss loan categories were required to be made at the rate of 20%, 50% and 100% respectively.
Setting of loan recovery targets	Nov-1993	Banks were directed to lay down quarterly recovery targets as percentage of the overdue obligation. They were also required to submit progress report on recovery in relation to targets set on quarterly basis
New loan recovery law	Feb-1997	In order to provide necessary legal framework to expedite the recovery of stuck-up loans, two existing recovery laws i.e., Banking Tribunal Ordinance, 1994 and Banking Companies (Recovery of Loans) Ordinance, 1997 were repealed and replaced with a new comprehensive law--Banking Companies (Recovery of Loans, Advances, Credits and Finances) Act, 1997.
Establishment of banking courts	Feb-1997	The Federal Government established 34 banking courts to admit cases of loan defaults below Rs 30 million. For cases above Rs 30 million, two judges form Lahore High Court and one judge each from Sindh and Baluchistan High Courts were nominated to deal exclusively with such cases.

Incentive schemes for loan defaulters	Jun-1997 Dec-1997	SBP introduced two separate incentive schemes to provide opportunity to loan defaulters to pay their overdue loans and to reschedule and regularize the remaining amounts.
Debt Management Reforms		
Setting up of Securities Department at SBP	Dec-1990	Securities Department was set up in the SBP to launch auction system of public debt and to develop a secondary market for government securities. In July 1998, Foreign Exchange Dealing Room was setup. These two were merged and became Exchange & Debt Management Department (EDMD) on February 17, 2000.
Auction system of treasury bills	Mar-1991	Realizing the disadvantages of the tap system and in order to develop an active money market, the government decided to introduce six-month treasury bills to be sold through auctions.
National Savings Scheme (NSS)	Feb-1990	Unfunded debt instruments like the Khas Deposit Certificates (KDCs) were replaced with three new instruments, which offered lower but still quite attractive rates of return.
Introduction of long-term government paper	Mar-1991	To cater for the need of a long-term market-based government paper. Federal Investment Bonds (FIBs) were introduced with 3, 5 and 10 years maturities.
Appointment of Approved Dealers	Dec-1990	Before launching the auction system of government securities, process of selecting and appointing primary dealers (PDs) was started. However by February 1991, before firming up of selection criteria of PDs, all banks were made eligible to participate directly in the auction of government papers as Approved Dealers. SBP later firmed up the criteria in June 2000 and appointed seven PDs on December 1, 2000.
Activation of Subsidiary General Ledger Account (SGLA)	Mar-1991	Facility of opening SGLA was extended to NBFIs. The system allowed the issuance and settlement of government securities in dematerialized form without any physical movement.
Rationalization of NSS	May-1999	Rates on these schemes were cut down to reduce distortions in term structure of interest rates.
Bearer instruments	Dec-1999	From the mid 1980s till December 2000, Government issued various bearer instruments such as FEBCs, SNFBs, BNFBs and DBCs etc., with the aim to raise finance from the informal sector. However, the sale of these bearer instruments was discontinued in December 1999.
Monetary Management Measures		
Statuary Cash Reserve Requirement (CRR) Averaging Mechanism of CRR	Oct-1991	Under section 36(1) of SBP Act, 1956, all scheduled banks in Pakistan were required to maintain a balance--return free--with SBP equivalent to 5% of their demand and time liabilities. Throughout the reform period CRR remained more or less constant at 5%. Effective from July 26 1997, banks were advised to maintain with SBP an average balance of 5% of its total time and demand liabilities in Pakistan, worked out on weekly basis, provided that the amount of the balance should not at the close of business on any day be less than 4% of the total demand and time liabilities in Pakistan.
Special Cash Deposits (SDC)	Oct-1991	SCD as an instrument of monetary policy was introduced on October 9, 1991 when banks were asked to maintain 7% of their outstanding credit in addition to CRR. Unlike CRR, deposits under SCD are remunerated at certain percentage. This requirement was dropped from January 15, 1992. Effective from February 9, 1995, banks were directed to maintain a SCD of 1.5 percent of their demand and time liabilities. This requirement was further enhanced to 3.5 percent from December 11, 1995. Effective from July 1, 1996, it was decided to dispense with this requirement.
Statuary Liquidity Requirement (SLR) for NBFIs	Jan-1992	Effective from January 1, 1992, all NBFIs had to maintain SLR @ 15 percent (varying from time to time).

Discount window replaced with 3-Day Repo Facility	Feb-1992	After the introduction of 3-Day Repo facility from February 1, 1992, it was felt prudent to close the discount window from February 15, 1992.
System of credit ceiling replaced by credit deposit ratio (CDR)	Aug-1992	System of credit ceilings was abolished from August 1, 1992 and replaced by a relatively flexible control through fixing of CDR in each quarter. System of CDR was also abolished on September 30, 1995 and replaced by market-based mechanism.
Statutory Liquidity Requirement (SLR) for Banks	Oct-1993	This required the commercial banks to maintain a minimum amount under section 29 of BCO, 1962, mainly in terms of eligible government papers in a certain ratio of their demand and time liabilities. As a part of liberalization of the financial system, this ratio was gradually reduced from 45% to 35% in October 1993 and to 25% in May 1994. The ratio was further reduced to 20% in May 1997, to 18 % in January 1998 and further to 15% in June 1998.
Introduction of Open Market Operations (OMOs)	Jan-1995	To exercise an effective indirect monetary policy, OMOs were introduced and now these constitute a major instrument of monetary policy.
Removal of caps on maximum lending rates	Mar-1995	As a major step towards market-based monetary management, caps on maximum lending rates of banks and NBFIs for trade related modes of financing were removed. In October 1995 ceilings on lending rates for project financing were also removed.
Cash Reserve Requirement (CRR) for NBFIs	Jan-1996	All NBFIs were required to maintain 1 percent CRR in addition of 15 percent SLR.
Removal of caps on minimum lending rates	Jul-1997	Caps on minimum lending rates of banks and NBFIs for trade and project related modes of financing were removed.
Rationalization of subsidized credit	1990-2000	Lending rates on special financing schemes including locally manufactured machinery and export finance schemes were gradually raised to eliminate the element of subsidy.
Master Repo	Nov-1999	With a view to bring about operational improvements in the money market transactions, strengthening the repurchase market and ensuring transparency, the banks & NBFIs would enter into Master Repo agreement before entering into repo transaction.
Exchange and Payment Reforms		
Permission to open foreign currency accounts (FCAs) to resident Pakistanis.	Jan-1991	A comprehensive package of exchange and payments reforms was announced. Resident Pakistanis were allowed to hold FCAs with banks in Pakistan on the same basis as non-residents. Later in April, Charitable Trusts, Foundations etc., were also allowed to open FCAs in Pakistan.
Investment by foreigners	Feb-1991	Foreigners were allowed to invest without prior approval. They could purchase equity upto 100 percent.
Foreign banks allowed to underwrite shares	Feb-1991	Foreign banks operating in Pakistan were allowed to underwrite shares of an individual company to the extent of 30% of the public offering or its own capital and reserves whichever is less, with limits applied individually to each foreign bank.
Remittance of profit by foreign companies	Feb-1991	Authorized dealers designated by foreign companies were allowed to remit profits without specific SBP approval. Later in Feb 1992, the government also abolished ceiling on payment of royalty and technical fee to non-residents.
Import license	Feb-1991	The requirement of obtaining license from the Chief Controller of Imports and Exports (CCI&E) for items on the free list and other specified items was withdrawn. Effective from July 15, 1993, the office of CCI&E ceased to function. Since then, EPB has been looking after these functions.
Domestic borrowing by foreign companies (capital expenditure)	Feb-1991	Foreign-controlled manufacturing companies were allowed to borrow for their capital expenditure form banks, DFIs and other financial institutions by issuing Participation Term Certificates (PTCs).

US Dollar Bearer Certificates	Apr-1991	Government introduced a scheme for issuance of one-year US Dollar Bearer Certificates. Later in March 1992, government introduced 5-year Foreign Currency Bearer Certificates (FCBC) denominated in US Dollar, Deutsche Mark, Pound Sterling and Japanese Yen with six monthly fixed rate of return. Another scheme of FCBC in US Dollar and Pound Sterling with three-year maturity was introduced in Feb 1998. All these schemes were immune from tax and scrutiny.
Foreign exchange remittance	Jul-1991	During 1991, a number of decisions were taken to liberalize remittance of foreign exchange, which was otherwise restricted or required prior SBP approval. These included payments to non-residents on account of News Feature Services, News Pictures, Syndicate Services, contribution for publication in Pakistani news papers, subscription to foreign news papers and periodicals etc.
Export proceeds	Jul-1991	Exporters were allowed to retain an amount not exceeding 5% of their FOB value of the goods realized in their special FCAs.
Investment banks allowed to raise foreign currency funds	Apr-1992	Investment banks were allowed to raise funds from abroad, through issuance of Certificates of Investment (COIs) of maturity not less than three months. Foreign exchange so raised was to be surrendered immediately to SBP.
Grant of license to money changers and lifting of restrictions	May-1992	Pakistani nationals, resident companies/firms working as 'Money Changers' were granted licenses on payment of prescribed fees. Later in December 1992, all restrictions on import and export of foreign currency were lifted.
Foreign investment	Mar-1993	Foreign investment upto 100 percent of the equity of an industrial concern in Pakistan were permitted on repatriable basis. Furthermore, non-residents were allowed to trade freely in the shares quoted on the stock exchanges in Pakistan.
Investment abroad by residents	Mar-1993	Resident Pakistanis including firms and companies incorporated in Pakistan were allowed to make investment in companies/joint ventures abroad on repatriable bases through FEBCs.
Investment in debt instruments	Jan-1994	Non-residents were allowed to invest freely in FIBs and T-bills in the secondary market. They were also allowed to invest on repatriable basis in corporate debt instruments viz. PTCs and TFCs.
Discontinuation of forward buying/selling	May-1994	SBP decided to discontinue forward buying/selling of US dollars for 6/12 months in connection with the transactions undertaken by ADs relating to export and specific imports and leave the short-term forward cover to the market.
Discontinuation of forward cover	Jun-1994	The scheme of providing exchange risk coverage to private sector by the SBP on behalf of federal government on direct borrowings inclusive of suppliers' credit/guaranteed loans/ PAYE loans was abolished.
Current account made convertible	Jul-1994	Pak Rupee made convertible w.e.f. July 1, 1994 by accepting obligations of Article VIII, sections 2,3 and 4 of IMF Article of Agreement.
Foreign currency accounts holders allowed to sell forward	Sep-1994	Persons maintaining FCAs with the ADs in Pakistan were permitted to sell forward the balance held in their accounts to the importers in connection with imports LCs/Indents.
Domestic borrowing by foreign companies (Working Capital)	Dec-1997	Authorized dealers were permitted to grant rupee loans and credits for working capital requirement to the foreign controlled companies. Later foreign controlled investment banks were also allowed to meet their working capital requirement through local borrowing.
No surrender of foreign exchange of FCAs	Jun-1998	Following the freeze, the new FCAs (FE-25) had no obligation on ADs to surrender the foreign exchange to the SBP.
Market-based exchange rate system	May-1999	Effective from July 22, 1998, dual exchange rate system was adopted. On May 19, 1999, this was replaced by market-based exchange rate system given a narrow band. The unofficial cap on exchange rate was finally removed on July 21, 2000 to make it pure market-based.

Capital Market Reforms		
Creation of Pakistan Credit Rating Agency (PACRA) and DCR-VIS Credit Rating Company Limited	Aug-1994	Pakistan Credit Rating Agency Limited (PACRA) was set up in 1994, by IFC in collaboration with Fitch-IBCA Inc., of UK and LSE while DCR-VIS Credit Rating Co. Ltd was setup in 1997 in association with Duff and Phelps Credit Rating Co to improve transparency in the stock market.
Companies (Issue of Capital) Rules	Feb-1996	The government repealed the Capital Issues (Continuance of Control) Act, 1947, to abolish controls on pricing of new issues, and introduced the Companies (Issue of Capital) Rules, 1996.
Capita Market Development Program	May-1997	With a view to strengthen regulatory & institutional framework, the government in collaboration with ADB formulated this program.
Creation of Central Depository Company (CDC)	Sep-1997	To facilitate electronic transfer of stocks, Central Depository Company of Pakistan Limited was set up in collaboration with IFC, Citibank, other leading commercial banks and DFIs. It commenced its operations in Sep 1997.
Automation of all three stock exchanges	Sep-1997	All three stock exchanges were automated and rules and regulations of conduct were accordingly revised to enhance investors' confidence.
Establishment of Securities & Exchange Commission of Pakistan (SECP)	Jan-1999	SECP became operational from January 1, 1999 through SECP Act, 1997, replacing Corporate Law Authority (CLA).
Buy-back of shares	Dec-1999	The companies were allowed to buy-back its shares through an amendment in the Companies Rules w.e.f. December 14, 1999.

Annex 3

Annex 3.1: CAMELS Framework

Supervisory framework of SBP, consistent with international norms, covers risk-monitoring factors for evaluating the performance of banks. Specifically, CAMELS framework is in place since December 1997 for on-site and off-site surveillance. This framework involves the analyses of six groups of indicators reflecting the health of financial institutions.

