

Financial Sector Regulation in Pakistan: The Way Forward

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The 2008 global financial crisis that turned into the worst economic recession across the world has led to some serious soul searching among the scholars and practitioners about the ways in which financial sector has to be regulated and supervised. There is very little doubt that the U.S. and European financial systems were badly affected and trillions of public tax dollars had to be poured into the system to avert a complete breakdown. The prompt and coordinated response of the G-8 and G-20 to the crisis was something which had not been seen before. Emerging and Developing Economies (EDEs) particularly China, India and Pakistan however survived this onslaught as well as the 1995-96 Asian crisis. It thus becomes an interesting question to explore as to why the financial systems in these countries were able to insulate themselves or at least created fire walls of safety and security that were difficult to permeate.

This paper would begin by analyzing the lessons learnt for the financial sector from the recent global crisis, and the differentiated approach adopted to manage and mitigate these risks. By dividing the two groups of countries – Emerging & Developing Economies (EDEs) and Developed Economies (DEs) in two broad categories the differentiation becomes easier to follow. There are at least seven reasons that buttress this differentiation.

First, Bank lending forms the bulk of financial sector lending in EDEs and capital markets are not so well developed unlike the U.S. and Europe. The contagion risk and transmission effects of an interconnected world capital markets in the EDEs therefore remain muted and is not as intense as in the DEs.

Second, Asian countries had learnt the hard way from their 1997-98 crisis and developed a number of shock absorbers that made them resilient in facing this latest global crisis. Prudent macroeconomic management, credibility of policy makers, open trading and investment regimes, accumulation of sufficient foreign exchange reserves, an enabling environment all combined together to maintain macroeconomic stability as well as promote growth impulses. Countries that had

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attained and pursued macroeconomic and financial stability prior to the crisis came out strongly. For example, financial sector reforms in China that created Asset Management Companies to clean up the banks' balance sheets in 2003-05 period deflected the likely shocks to the system.

Third, the banks in EDEs relied upon low cost and stable deposits for financing their assets rather than wholesale funding that was volatile and expensive. This permitted maturity transformation, ample liquidity to the system and preserved confidence among investors. Unlike the U.S. and Europe where abrupt withdrawal of wholesale funds led to a vicious cycle of distressed sale of assets, falling asset values, shortages in capital adequacy and difficulties in raising fresh capital from the private sources the Asian banks were not susceptible to a sudden shift in investor sentiments.

Fourth, the central banks in EDEs had developed the capacity to draw the rules of the game and enforce them in a way that was orderly and least disruptive. The quality of banks' portfolio had improved as a result of the central banks' vigilance and continuous watchdog functions. Mark-to market accounting, loan-loss provisioning and capital infusion helped the strengthening of the banks.

Fifth, the banks' lending in the EDEs avoided exotic products such as derivatives, loans to hedge funds, private equity, credit default swaps, and securitization did not figure much in their portfolios. The banks thus retained relationship with the borrowers throughout the credit cycle and manage the risks prudently. Excessive risk taking was thus discouraged and although it was resented at the time as too much intrusion and micromanagement, this approach proved to be an ultimate savior of the system.

Sixth, partial capital controls and lack of full Capital Convertibility in China, India, Pakistan and Bangladesh did not allow large exposure to foreign currency denominated assets. The market share of the large financial conglomerates (that were too big to fail) was kept limited by design and therefore direct exposure of the significantly important financial institutions to global financial markets was quite low.

Seventh, as the markets in EDEs are generally considered imperfect, or incomplete and the market failures loom large on the horizon the intellectual foundation of the contemporary financial theory – efficient market hypothesis – did not assume as pivotal a role as in the developed markets and therefore did not lead to the widespread belief and practice in 'Market is self correcting' and therefore a hands off approach by the regulators.

Ross Levine has argued that failures in the governance of financial regulations helped cause the global financial crisis. According to him there was a fatal inconsistency between a dynamic financial sector and a regulatory system that failed to adapt appropriately to financial innovation. Levine's main thesis is that "financial innovations, such as securitization, collateralized debt obligations and credit default swaps, could have had primarily positive effects on the lives of most citizens. Yet, the inability or unwillingness of the governance apparatus overseeing financial regulation to adapt to changing conditions allowed these financial innovations to metastasize and ruin the financial system."¹

While agreeing with the broad thrust of the above argument as far as the DEs are concerned the differentiation presented above shows that financial regulation cannot be considered in isolation from the larger questions of market structure, financial institutions, financial infrastructure and overall macroeconomic framework of a country. The U.S. and European failure in regulation and supervision cannot be ipso facto applied to Pakistan or other EDEs without examining the context and addressing these questions. How do these factors impinge upon regulation?

Market structure consists of the degree of competition and interlocking control between financial institutions and business enterprises as well as the degree of specialization within the financial sector. It is influenced by the internal organization, management and governance structure of financial institutions. These, in turn, are affected by the degree of government ownership and control.

A well developed technology driven financial infrastructure such as laws, payment system, accounting and auditing can aid or hinder the efficient functioning of the financial system. The overall macroeconomic framework particularly monetary stability, fiscal prudence and realistic exchange rate is a powerful anchor of the regulations. The higher is the reliance of the government on the banking system the weaker is the effectiveness of the regulatory framework.

The regulatory framework in a particular country has therefore to be designed in light of the prevailing market structure, the state of the financial institutions, the condition of financial infrastructure and the overall nature of macroeconomic policies. This framework should be broad enough to include regulations imposed both for monetary policy as well as prudential purposes. The test of an adequate regulatory framework is whether it can help ensure financial stability by reducing

¹ Ross Levine (2010): "The governance of financial regulation: Reform lessons from the recent crisis", *BIS Working Papers* 329, November.

the probability of bank failures and the costs of those that occur. Regulation is primarily about changing the behavior of regulated institutions because unconstrained market behavior tends to produce socially sub-optimal outcomes. The regulator therefore has the responsibility to move the system towards a socially optimum outcome.

The strategy that is followed by the State Bank of Pakistan is multi-pronged i.e. to improve the market structure and competition, to strengthen the governance and risk management within financial institutions, to build up an adequate financial infrastructure and to contribute to