Capital Adequacy

Capital base of financial institutions facilitates depositors in forming their risk perception about the institutions. Also, it is the key parameter for financial managers to maintain adequate levels of capitalization. Moreover, besides absorbing unanticipated shocks, it signals that the institution will continue to honor its obligations. The most widely used indicator of capital adequacy is capital to risk-weighted assets ratio (CRWA). According to Bank Supervision Regulation Committee (The Basle Committee) of Bank for International Settlements, a minimum 8 percent CRWA is required.

Asset Quality

Asset quality determines the robustness of financial institutions against loss of value in the assets. The deteriorating value of assets, being prime source of banking problems, directly pour into other areas, as losses are eventually written off against capital, which ultimately jeopardizes the earning capacity of the institution. With this backdrop, the asset quality is gauged in relation to the level and severity of non-performing assets, adequacy of provisions, recoveries, distribution of assets etc. Popular indicators include non-performing loans to advances, loan default to total advances, and recoveries to loan default ratios.

Management Soundness

Management of financial institution is generally evaluated in terms of capital adequacy, asset quality, earnings and profitability, liquidity and risk sensitivity ratings. In addition, performance evaluation includes compliance with set norms, ability to plan and react to changing circumstances, technical competence, leadership and administrative ability. In effect, management rating is just an amalgam of performance in the above-mentioned areas.

Earnings and Profitability

Earnings and profitability, the prime source of increase in capital base, is examined with regards to interest rate policies and adequacy of provisioning. In addition, it also helps to support present and future operations of the institutions. The single best indicator used to gauge earning is the Return on Assets (ROA), which is net income after taxes to total asset ratio.

Liquidity

An adequate liquidity position refers to a situation where institution can obtain sufficient funds, either by increasing liabilities or by converting its assets quickly at a reasonable cost. It is, therefore, generally assessed in terms of overall assets and liability management, as mismatching gives rise to liquidity risk. Efficient fund management refers to a situation where a spread between rate sensitive assets (RSA) and rate sensitive liabilities (RSL) is maintained. The most commonly used tool to evaluate interest rate exposure is the Gap between RSA and RSL, while liquidity is gauged by liquid to total assets ratio.

Sensitivity to Market Risk

The diversified nature of bank operations makes them vulnerable to various kinds of financial risks. Sensitivity analysis reflects institution's exposure to interest rate risk, foreign exchange volatility and

equity price risks (these risks are summed in market risk). Risk sensitivity is mostly evaluated in terms of management's ability to monitor and control market risk.

Annex 3.2: Glossary of Important Terms

Capital to Risk-weighted Assets
It is a ratio of capital -- sum of tier 1 and tier 2 -- to risk-weighted assets. Each asset and off balance sheet item is assigned one of four broad risk categories, based on the perceived credit risk of the obligor (borrower) or, if relevant, the guarantor or type of collateral. The appropriate rupee value of the amount in each category is multiplied by the risk weight associated with that category. The resulting weighted values for each of the risk categories are added to calculate the risk-weighted assets.[1]

Earning Assets
This parameter represents the assets generating interest income. In this study, the sum total of net advances, net investments and money at call has been used as a proxy of earning assets.

Rate Sensitive Assets (RSA)
These are the same as earning assets, i.e., advances, investments and money at call.

Rate Sensitive Liabilities (RSL)
Since cost of interest-bearing liabilities depends on changes in interest rate, these are called rate sensitive liabilities. The sum of deposits and borrowings is used as RSL in this study.

GAP
Term commonly used to describe the rupee volume of the mismatch between interest Rate Sensitive Assets (RSA) and interest Rate Sensitive Liabilities (RSL) for a specific time frame.

Interest Rate Spread
The ratio obtained by subtracting the cost factor for interest-bearing liabilities from the percentage yield on earning assets.[2]

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

Liquid Assets
The sum of cash and bank balances, investment in government securities and money at call is used as a measure of liquid assets.

Net Interest Margin
Net Interest Income as a percentage of average earning assets. It reveals the difference between the yield on Earning Assets and the Break-even Yield (or the yield that is needed to cover all interest expense). As interest-bearing liabilities are not normally equal to total earning assets, the "spread" is usually different from the net interest margin

Operating Expenses
Refers to expenses other than interest expense, for example, salaries, administrative expenses, etc.

Break-even Yield
Measured in terms of interest expense to earning assets ratio, it indicates the minimum rate to earn some profit.

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[1] For detail see BPRD Circular No. 36 dated 4th November 1997.
[2] (Interest income / earning assets) – (interest expense / interest paying liabilities)

Annex 3.3: Group-wise data of Select Financial Variables of Banks

Table 3A.1: State-owned Banks

billion Rupees

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Paid-up capital	6.5	6.5	6.7	7.0	7.6	8.5	9.3	9.6	40.4	40.5	40.9
Equity	14.9	16.2	18.0	21.1	22.8	24.6	19.2	8.7	46.3	39.2	48.5
Deposits	329.7	382.4	456.8	510.6	586.2	674.4	737.9	784.9	859.3	924.9	974.2
Liabilities	377.3	434.6	520.2	580.2	669.4	764.0	836.3	910.8	982.1	1070.4	1109.5
Advances	201.2	206.9	223.7	277.0	295.8	352.3	379.6	389.3	414.6	479.1	543.6
Investment	104.1	129.0	184.5	185.3	230.2	249.4	255.6	272.1	314.8	284.0	265.0
Assets	392.3	450.8	538.2	601.3	692.2	788.6	855.5	919.4	1028.4	1109.6	1158.0
Income	37.6	40.9	48.1	60.2	66.1	80.3	81.8	98.3	109.2	110.6	110.4
Expense	35.9	38.6	43.9	54.7	61.4	75.4	86.1	119.9	111.1	112.6	106.9

Figure 3A.1: Dispersion in Financial Variables

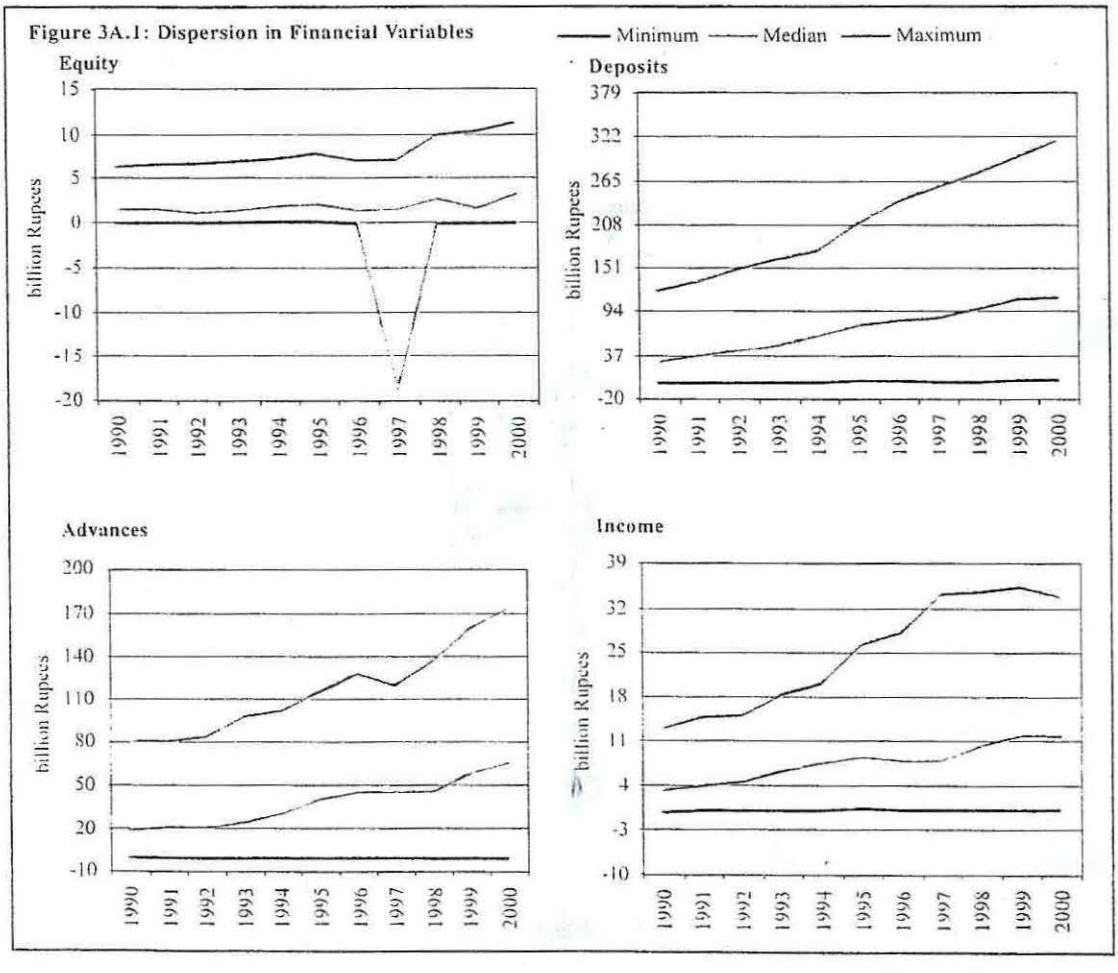


Table 3A.2: Private Banks

billion Rupees

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Paid-up capital	2.6	2.9	3.4	5.6	6.1	6.9	7.3	7.6	8.3
Equity	2.8	3.7	4.9	8.6	10.1	11.8	12.1	13.7	14.4
Deposits	15.8	25.7	38.3	59.3	81.8	115.9	126.9	131.3	161.4
Liabilities	21.8	35.6	51.0	78.6	104.4	139.1	154.2	169.5	208.9
Advances	8.6	13.8	22.7	40.6	51.3	71.4	78.3	88.7	120.7
Investment	10.2	13.5	16.8	19.6	28.1	53.2	53.8	43.4	48.3
Assets	24.5	39.3	55.9	87.3	114.5	150.9	166.4	183.2	223.3
Income	1.0	4.1	5.9	10.2	14.1	19.2	21.8	21.1	22.7
Expense	0.7	2.6	3.9	7.5	10.5	15.6	19.6	18.4	20.1

Figure 3A.2: Dispersion in Financial Variables

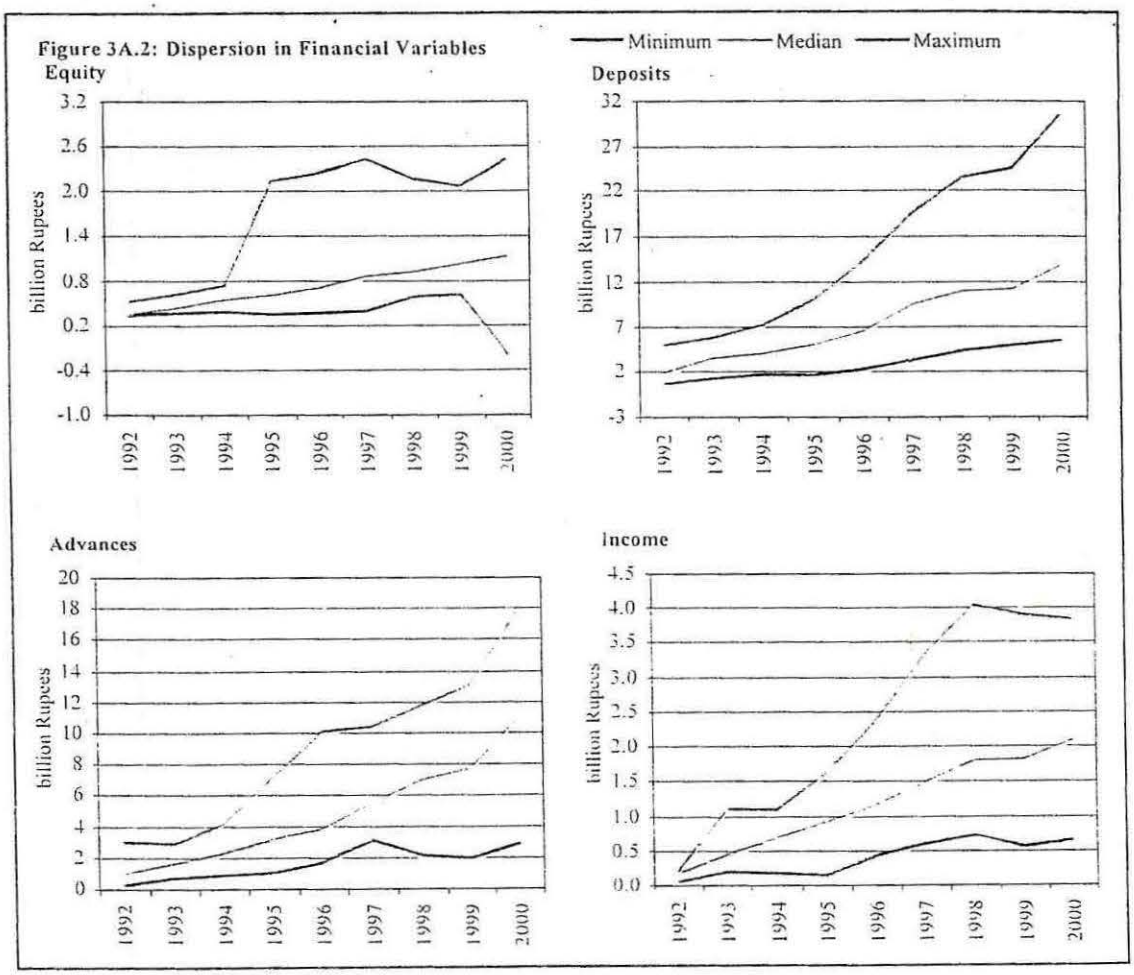
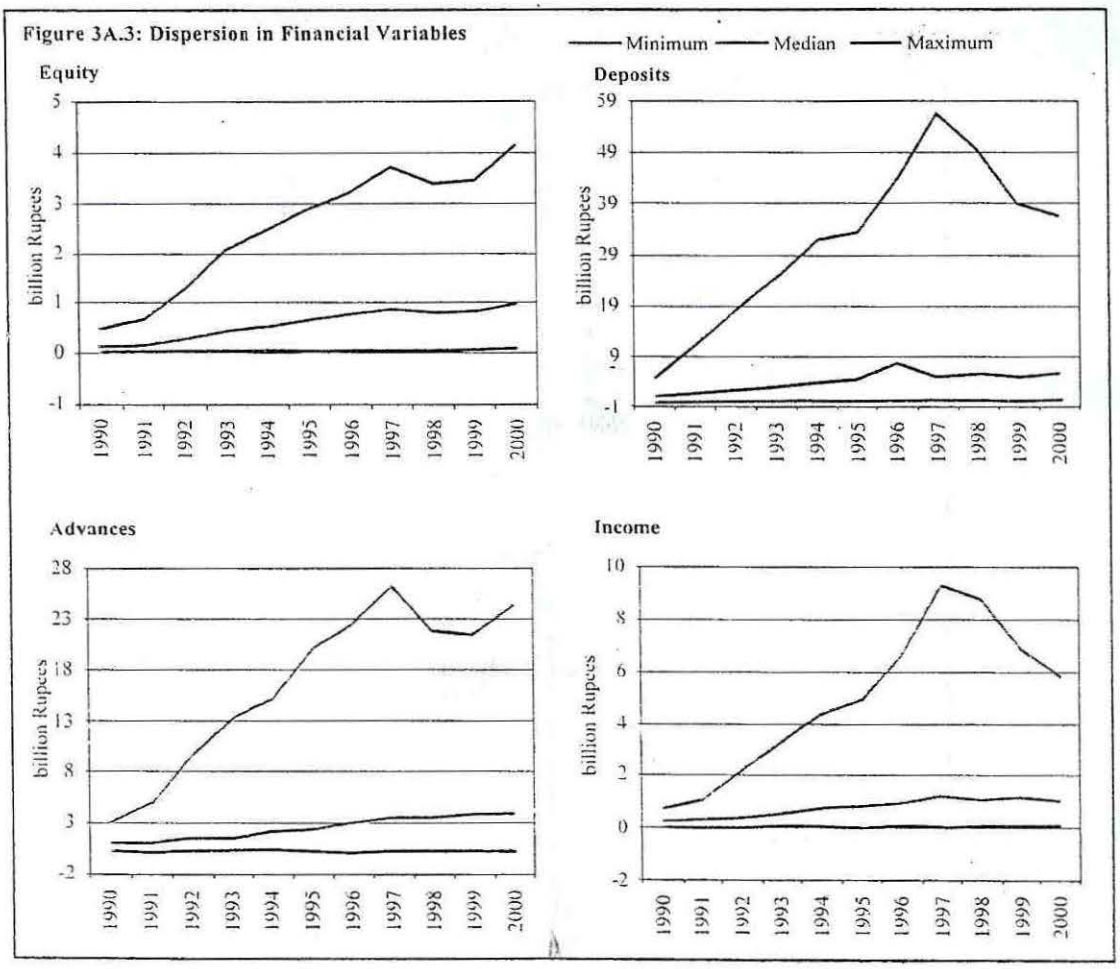


Table 3A.3: Foreign Banks

billion Rupees

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Paid-up capital	1.8	2.6	4.3	7.3	8.9	11.4	13.9	17.0	19.0	21.3	22.6
Equity	2.5	4.0	6.7	10.0	11.8	13.6	16.7	21.2	23.3	24.4	24.3
Deposits	24.9	43.5	62.1	85.5	106.4	122.0	176.3	221.3	212.9	183.2	187.1
Liabilities	30.8	51.4	73.4	100.2	122.4	138.9	196.0	247.6	240.0	228.1	235.1
Advances	17.3	23.0	33.5	41.5	54.6	70.2	89.2	120.1	120.6	125.0	134.0
Investment	7.3	17.7	28.8	41.1	45.1	39.3	66.2	78.4	70.6	32.6	53.3
Assets	33.4	55.3	80.2	110.3	134.2	152.5	212.6	268.9	263.3	252.6	259.5
Income	4.0	6.2	9.7	13.4	16.9	19.1	26.5	39.2	40.1	35.0	29.9
Expense	2.8	3.5	5.2	9.3	12.9	16.0	21.3	31.8	35.5	30.4	26.1

Figure 3A.3: Dispersion in Financial Variables

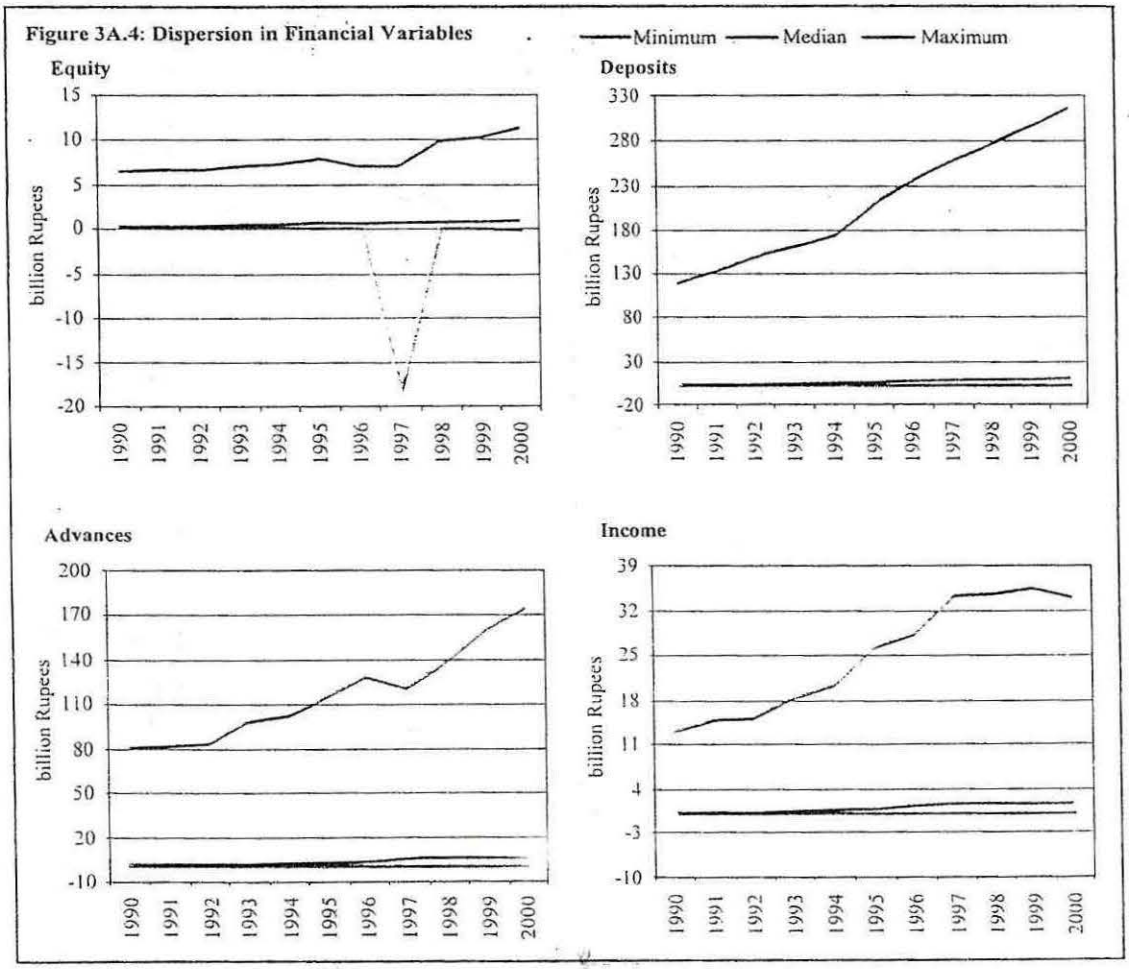


Tables 3A.4: All Banks

billion Rupees

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Paid-up capital	8.3	9.3	13.7	17.2	19.9	25.6	29.3	33.5	65.7	69.3	71.9
Equity	17.5	20.5	27.5	34.8	39.5	46.9	45.9	41.7	81.7	77.3	87.2
Deposits	354.6	425.9	534.7	621.9	730.9	855.7	996.0	1122.1	1199.2	1239.4	1322.8
Liabilities	408.2	485.9	615.4	716.1	842.8	981.6	1136.7	1297.5	1376.3	1468.0	1553.5
Advances	218.5	229.9	265.9	332.4	373.1	463.1	520.2	580.8	613.5	692.9	798.3
Investment	111.3	146.7	223.4	239.9	292.0	308.3	350.0	403.6	439.2	360.0	366.5
Assets	425.6	506.4	642.9	750.9	882.3	1028.4	1182.6	1339.2	1458.0	1545.3	1640.7
Income	41.5	47.1	58.8	77.6	88.8	109.6	122.4	156.7	171.1	166.7	163.0
Expense	38.8	42.1	49.8	66.5	78.1	98.9	117.9	167.4	166.2	161.4	153.1

Figure 3A.4: Dispersion in Financial Variables



Annex 4

Annex 4.1: Functions of NBFIs

Non-Bank Finance Institutions
These include development finance institutions (DFIs), investment banks (IBs), leasing companies, modaraba companies, housing finance companies (HFCs), discount houses (DHs), and venture capital companies (VCCs).

Development Finance Institutions
Major business activities of DFIs include acceptance of fixed maturity deposits, trade and investment in securities, project financing, leasing, underwriting of equity and debt issues, and participation with other financial institutions in extending loans and advances. Their history dates back to 1957, when the Pakistan Industrial Credit and Investment Corporation (PICIC) was established with the help of World Bank. Since then, a number of DFIs have been established in the public sector including three joint ventures with foreign partners to provide resources to real sector. Government also established a commercial bank namely, Industrial Development Bank of Pakistan (IDBP) in 1961 to supplement the role of PICIC.

Investment Banks
Also known as investment finance companies, these banks are relatively new entrants compared to other NBFIs.[1] These banks are permitted to participate in money and capital markets, besides being allowed to mobilize both short-term (but not less than 30 days) as well as long-term deposits. In addition, these banks also provide project financing and fund management services.
Despite the wide scope of their activities, only five-investment bank were established till 1990, as rapid growth in leasing and modaraba companies marginalized this sector.

Leasing Companies
In addition to their primary business of providing lease finance for a wide range of items such as industrial equipment and machinery, office equipment and computers and motor vehicles etc., to businesses, these also invest in equities. The first leasing company was established in 1984. Being compatible with the Islamic mode of financing, these companies received a major boost in the later half of the 1980s and early 1990s. By end-June 1990, a total of 5 leasing companies were established.

Modaraba Companies
Although, their organizational structure was formulated in 1980, the first company was floated in 1985 with the enforcement of Modaraba Ordinance. These companies are mainly involved in leasing, equity portfolio management, and trading/lending activities. In view of government's efforts toward Islamization and compatibility of modaraba business activities with Islamic mode of financing, these companies showed impressive growth in late 1980s. By end-June 1990, a total of 10 such companies were established.

Housing Finance Companies
Though restricted to housing sector these companies are very similar to DFIs. In 1990, there was only one such entity: House Building Finance Corporation (HFBC) in the public sector, which was categorized as a DFI. However, with the establishment of three new housing finance companies in the private sector during 1990s, separate rules for Housing Finance Companies were specified. HFCs are allowed to mobilize long-term savings for housing investment, which include long term financing

[1] The legal framework to investment banks was provided in July 1987 vide an SRO 585(I)/87, issued by Ministry of Finance.

for construction, purchase or alteration, leasing and renting. In this category, HBFC being the oldest and in public sector enjoys almost a monopoly position.

Venture Capital Companies and Discount Houses

The venture capital companies are allowed to extend equity support to enterprises desiring to undertake innovative projects, while discount houses deal with discounting and related services. By end-June 1990, there was only one discount house operating in the country, however, during 1990s a number of discount houses and venture capital companies were established.

Annex 4.2: Group-wise data of Select Financial Variables of NBFIs

Table 4A.1: Development Finance Institutions

billion Rupees

	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Paid-up capital	5.4	5.6	7.3	8.6	9.5	10.0	10.7	10.9	11.0	11.0	11.1
Equity	13.5	14.6	17.3	19.9	22.0	22.8	21.1	21.7	11.8	-2.7	-10.5
Deposits	20.3	27.2	33.6	39.3	47.3	54.2	59.1	88.4	69.2	63.0	57.8
Liabilities	91.8	104.7	118.1	140.0	159.0	176.4	192.4	230.5	214.7	211.9	211.0
Advances	79.0	92.5	98.3	108.5	117.2	130.4	133.2	161.7	136.4	130.0	122.6
Investment	12.0	9.0	15.6	23.4	27.4	27.2	31.7	36.8	28.7	29.5	29.6
Assets	105.3	119.3	135.4	159.9	181.1	199.2	213.6	252.1	226.5	209.2	200.5
Income	9.7	11.5	13.5	17.2	19.2	19.2	20.0	24.8	24.6	22.1	22.9
Expense	7.1	8.8	9.9	1[illegible]4	15.1	16.9	19.8	22.1	28.3	23.2	23.3

Figure 4A.1: Dispersion in Financial Variables

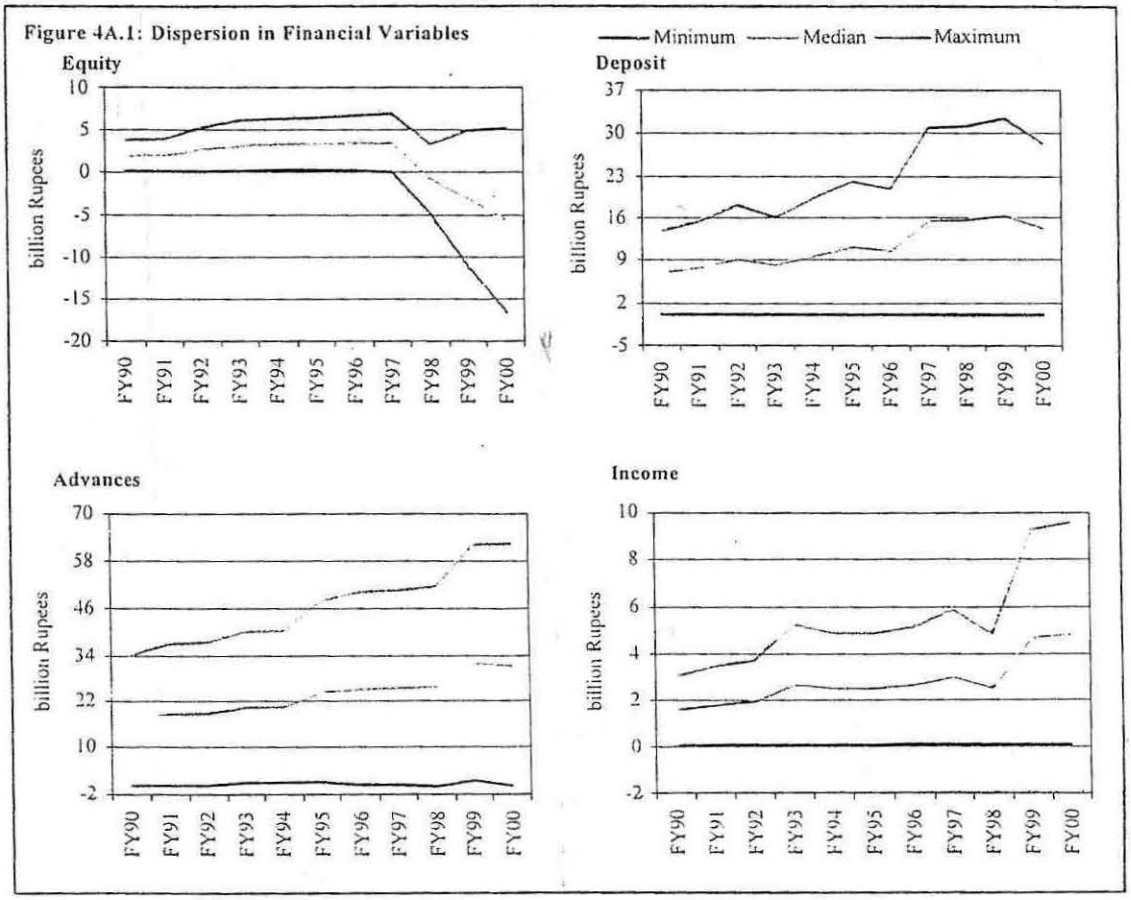


Table 4A.2: Investment Banks

billion Rupees

	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Paid-up capital	0.5	0.8	1.4	1.6	2.4	2.6	3.0	3.3	4.3	4.4	4.4
Equity	0.5	0.9	1.7	2.4	3.6	3.9	4.4	5.0	5.7	5.6	6.0
Deposits	1.8	3.4	5.9	16.1	21.1	23.0	29.7	32.6	35.4	36.7	26.5
Liabilities	1.9	3.8	6.7	18.4	24.5	26.5	32.4	36.7	40.2	43.1	36.1
Loans & advances	1.7	3.5	5.3	13.0	16.9	16.4	18.9	21.2	22.5	20.9	13.4
Investment	2.6	0.5	1.8	4.2	6.4	8.9	10.2	12.7	11.9	14.9	17.6
Assets	2.4	4.7	8.4	20.7	28.1	30.5	36.8	41.7	45.9	48.7	42.1
Income	0.1	0.6	0.9	2.4	4.0	4.4	6.9	5.9	6.7	7.4	7.4
Expense	0.1	0.4	0.7	1.9	3.1	3.6	6.0	5.2	6.2	6.4	5.9

Figure 4A.2: Dispersion in Financial Variables

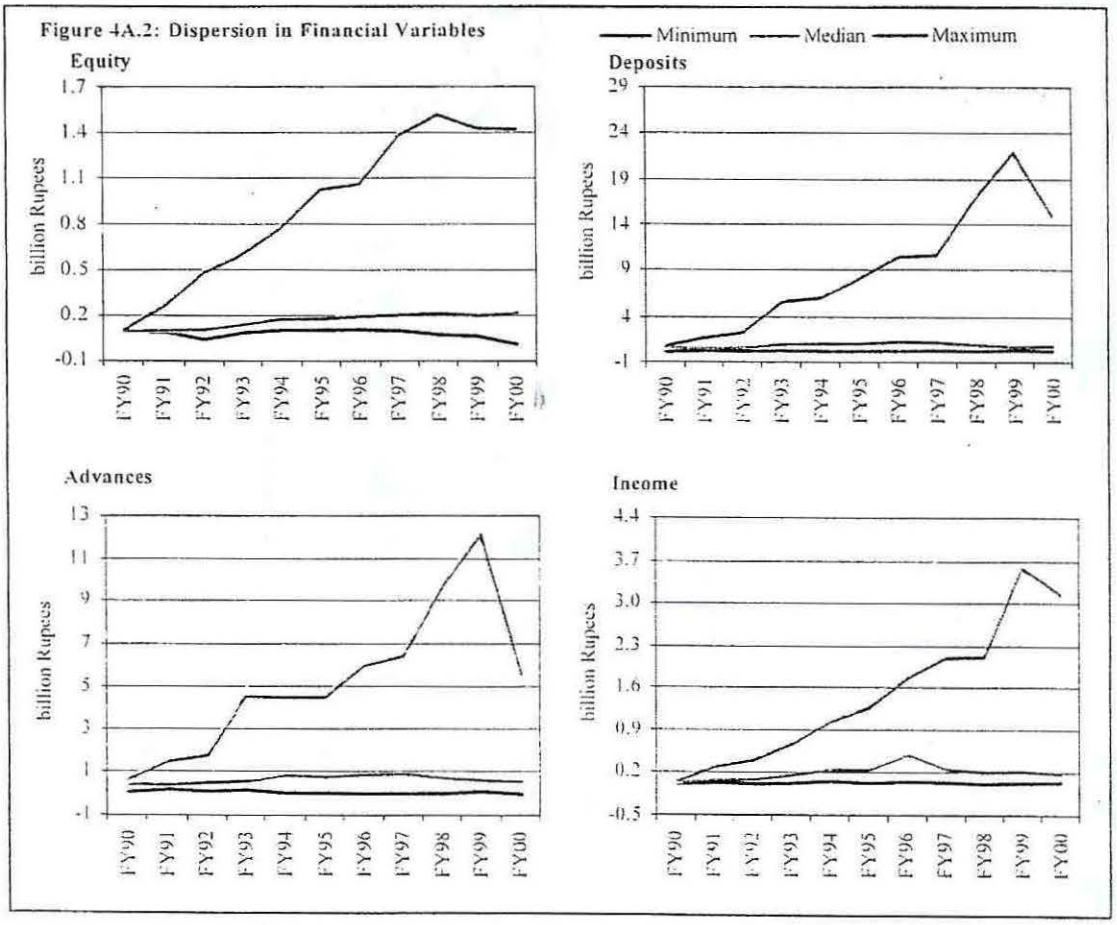


Table 4A.3 : DFIs: Asset Shares

percent

	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
ADBP	37.4	35.5	33.3	32.7	30.2	30.9	29.9	26.4	30.7	36.5	38.9
NDFC	21.8	20.7	20.5	16.4	16.7	16.4	13.8	13.1	17.2	13.5	10.4
IDB	9.9	10.8	10.7	10.5	10.3	9.1	8.5	8.2	8	10.3	10.3
PICIC	11.1	11.3	12	13	11	10	8.6	7.3	7.9	7.6	7.7
SBFC	1.1	1.2	2.1	2.8	4	6	5.9	4.8	5.3	5.6	5.8
PKIC	0.7	0.8	0.8	2.8	4.2	6.5	9.3	14.3	9.3	5.5	4.9
BEL	7.1	7.7	8.1	9	7.9	7.5	6.9	6.4	6.8	4.9	4.8
PLHC	2.1	2	1.7	1.6	3.8	1.7	2.4	7.3	4.2	4.8	4.6
SPIAIC	1.6	1.8	2.2	3.2	4.6	5.1	7.5	6.9	4.5	4.7	4.3
PPCB	3.3	3.7	3.9	3.6	3	2.7	2.7	2.2	2.6	2.8	3.5
FCB	3.1	3.3	3.4	3	2.4	2.3	2.2	1.8	2.2	2.4	3
RDFC	1	1.2	1.3	1.4	2	1.8	2.3	1.5	1.5	1.5	1.7
Total assets (billion Rupees)	105.3	119.3	135.4	159.9	181.1	199.2	213.6	252.1	226.5	209.2	200.5

Table 4A.4 : Investment Banks: Asset Shares

percent

	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Al-Faysal	-	-	11.8	13.5	24.6	31.9	33.1	30.3	41.7	50.4	43.4
Crescent	35.5	45	34.4	31.7	25.6	23.7	24.1	24.6	18.2	14.6	19
Al-Towfeeq	6.2	6.7	6.3	10.2	10.1	9.3	9.3	6.8	5.9	4.3	3.2
Orix	-	-	-	-	-	-	0.6	2.7	3.3	3.8	3.5
Prudential	22.5	13.6	8.6	4.6	3.6	2.9	2.6	3.4	2.5	2	1.8
Franklin	-	-	0.9	2.4	3	2.5	1.8	2.8	0.6	0.2	0.4
Asset	-	-	1.2	2.2	1.1	1	0.9	1.1	1.1	0.7	0.6
First International	-	-	6.4	6.5	8	7.4	4.1	3.1	3.2	3.2	3.3
Fidelity	31.6	15.7	11.6	8.1	5.9	5.4	7.7	7.1	7.1	6.6	6.5
Al-Meezan	-	-	-	-	-	-	-	-	2	2.4	3.1
Escort	-	-	-	-	-	-	-	1.5	1.2	1.6	1.7
Atlas	-	6.1	7.8	6.4	5.2	4.8	4.2	4.3	4	2.6	3.1
Jahanjir Siddiqui	-	-	-	3.2	2.3	3.6	4.5	4.2	0.9	1.6	2.8
Security	-	2.2	2.7	4.5	5.4	2.7	3.5	3.3	3.8	2.8	2.5
Trust	-	-	-	-	-	-	-	1.5	1.4	0.9	1.1
Islamic	4.2	10.6	8.3	6.6	5.1	4.7	3.6	3.3	3.1	2.4	4
Total assets (billion Rupees)	2.4	4.7	8.4	20.7	28.1	30.5	36.8	41.7	45.9	48.7	42.1

Table 4A.5: Leasing Companies

million Rupees

	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Paid-up capital	303	549	1,155	1,550	1,950	3,139	3,768	4,155	4,328	4,429	4,584
Equity	729	1,177	2,015	2,644	3,407	5,330	6,404	7,217	7,457	7,521	7,850
Deposits	280	375	733	1,344	1,981	2,112	3,471	4,662	4,529	5,336	7,624
Liabilities	5,539	5,539	5,539	5,539	5,539	5,539	5,539	5,539	5,539	5,539	5,539
Lease finance	1,896	2,555	4,228	5,953	8,555	10,237	14,984	16,032	15,007	16,352	17,322
Investment	82	63	230	159	272	458	602	825	1,025	921	851
Assets	6,268	5,193	8,043	10,792	15,891	20,424	27,437	31,358	33,040	35,515	39,077

Table 4A.6: Modaraba Companies

million Rupees

	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Paid-up capital	6,036	6,710	6,760	6,760	7,067	6,765	6,720
Equity	6,955	7,418	7,365	7,569	7,876	7,039	7,070
Deposits	451	571	654	717	792	790	874
Liabilities	4,890	5,348	5,328	6,350	7,316	7,780	7,913
Advances	7,788	7,776	7,308	9,159	10,118	9,887	9,899
Investment	593	1,105	1,500	1,015	1,346	1,721	1,758
Assets	11,844	12,765	12,693	13,920	15,192	14,819	14,983

Table 4A.7: Housing Finance Companies

million Rupees

	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Paid-up capital	200	203	307	363	363	423	485	485	485	485	485
Equity	456	539	751	609	838	1,165	1,677	2,171	2,817	3,340	3,801
Deposits	-	-	-	-	5	57	145	124	101	231	133
Liabilities	16,041	16,208	17,106	17,959	18,105	18,277	18,488	18,200	18,486	18,204	18,461
Advances	14,539	14,686	14,504	14,605	14,319	13,738	13,617	13,569	13,376	11,713	11,402
Investment	445	686	1,480	2,059	2,729	3,445	4,411	4,732	5,931	3,388	5,997
Assets	16,497	16,745	17,855	18,570	18,945	19,443	20,165	20,371	21,303	21,543	22,260
Income	661	487	1,038	1,318	1,494	1,680	1,709	1,850	2,102	1,632	1,825
Expense	273	309	205	254	319	372	477	545	636	705	581

Table 4A.8: Discount Houses

million Rupees

	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Paid-up capital	10	110	110	110	110	110	185	635	635	635	635
Equity	14	137	167	201	244	259	353	822	886	916	933
Deposits	-	-	-	-	-	-	-	-	-	-	-
Liabilities	915	966	649	1,075	535	553	623	702	717	685	379
Advances	-	-	-	-	-	-	-	125	215	114	88
Investment	11	102	268	691	344	445	568	902	808	924	713
Assets	929	1,103	816	1,276	778	812	976	1,524	1,603	1,601	1,312
Income	74	121	126	162	126	63	152	227	270	239	218
Expense	70	77	74	75	54	22	63	79	110	77	75

Table 4A.9: Venture Capital Companies

million Rupees

	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Paid-up capital	1	100	100	100	100	100	475	475	475	475
Equity	1	100	111	131	127	131	532	527	505	368
Liabilities	3	5	10	6	7	1	98	724	753	666
Advances	0	9	8	23	11	1	7	25	4	33
Investment	-	70	105	86	97	106	570	1,036	899	743
Assets	4	105	121	137	134	133	629	1,251	1,265	1,027
Income	-	-	18	35	4	18	57	113	239	234
Expense	-	-	4	4	3	8	18	74	129	367

Table 4A.10: Outstanding Amount in National Saving Schemes

billion Rupees

National saving scheme	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Defense saving certificates	35.2	41.9	47.5	53.0	64.4	85.0	105.2	136.6	168.8	207.2	248.4
National deposit cert./ accounts	5.5	4.8	4.2	3.6	3.0	2.2	1.1	0.2	0.1	0.1	0.1
Khas deposit cert./accounts	79.0	49.3	23.0	2.5	1.8	1.4	1.0	0.9	0.8	0.8	0.7
Special saving certificates-registered	6.6	24.9	43.0	58.5	64.1	71.5	83.9	98.8	119.0	143.9	163.3
Special saving certificates-bearer	0.5	1.9	2.9	3.7	4.3	5.4	4.6	3.4	1.7	0.8	0.3
Regular income certificates	0.0	0.0	0.0	1.1	5.4	9.4	14.1	30.6	85.0	144.1	170.2
Special saving accounts	1.7	6.6	11.9	15.7	16.7	18.8	21.0	24.8	27.4	33.3	38.8
Mahana amdani accounts	0.5	0.7	0.9	1.1	1.3	1.5	1.7	1.8	1.9	1.9	1.9
Saving accounts	3.0	4.7	5.6	5.2	15.8	15.6	20.3	14.7	8.0	10.3	10.1
Total	**131.9**	**134.7**	**139.0**	**144.3**	**176.7**	**210.8**	**252.9**	**311.8**	**412.8**	**542.4**	**633.8**
Annual flow in national saving schemes											
Defense saving certificates	9.8	6.8	5.6	5.5	11.4	20.7	20.1	31.4	32.3	38.4	41.2
National deposit cert./ accounts	0.6	-0.6	-0.6	-0.6	-0.6	-0.8	-1.1	-0.9	-0.1	0.0	0.0
Khas deposit cert./accounts	-1.9	-29.8	-26.3	-20.5	-0.7	-0.4	-0.3	-0.2	0.0	-0.1	-0.1
Special saving certificates-registered	6.6	18.3	18.1	15.4	5.7	7.4	12.3	14.9	20.2	25.0	19.4
Special saving certificates-bearer	0.5	1.4	1.0	0.8	0.6	1.1	-0.7	-1.3	-1.7	-0.9	-0.5
Regular income certificates	0.0	0.0	0.0	1.1	4.2	4.0	4.7	16.5	54.4	59.1	26.1
Special saving accounts	1.7	4.9	5.3	3.7	1.1	2.1	2.1	3.9	2.6	5.9	5.5
Mahana amdani accounts	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.1	0.0	0.0	0.0
Saving accounts	0.5	1.7	0.9	-0.4	10.6	-0.1	4.7	-5.6	-6.7	2.3	-0.2
Total	17.8	2.8	4.3	5.3	32.4	34.1	42.1	58.9	101.0	129.6	91.4

Annex 5

Annex 5.1: Select Indicators of Money Market

Table 5A.1: Open Market Operation

billion Rupees

Absorption

	FY95		FY96		FY97		FY98		FY99		FY00	
	Offered	Accepted	Offered	Accepted	Offered	Accepted	Offered	Accepted	Offered	Accepted	Offered	Accepted
July	-	-	9.3	9.3	31.4	26.9	26.9	15.5	16.6	10.2	7.7	-
August	-	-	23.9	17.1	24.6	21.5	26.6	21.4	76.5	41.0	54.7	21.6
September	-	-	13.2	10.9	14.0	12.7	33.9	22.0	105.8	64.4	56.0	28.2
October	-	-	0.6	0.6	2.0	1.5	33.0	12.2	-	-	15.3	-
November	-	-	11.3	8.2	35.0	27.7	33.5	25.8	16.4	10.2	20.4	5.5
December	-	-	2.8	2.0	28.6	20.9	39.2	20.8	57.7	40.1	15.3	5.0
January	23.6	11.4	6.3	4.9	6.2	2.9	10.6	-	-	-	5.6	-
February	7.4	2.2	5.0	3.6	18.8	18.1	34.7	28.9	60.7	24.0	37.4	3.4
March	22.5	16.5	8.9	4.4	20.3	18.1	41.1	31.3	4.2	-	22.0	-
April	18.2	14.8	5.9	5.6	20.7	14.0	2.4	0.8	4.0	-	31.3	12.5
May	7.6	3.5	17.7	17.4	58.2	32.8	45.2	27.9	15.1	-	0.9	-
June	5.6	2.2	17.4	16.6	13.2	2.9	34.8	30.0	50.9	10.0	4.0	-
Average												
per month	7.1	4.2	10.2	8.4	22.7	16.7	30.2	19.7	34.0	16.6	22.5	6.3
per day	0.2	0.1	0.3	0.3	0.8	0.6	1.0	0.7	1.1	0.6	0.8	0.2

Injection

	Bid	Injected	Bid	Injected	Bid	Injected	Bid	Injected	Bid	Injected	Bid	Injected
July	-	-	-	-	-	-	-	-	-	-	9.0	4.8
August	-	-	-	-	-	-	-	-	-	-	-	-
September	-	-	-	-	-	-	-	-	-	-	-	-
October	-	-	-	-	-	-	2.3	1.1	-	-	34.4	18.2
November	-	-	-	-		-	8.4	2.6	-	-	4.4	4.4
December	-	-	-	-	-	-	5.8	0.9	-	-	50.7	24.5
January	-	-	-	-	-	-	-	-	-	-	37.9	35.6
February	-	-	-	-	-	-	-	-	-	-	45.6	27.6
March	-	-	-	-	-	-	-	-	-	-	18.9	1.8
April	-	-	-	-	-	-	-	-	8.3	4.8	6.0	-
May	-	-	-	-	-	-	-	-	24.3	6.1	25.8	9.3
June	-	-	-	-	-	-	-	-	-	-	49.8	11.7
Average												
per month	-	-	-	-	-	-	1.4	0.4	2.7	0.9	23.5	11.5
per day	-	-	-	-	-	-	0.0	0.0	0.1	0.0	0.8	0.4

Note: Injections (through OMOs) started from FY98.

Table 5A.2: Call Money Market

Call rates

percent per annum

	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
July	7.5	3.9	4.5	2.5	12.4	9.6	9.5	11.0	9.2	9.2
August	7.5	7.4	1.7	5.0	5.7	11.3	9.5	10.5	3.9	8.2
September	7.0	6.1	11.9	15.8	6.9	11.8	9.5	7.3	2.6	7.9
October	6.8	10.5	10.2	13.7	6.0	11.5	13.6	9.6	12.7	10.6
November	7.3	9.3	8.0	10.2	10.7	8.1	9.6	7.5	4.9	9.2
December	8.0	8.8	11.5	14.9	10.7	14.4	17.8	13.2	7.6	10.1
January	8.1	7.9	12.9	8.9	14.7	13.8	18.4	15.8	14.1	8.2
February	7.8	8.3	13.5	5.8	11.7	11.9	16.3	13.2	8.2	6.3
March	8.8	11.5	10.6	8.2	9.0	12.7	11.6	13.3	5.8	6.7
April	5.5	7.3	6.7	3.3	13.5	14.3	15.9	17.4	13.4	5.6
May	5.7	3.5	14.2	11.6	11.0	5.5	11.3	13.3	8.9	9.3
June	5.6	3.8	12.1	10.1	11.7	9.0	12.5	14.6	2.8	10.9
Average	7.1	7.4	9.8	9.2	10.3	11.2	13.0	12.2	7.8	8.5

Money at call and short notice

million Rupees

July	11,407	4,629	6,167	8,065	5,983	7,396	3,590	4,607	6,794	6,794
August	11,824	5,767	5,738	8,390	2,183	8,627	4,023	4,369	6,656	6,656
September	11,592	4,555	3,657	8,866	3,530	9,985	3,167	4,136	7,549	7,549
October	11,785	3,798	4,577	8,293	5,894	4,457	4,477	4,372	5,414	33,505
November	11,739	2,262	4,736	9,374	7,806	3,949	5,832	4,661	7,035	33,262
December	8,872	3,094	4,601	6,295	7,213	6,459	7,509	6,484	6,226	28,363
January	11,271	5,455	6,224	8,939	8,627	3,527	8,710	13,270	9,711	32,411
February	9,267	5,684	6,128	7,949	8,581	3,934	9,528	7,172	8,959	33,201
March	7,856	6,377	7,040	6,912	10,268	3,535	9,068	8,488	10,526	37,451
April	8,195	9,608	9,342	7,594	3,575	3,866	8,948	6,188	41,874	41,874
May	5,281	8,849	8,010	6,201	4,556	3,473	6,762	8,193	54,441	54,441
June	5,938	6,719		7,062	8,814	3,667	5,370	7,768	42,469	42,469
Average	9,586	5,566	6,020	7,828	6,419	5,240	6,415	6,642	17,305	29,831

Note: Outstanding at month end

Table 5A.3: SBP 3-Day Repo Window

Cash accommodation

million Rupees

	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
July	-	2,350	-	1,518	2,964	4,275	7,400	17,460	33,585
August	-	-	4,202	-	3,054	12,760	5,373	6,945	28,152
September	-	38,326	22,726	-	3,208	34,120	360	900	7,806
October	-	8,349	53,897	-	5,380	150,576	54,370	85,790	29,458
November	-	2,193	14,892	4,930	1,460	17,230	25,020	-	28,230
December	-	5,806	118,367	2,316	33,585	80,089	86,054	-	62,280
January	-	32,693	20,341	35,812	20,935	304,684	97,800	152,398	106,860
February	1,175	41,284	3,179	1,750	-	215,456	19,980	18,351	12,656
March	37,310	50,180	20,197	175	-	6,570	8,703	37,400	42,616
April	5,140	2,383	-	925	30,155	39,321	198,795	117,754	19,120
May	-	40,535	16,673	5,470	86,945	25,098	10,615	40,512	49,200
June	555	42,879	4,422	1,988	26,053	38,847	91,885	-	317,700
Average									
per month	3,682	22,248	23,241	4,574	17,812	77,419	50,530	39,793	61,472
per day	123	742	775	152	594	2,581	1,684	1,326	2,049

SBP 3-Day repo rate

percent per annum

July	-	14.0	15.0	15.0	15.5	16.5	18.5	16.5	13.0
August	-	14.0	17.0	17.0	15.5	16.5	18.5	16.5	13.0
September	-	14.0	17.0	17.0	15.5	16.5	18.5	16.5	13.0
October	-	14.0	17.0	17.0	16.5	20.0	18.0	16.5	13.0
November	-	14.0	17.0	17.0	16.5	20.0	18.0	16.5	13.0
December	-	15.0	17.0	17.0	16.5	20.0	18.0	16.5	13.0
January	-	15.0	17.0	17.0	16.5	20.0	18.0	16.5	11.0
February	14.0	15.0	17.0	15.5	16.5	20.0	18.0	16.5	11.0
March	14.0	15.0	15.0	15.5	16.5	20.0	18.0	15.5	11.0
April	14.0	15.0	15.0	15.5	16.5	20.0	18.0	14.0	11.0
May	14.0	15.0	15.0	15.5	16.5	20.0	18.0	13.0	11.0
June	14.0	15.0	15.0	15.5	16.5	19.0	18.0	13.0	11.0

Note: Rates applicable against T-bills

Table 5A.4: Six-Month Treasury Bills

Amount offered

million Rupees

	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY100
July	-	12,098	34,960	26,245	19,800	13,275	7,702	34,864	9,944	10,950
August	-	8,908	36,936	17,921	39,848	9,420	13,035	47,099	71,046	10,425
September	-	8,740	21,994	11,122	36,303	21,535	13,852	62,518	71,734	30,245
October	-	775	10,497	7,991	36,319	11,321	5,518	44,726	9,642	10,750
November	-	1,030	11,780	11,620	15,505	11,275	14,524	57,559	33,101	35,375
December	-	7,950	13,535	5,460	5,846	3,791	14,133	66,774	23,111	8,000
January	-	23,100	30,070	39,520	23,290	7,731	10,210	38,248	11,677	12,650
February	-	9,218	8,028	56,113	15,172	7,250	15,618	45,472	41,474	19,850
March	13,630	6,485	13,735	35,236	18,219	15,313	20,495	29,687	36,562	13,950
April	10,561	9,615	7,796	34,843	19,210	13,829	9,116	17,926	3,850	20,590
May	7,212	17,736	3,615	20,500	15,237	10,913	20,913	33,790	15,154	25,315
June	17,816	17,261	7,550	5,771	5,709	9,896	38,346	50,244	16,642	7,880
Total	49,218	122,916	200,496	272,341	250,457	135,549	183,462	528,906	343,937	205,980

Amount accepted

million Rupees

July	-	11,138	33,400	24,945	16,505	13,015	7,102	23,074	8,494	-
August	-	7,128	8,972	16,816	29,803	4,820	12,670	25,013	28,296	3,525
September	-	5,315	16,749	3,977	21,227	16,130	12,402	13,238	16,098	16,700
October	-	135	4,517	3,885	12,635	9,256	5,218	4,825	-	2,300
November	-	280	3,060	8,915	10,235	8,395	8,864	31,404	1,000	24,825
December	-	6,715	2,875	1,835	1,966	3,391	9,208	47,214	7,611	1,500
January	-	17,860	15,100	11,995	7,321	6,931	7,295	18,726	8,157	2,350
February	-	6,423	4,233	27,493	2,792	4,300	12,168	22,807	20,139	3,250
March	6,673	2,500	3,975	13,405	15,089	14,010	10,410	18,022	12,700	500
April	7,271	4,240	4,896	8,908	11,130	8,154	6,036	11,146	175	11,150
May	3,873	5,120	2,270	10,840	12,767	8,571	18,673	21,822	-	18,915
June	12,906	8,160	6,165	3,492	5,224	9,336	34,707	34,839	-	500
Total	30,723	76,014	106,212	136,506	146,693	106,308	144,752	272,128	102,670	85,515

Weighted average yield

percent per annum

July	-	9.4	11.9	12.4	11.0	12.7	13.0	16.4	15.6	-
August	-	9.5	12.0	13.1	11.5	12.7	13.1	15.4	15.1	9.4
September	-	9.6	12.3	13.9	11.5	12.7	13.4	15.2	13.7	10.2
October	-	9.8	12.7	13.9	10.8	12.7	14.0	14.1	-	10.4
November	-	9.8	12.3	13.8	11.0	12.7	15.2	12.1	12.0	10.0
December	-	11.0	12.4	14.1	11.4	12.8	16.6	13.5	11.9	10.1
January	-	12.5	12.4	12.5	11.4	12.7	16.8	14.4	12.3	8.5
February	-	12.8	12.4	12.0	11.6	12.8	17.0	14.9	13.1	7.7
March	7.8	13.0	12.4	11.7	12.1	12.8	16.8	15.7	12.2	7.4
April	8.8	13.1	12.4	10.7	12.6	12.9	17.2	16.0	10.6	7.2
May	9.4	13.1	12.5	10.4	12.7	12.9	17.2	16.2	-	7.1
June	9.3	12.2	12.5	10.8	12.7	13.0	16.2	15.8	-	7.2
Average	8.8	11.3	12.3	12.4	11.7	12.8	15.5	15.0	9.7	7.9

Table 5A.5: Federal Investment Bonds (All Maturities)

million Rupees

	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98
Amount offered								
July	-	-	3,924	2,573	5,301	2,120	1,177	98
August	-	1,065	12,126	3,315	3,083	2,088	1,380	715
September	-	8,315	6,919	2,236	2,131	1,518	257	461
October	-	10,645	6,270	2,127	8,742	2,072	679	650
November	-	7,743	8,312	5,148	1,771	500	535	325
December	-	6,589	5,940	1,115	7,061	380	12	565
January	-	9,686	14,765	2,963	1,357	5,995	111	482
February	-	3,289	5,863	5,203	5,324	1,033	240	482
March	-	1,021	5,835	8,271	4,493	1,297	79	787
April	13,661	1,424	2,697	10,238	2,890	720	-	125
May	15,466	2,712	2,341	14,025	748	56	126	-
June	10,141	3,919	2,135	6,071	1,452	247	345	191
Total	**39,268**	**56,407**	**77,127**	**63,284**	**44,353**	**18,026**	**4,841**	**4,881**
Amount accepted								
July	-	-	2,522	1,743	1,881	1,519	1,127	98
August	-	830	4,876	1,315	2,403	1,788	1,380	465
September	-	7,690	2,424	909	1,891	1,218	257	411
October	-	9,394	3,824	803	8,027	1,644	679	150
November	-	6,940	6,467	4,010	1,231	429	535	325
December	-	6,369	4,580	-	6,526	375	12	565
January	-	6,591	12,615	884	810	5,863	111	482
February	-	1,987	4,288	1,984	3,141	933	240	61
March	-	556	5,485	1,175	1,015	1,172	79	787
April	12,029	779	2,332	3,582	1,745	720	-	125
May	14,221	1,082	2,241	6,678	297	56	51	-
June	8,688	2,756	1,925	3,528	1,022	247	245	191
Total	**34,938**	**44,974**	**53,579**	**26,611**	**29,988**	**15,964**	**4,716**	**3,660**
Amount accepted (Banks)								
July	-	-	1,632	1,383	300	600	52	-
August	-	430	4,530	498	1,508	287	169	-
September	-	7,154	1,010	133	993	834	6	-
October	-	7,131	2,777	266	6,508	30	1	-
November	-	3,237	4,027	1,597	193	37	-	275
December	-	4,146	3,381	-	2,772	-	2	250
January	-	5,363	11,786	331	400	5,101	-	2
February	-	1,449	3,442	381	2,200	201	-	-
March	-	432	4,426	851	500	-	-	670
April	11,385	612	1,713	3,185	436	50	-	-
May	12,505	651	1,627	6,270	27	0	-	-
June	5,087	2,313	556	2,317	535	31	-	-
Total	**28,977**	**32,918**	**40,907**	**17,211**	**16,371**	**7,171**	**230**	**1,197**
Amount accepted (Non-bank)								
July	-	-	891	361	1,581	918	1,075	98
August	-	400	346	817	895	1,501	1,210	465
September	-	536	1,414	776	898	384	251	411
October	-	2,263	1,047	538	1,519	1,614	678	150
November	-	3,703	2,440	2,413	1,038	392	535	50
December	-	2,223	1,198	-	3,754	375	10	315
January	-	1,228	830	554	410	762	111	480
February	-	538	846	1,603	941	732	240	61
March	-	124	1,059	324	515	1,172	79	117
April	644	167	619	397	1,310	670	-	125
May	1,716	431	614	408	270	56	51	0
June	3,601	443	1,369	1,211	487	216	245	191
Total	**5,961**	**12,056**	**12,671**	**9,400**	**13,617**	**8,793**	**4,486**	**2,463**

Note: FIB auctions were suspended in June 1998.

Table 5A.6: Federal Investment Bonds Amount Accepted (Non-bank)

million Rupees

3-year bond	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98
July	-	-	256	53	1,581	61	300	50
August	-	109	54	1	287	40	250	50
September	-	225	13	5	100	40	100	101
October	-	1,105	81	10	462	477	80	50
November	-	2,233	106	1	100	350	100	50
December	-	1,176	2	-	821	60	-	50
January	-	305	10	51	150	60	-	480
February	-	129	26	1,000	450	215	150	-
March	-	0	88	113	200	350	20	100
April	37	100	13	25	172	90	-	100
May	924	60	-	170	0	-	50	0
June	1,676	1	45	375	150	133	50	150
Total	2,637	5,444	693	1,804	4,474	1,877	1,101	1,181
5-year bond								
July	-	-	107	31	-	-	45	0
August	-	150	50	49	75	152	4	2
September	-	240	171	41	-	-	50	-
October	-	84	168	32	244	4	-	-
November	-	210	5	40	-	-	-	-
December	-	193	49	-	744	6	-	-
January	-	30	131	50	1	5	-	-
February	-	34	39	54	-	3	-	-
March	-	91	101	30	105	300	4	-
April	185	20	48	-	-	500	-	-
May	377	49	36	210	28	-	-	-
June	607	16	24	250	1	-	-	-
Total	1,169	1,116	930	786	1,198	969	102	2
10-year bond								
July	-	-	529	277	-	857	731	48
August	-	141	242	767	533	1,310	957	413
September	-	72	1,230	730	798	343	101	310
October	-	1,074	798	496	813	1,134	598	100
November	-	1,259	2,329	2,372	938	42	435	-
December	-	853	1,147	-	2,189	310	10	265
January	-	892	688	453	259	697	111	-
February	-	375	781	549	491	514	90	61
March	-	33	870	182	210	522	55	17
April	422	47	557	372	1,138	80	-	25
May	415	322	578	28	242	56	1	-
June	1,317	426	1,300	585	335	83	195	41
Total	2,154	5,495	11,049	6,810	7,946	5,948	3,283	1,279

Table 5A.7: Federal Investment Bonds Amount Accepted (Banks)
million Rupees

3-year bond	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98
July	-	-	817	550	300	-	-	-
August	-	50	2,035	215	900	-	-	-
September	-	915	760	-	220	-	-	-
October	-	3,160	-	-	1,625	-	-	-
November	-	-	475	40	91	-	-	-
December	-	-	500	-	170	-	-	150
January	-	575	5,575	-	400	2,000	-	-
February	-	20	205	20	-	-	-	-
March	-	20	190	630	500	-	-	-
April	6,915	10	-	1,705	1	-	-	-
May	3,595	-	1,225	4,175	-	-	-	-
June	787	455	125	1,570	105	-	-	-
Total	11,297	5,205	11,907	8,905	4,312	2,000	-	150
5-year bond								
July	-	-	25	-	-	-	-	-
August	-	-	875	50	170	-	-	-
September	-	813	-	1	270	200	3	-
October	-	358	60	1	500	-	-	-
November	-	7	410	60	-	-	-	175
December	-	-	1,513	-	10	-	-	-
January	-	227	400	-	-	3,000	-	-
February	-	4	100	-	-	-	-	-
March	-	127	0	120	-	-	-	-
April	660	3	50	500	50	-	-	-
May	3,380	2	375	2,095	8	-	-	-
June	960	350	400	420	61	-	-	-
Total	5,000	1,891	4,208	3,248	1,069	3,200	3	175
10-year bond								
July	-	-	[illegible]	833	-	600	52	-
August	-	380	1,620	234	438	287	169	-
September	-	5,426	250	132	503	634	3	-
October	-	3,613	2,717	265	4,383	30	1	-
November	-	3,230	3,142	1,497	102	37	-	100
December	-	4,146	1,369	-	2,592	-	2	100
January	-	4,561	5,811	331	-	101	-	2
February	-	1,425	3,137	361	2,200	201	-	-
March	-	285	4,236	101	-	-	-	670
April	3,810	599	1,663	-980	385	50	-	-
May	5,530	649	27	-	19	0	-	-
June	3,340	1,508	31	327	368	31	-	-
Total	12,680	25,822	24,792	5,059	10,990	1,971	227	872

Annex 6

Annex 6.1: List of Core Principles for Effective Banking Supervision

1. An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organizations. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking organizations and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

2. The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word "bank" in names should be controlled as far as possible.

3. The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organization's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained.

4. Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.

5. Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

6. Banking supervisors must set prudent and appropriate minimum capital adequacy requirements for all banks. Such requirements should reflect the risks that the banks undertake, and must define the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the Basel Capital Accord and its amendments.

7. An essential part of any supervisory system is the evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.

8. Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and loan loss reserves.

9. Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.

10. In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.

11. Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.

12. Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

13. Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.

14. Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

15. Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

16. An effective banking supervisory system should consist of some form of both on-site and off-site supervision.

17. Banking supervisors must have regular contact with bank management and thorough understanding of the institution's operations.

18. Banking supervisors must have a means of collecting, reviewing and analyzing prudential reports and statistical returns from banks on a solo and consolidated basis.

19. Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.

20. An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.

21. Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.

22. Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking licence or recommend its revocation.

23. Banking supervisors must practice global consolidated supervision over their internationally-active banking organizations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organizations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.

24. A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.

25. Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.

Annex 6.2: Dynamics of Financial Sector During 1990s

Table 6A.1: Financial Sector Assets

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Assets (billion Rupees)											
Banks	*426*	*506*	*643*	*751*	*882*	*1028*	*1183*	*1339*	*1458*	*1545*	*1641*
State-owned	392	451	538	601	692	789	855	919	1028	1110	1158
excluding ABL & MCB	392	377	438	484	546	610	657	697	789	844	885
Private	0	0	25	39	56	87	114	151	166	183	223
including ABL & MCB	0	74	125	156	202	265	313	373	405	449	496
Foreign	33	55	80	110	134	153	213	269	263	253	259
NBFIs	*134*	*168*	*232*	*270*	*335*	*360*	*377*	*410*	*369*	*356*	*352*
Public	125	158	191	216	257	263	278	309	270	252	248
Private	3	6	9	43	57	69	83	95	102	108	104
CDNS	*132*	*135*	*139*	*144*	*177*	*211*	*253*	*312*	*413*	*542*	*634*
Total	691	809	1014	1165	1394	1599	1813	2061	2240	2444	2626
Assets Shares (percent)											
Banks	*61.6*	*62.6*	*63.4*	*64.5*	*63.3*	*64.3*	*65.2*	*65*	*65.1*	*63.2*	*62.5*
State-owned	56.7	55.7	53.1	51.6	49.6	49.3	47.2	44.6	45.9	45.4	44.1
excluding ABL & MCB	56.7	46.6	43.2	41.6	39.2	38.2	36.2	33.8	35.2	34.5	33.7
Private	0.0	0.0	2.5	3.4	4.1	5.6	6.4	7.3	7.4	7.5	8.5
including ABL & MCB	0.0	9.2	12.3	13.6	14.5	16.6	17.3	18.2	18.1	18.3	18.9
Foreign	4.9	6.9	8.2	9.6	9.8	9.7	11.8	13.1	11.7	10.3	9.9
NBFIs	*19.4*	*20.7*	*22.9*	*23.1*	*24.*	*22.5*	*20.8*	*19.9*	*16.5*	*14.6*	*13.4*
Public	18.2	19.6	19.5	18.7	18.7	16.7	15.5	15.0	12.0	10.3	9.5
Private	0.5	0.7	1.0	3.7	4.2	4.4	4.6	4.6	4.6	4.4	4.0
CDNS	*19.2*	*16.7*	*13.7*	*12.4*	*12.7*	*13.2*	*14.0*	*15.1*	*18.4*	*22.2*	*24.1*
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
As percent of GDP											
Financial Sector Assets	80.8	79.3	83.7	86.8	88.6	85.0	85.5	83.9	83.7	83.2	82.5

Figure 6A.1: Assets of Financial Sector

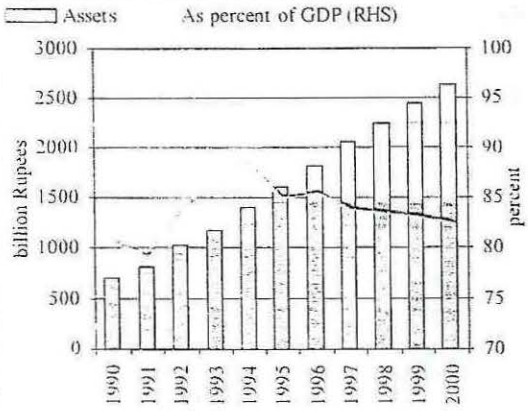


Figure 6A.2: Share in Financial Sector Assets

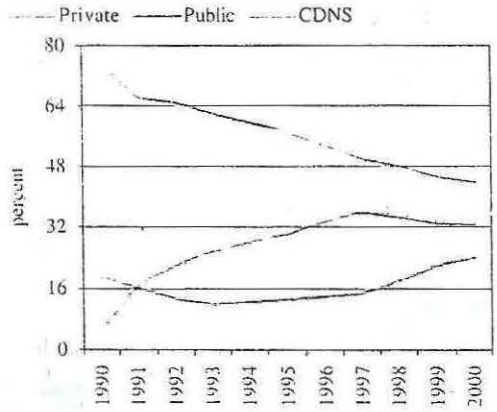


Table 6A.2: Financial Sector Advances

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Advances (billion Rupees)											
Banks	*219*	*230*	*266*	*332*	*373*	*463*	*520*	*581*	*614*	*693*	*798*
State-owned	201	207	224	277	296	352	380	389	415	479	544
excluding ABL & MCB	201	174	182	228	234	272	289	289	306	356	401
Private	0	0	9	14	23	41	51	71	78	89	121
including ABL & MCB	0	33	50	63	84	121	142	172	187	211	264
Foreign	17	23	34	42	55	70	89	120	121	125	134
NBFIs	*98*	*114*	*124*	*144*	*166*	*180*	*189*	*222*	*198*	*189*	*175*
Public	82	95	101	111	119	133	135	164	138	132	124
Private	2	3	5	28	36	41	50	58	62	62	57
CDNS	*132*	*135*	*139*	*144*	*177*	*211*	*253*	*312*	*413*	*542*	*634*
Total	**449**	**479**	**528**	**620**	**716**	**854**	**962**	**1115**	**1224**	**1425**	**1607**
Shares (percent)											
Banks	*48.7*	*48.0*	*50.3*	*53.6*	*52.1*	*54.3*	*54.1*	*52.1*	*50.1*	*48.6*	*49.7*
State-owned	44.8	43.2	42.3	44.7	41.3	41.3	39.5	34.9	33.9	33.6	33.8
excluding ABL & MCB	44.8	36.3	34.5	36.8	32.7	31.8	30.0	25.9	25.0	25.0	24.9
Private	0.0	0.0	1.6	2.2	3.2	4.8	5.4	6.4	6.4	6.2	7.5
including ABL & MCB	0.0	6.9		10.1	11.8	14.2	14.8	15.4	15.2	14.8	16.4
Foreign	4.0	5.0	6.6	6.7	7.7	8.3	9.3	10.8	9.8	8.7	8.3
NBFIs	*21.9*	*23.9*	*23.4*	*23.1*	*23.2*	*21.0*	*19.6*	*20.0*	*16.2*	*13.3*	*10.9*
Public	21.1	22.6	21.6	20.1	18.5	17.0	15.3	15.7	12.2	9.9	8.3
Private	0.8	1.3	1.8	3.1	4.7	4.1	4.3	4.2	4.0	3.4	2.6
CDNS	*29.4*	*28.1*	*26.3*	*23.3*	*24.7*	*24.7*	*26.3*	*28.0*	*33.7*	*38.1*	*39.4*
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
As percent of GDP											
Financial Sector Advances	52.4	46.9	43.6	46.2	45.5	45.5	45.4	45.4	45.7	48.5	50.5

Figure 6A.3: Advances of Financial Sector

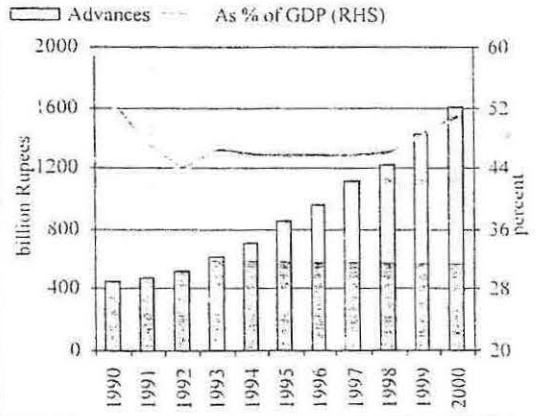


Figure 6A.4: Share in Financial Sector Adavnces

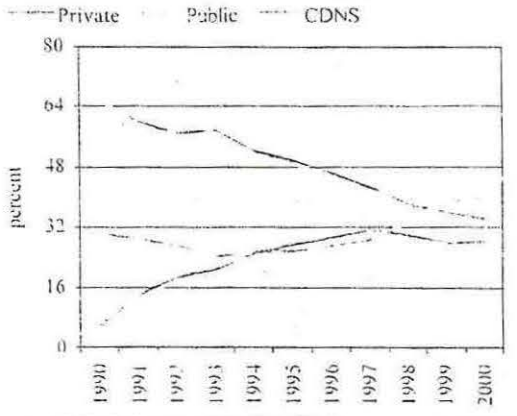


Table 6A.3: Financial Sector Investment

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Investment (billion Rupees)											
Banks	*111*	*147*	*223*	*240*	*292*	*308*	*350*	*404*	*439*	*360*	*367*
State-owned	104	129	184	185	230	249	256	272	315	284	265
excluding ABL & MCB	104	106	146	142	177	190	193	194	234	212	201
Private	0	0	10	14	17	20	28	53	54	43	48
including ABL & MCB	0	23	49	56	69	79	91	131	135	116	112
Foreign	7	18	29	41	45	39	66	78	71	33	53
NBFIs	*14*	*11*	*21*	*32*	*40*	*44*	*52*	*60*	*53*	*54*	*59*
Public	14	27	49	56	79	67	76	74	54	52	60
Private	0	1	2	7	10	14	15	18	18	21	25
CDNS	-	-	-	-	-	-	-	-	-	-	-
Total	126	158	244	272	332	352	402	464	492	414	426
Shares (percent)											
Banks	*89.1*	*92.8*	*91.5*	*88.2*	*87.9*	*87.5*	*87.1*	*87.0*	*89.2*	*86.9*	*86.1*
State-owned	83.3	81.6	75.5	68.1	69.3	70.8	63.6	58.7	64.0	68.6	62.2
excluding ABL & MCB	83.3	67.1	59.6	52.4	53.4	53.9	47.9	41.8	47.5	51.1	47.2
Private	0.0	0.0	4.2	5.0	5.0	5.6	7.0	11.5	10.9	10.5	11.3
including ABL & MCB	0.0	14.6	20.1	20.7	20.9	22.5	22.7	28.3	27.4	28.0	26.4
Foreign	5.8	11.2	11.8	15.1	13.6	11.1	16.5	16.9	14.4	7.9	12.5
NBFIs	*10.9*	*7.2*	*8.5*	*11.8*	*12.1*	*12.5*	*12.9*	*13.0*	*10.8*	*13.1*	*13.9*
Public	10.6	6.8	7.5	9.9	9.8	9.3	9.7	9.5	7.5	8.4	8.8
Private	0.3	0.4	1.0	1.9	2.3	3.1	3.2	3.5	3.3	4.7	5.1
CDNS	-	-	-	-	-	-	-	-	-	-	-
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
As percent of GDP											
Financial Sector Investment	14.6	15.5	20.2	20.3	21.1	18.7	19.0	18.9	18.4	14.1	13.4

Figure 6A.5: Investment of Financial Sector

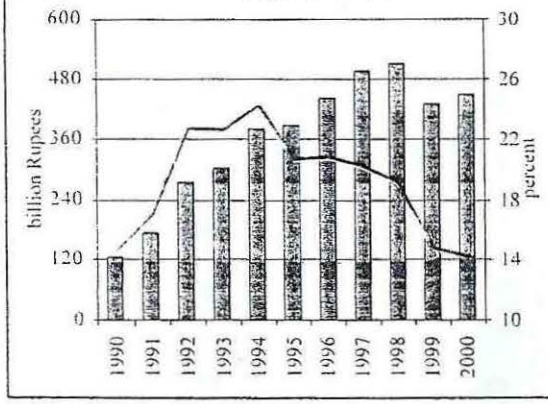


Figure 6A.6: Share in Financial Sector Investment

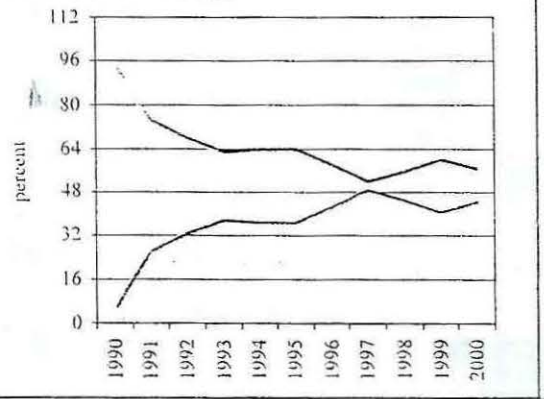


Table 6A.4: Financial Sector Deposits

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Deposits (billion Rupees)											
Banks	*355*	*426*	*535*	*622*	*731*	*856*	*996*	*1122*	*1199*	*1239*	*1323*
State-owned	330	382	457	511	586	674	738	785	859	925	974
excluding ABL & MCB	330	322	373	411	463	524	569	597	659	701	744
Private	0	0	16	26	38	59	82	116	127	131	161
including ABL & MCB	0	60	100	126	161	210	251	304	327	355	392
Foreign	25	44	62	85	106	122	176	221	213	183	187
NBFIs	*22*	*31*	*40*	*57*	*72*	*81*	*94*	*127*	*111*	*107*	*93*
Public	20	27	34	40	48	55	60	89	70	64	58
Private	2	3	6	17	23	27	36	40	43	44	36
CDNS	*132*	*135*	*139*	*144*	*177*	*211*	*253*	*312*	*413*	*542*	*634*
Total	509	592	714	823	979	1147	1343	1561	1723	1888	2050
Shares (percent)											
Banks	*69.7*	*72.0*	*75.0*	*75.5*	*74.6*	*74.6*	*74.2*	*71.9*	*69.6*	*65.6*	*64.5*
State-owned	64.8	64.6	64.0	62.0	59.9	58.7	54.9	50.3	49.9	48.9	47.5
excluding ABL & MCB	64.8	54.5	52.3	49.9	47.4	45.6	42.3	38.2	38.2	37.1	36.3
Private	0.0	0.0	2.2	3.1	3.9	5.2	6.1	7.4	7.4	6.9	7.9
including ABL & MCB	0.0	10.2	14.0	15.3	16.5	18.3	18.6	19.4	19.0	18.8	19.1
Foreign	4.9	7.4	8.7	10.4	10.9	10.6	13.1	14.2	12.3	9.7	9.1
NBFIs	*4.4*	*5.2*	*5.7*	*6.9*	*7.3*	*7.0*	*7.0*	*8.1*	*6.4*	*5.7*	*4.6*
Public	4.0	4.6	4.7	4.8	4.9	4.8	4.5	5.7	4.1	3.4	2.8
Private	0.4	0.6	0.8	2.1	2.3	2.4	2.7	2.6	2.5	2.3	1.8
CDNS	*25.9*	*22.8*	*19.5*	*17.5*	*18.1*	*18.4*	*18.8*	*19.9*	*23.9*	*28.7*	*30.9*
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
As percent of GDP											
Financial Sector Deposits	59.5	58.0	58.9	61.4	62.2	61.0	63.3	63.5	64.3	64.3	64.4

Figure 6A.7: Deposits of Financial Sector

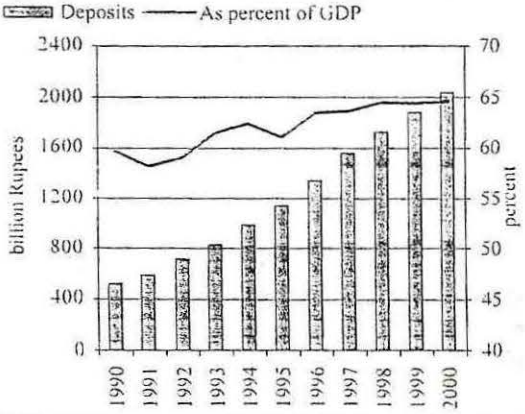
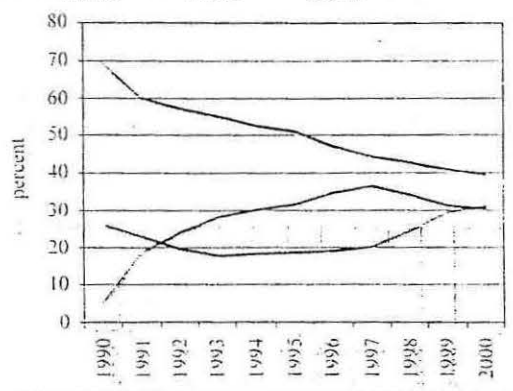


Figure 6A.8: Share in Financial Sector Deposits



Annex 6.3: Financial Savings

Table 6A.5: Financial Savings

billion Rupees

Components of Financial Savings	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00
Deposits of schedule banks	344	417	491	593	713	827	940	1051	1113	1140
Current account	72	89	103	118	151	158	156	166	172	168
Call deposits	4	5	6	8	14	13	12	14	22	17
Other deposits	11	13	18	20	18	26	33	33	35	48
Savings deposits	144	173	210	254	292	339	403	479	524	583
Fixed term deposits	113	137	153	194	238	291	337	360	360	324
Deposits of NBFIs	25	33	49	61	69	80	105	95	87	69
DFIs	22	26	32	39	44	49	79	59	49	42
Other NBFIs	3	6	16	22	25	31	26	36	38	27
Government debt instruments (non-bank)	218	226	250	302	347	407	476	592	758	853
National savings schemes	163	169	179	216	256	304	372	484	624	715
Defence savings certificates	42	48	53	64	85	105	137	169	207	248
Special savings certificates (reg)	25	43	58	64	72	84	99	114	131	163
Prize bonds	28	30	35	39	45	51	61	71	81	81
Other savings schemes	68	48	33	48	54	64	76	130	204	222
Others instruments	56	57	71	86	91	103	104	108	134	138
Currency in circulation	137	152	167	185	216	234	244	273	288	356
Financial savings (stock)	724	827	957	1141	1344	1548	1765	2011	2245	2418
Financial savings (flows)	114	103	130	184	203	204	217	246	235	173

Figure 6A.9: Financial Savings

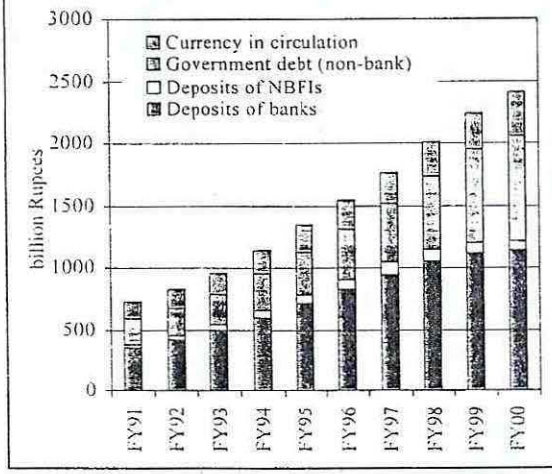
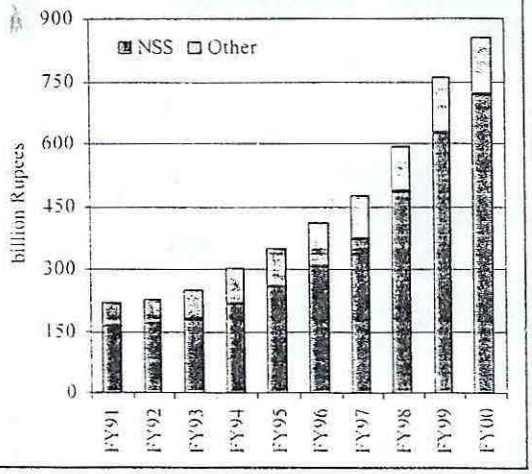


Figure 6A.10: Government Debt (Non-Bank)



Acronyms

ABL	Allied Bank Limited
ADB	Asian Development Bank
ADBP	Agriculture Development Bank of Pakistan
ADs	Authorized Dealers
AMCs	Authorized Money Changers
BCO	Banking Companies Ordinance
BEL	Bankers Equity Limited
BEY	Break-even Yield
BID	Banking Inspection Department
BNFBs	Bearer National Fund Bonds
BPRD	Banking Policy & Regulation Department
BSD	Banking Supervision Department
CAD	Current Account Deficit
CAELS	Capital Adequacy, Asset Quality, Earnings & Profitability, Liquidity and Sensitivity to Market Risk
CAMELS	Capital Adequacy, Asset Quality, Management Soundness, Earnings & Profitability, Liquidity and Sensitivity to Market Risk
CBR	Central Board of Revenue
CCI	Controller of Capital Issues
CCI&E	Chief Controller of Imports & Exports
CDC	Central Depository Company
CDNS	Central Directorate of National Savings
CDR	Credit Deposit Ratio
CIB	Credit Information Bureau
CIRC	Corporate and Industrial Restructuring Corporation
CLA	Corporate Law Authority
COIs	Certificates of Investment
CRR	Cash Reserve Requirement
CRWA	Capital to Risk-weighted Assets
DAD	Deposit Account Department
DBCs	Dollar Bearer Certificates
DFIs	Development Finance Institutions
DHs	Discount Houses
DSCs	Defense Savings Certificates
DSFL	Dewan Salman Fibre Limited
DvP	Delivery versus Payment
EFF	Extended Fund Facility
EFS	Export Finance Scheme
EPB	Export Promotion Bureau
ESAF	Enhanced Structural Adjustment Facility
FBC	Federal Bank for Cooperatives
FCAs	Foreign Currency Accounts
FE-12	Foreign Exchange Circular No. 12 dated 2nd June 1999
FE-25	Foreign Exchange Circular No. 25 dated 20th June 1998
FE-45	Foreign Exchange Circular No. 45 dated 11th August 1985
FEBCs	Foreign Exchange Bearer Certificates
FIBR	Floating Inter-bank Rate
FIBs	Federal Investment Bonds
FMAP	Financial Markets Association of Pakistan
FOB	Free on Board
FWBL	First Women Bank Limited
GATS	General Agreement of Trading in Services
GDP	Gross Domestic Product
GHS	Golden Hand Shake
GOP	Government of Pakistan
GRA	Growth Rate of Assets
GRC	Growth Rate of Capital
GTDRs	Government Treasury Deposit Receipts
HBFC	House Building Finance Corporation
HBL	Habib Bank Limited
HFCs	Housing Finance Companies
HUBCO	Hub Power Company
IAS	Investor Account Services
IBL	Indus Bank Limited
IBs	Investment Banks
ICI	Imperial Chemical Industries
ICP	Investment Corporation of Pakistan
IDBP	Industrial Development Bank of Pakistan
IFC	International Finance Corporation
IMF	International Monetary Fund
ISE	Islamabad Stock Exchange
KDCs	Khas Deposit Certificates
KSE	Karachi Stock Exchange
L/C	Letter of Credit
LIBOR	London Inter-bank Offered Rate
LMM	Locally Manufactured Machinery
LSE	Lahore Stock Exchange
MCA	Monopoly Control Authority
MCB	Muslim Commercial Bank
MOF	Ministry of Finance
MRTBs	Market Related Treasury Bills
MTBs	Market Treasury Bills
NBFCs	Non-bank Financial Companies
NBFIs	Non-bank Financial Institutions
NBP	National Bank of Pakistan
NCBs	Nationalized Commercial Banks
NCCC	National Credit Consultative Council
NDFC	National Development Finance Corporation
NDLC	National Development Leasing Corporation
NIBAF	National Institute of Banking and Finance

NIFT	National Institutional Facilitation Technology
NIM	Net Interest Margin
NIT	National Investment Trust
NITL	National Investment Trust Limited
NPLs	Non-performing Loans
NSS	National Savings Schemes
OAEM	Other Assets Especially Mentioned
OMOs	Open Market Operations
PACRA	Pakistan Credit Rating Agency
PBA	Pakistan Banks Association
PBC	Pakistan Banking Council
PCBL	Prudential Commercial Bank Limited
PDs	Primary Dealers
PIBs	Pakistan Investment Bonds
PICIC	Pakistan Industrial Credit and Investment Corporation
PILCORP	Pakistan Industrial Leasing Corporation
PKIC	Pakistan Kuwait Inv. Company (Pvt) Ltd.
PLHC	Pak-Libya Holding Co. (Pvt) Ltd.
POL	Petroleum, Oil & Lubricants
PPCB	Punjab Provincial Cooperative Bank
PSO	Pakistan State Oil
PTC	Pakistan Telecommunication Corporation
PTCL	Pakistan Telecommunication Company Ltd.
PTCs	Participation Terms Certificates
PTEQ	Private Travel Exchange Quota
RDFC	Regional Development Finance Corporation
RFCDs	Resident Foreign Currency Deposits
RICs	Regular Income Certificates
ROA	Return on Assets
ROE	Return on Equity
RSA	Rate Sensitive Assets
RSL	Rate Sensitive Liabilities
RTGS	Real Time Gross Settlement System
SBFC	Small Business Finance Corporation
SBP	State Bank of Pakistan
SBPBSC	State Bank of Pakistan: Banking Services Corporation
SCD	Special Cash Deposits
SCRAs	Special Convertible Rupee Accounts
SECP	Securities and Exchange Commission of Pakistan
SGLA	Subsidiary General Ledger Account
SIPS	Systematically Important Payment System
SLR	Statutory Liquidity Requirement/Ratio
SME	Small and Medium Enterprises
SNFBs	Special National Fund Bonds
SOEs	State-owned Enterprises
SPIAIC	Saudi-Pak Industrial & Agricultural Investment Co. (Pvt) Ltd.
SPLC	Saudi-Pak Leasing Corporation
SSCs	Special Saving Certificates
SWIFT	Society for Worldwide Inter-bank Financial Telecommunication
TCP	Trading Corporation of Pakistan
TCs	Travelers Cheques
TFCs	Term Finance Certificates
TTs	Telephonic Transfers
UBL	United Bank Limited
VCCs	Venture Capital Companies
WAPDA	Water and Power Development Authority
WTO	World Trade Organization

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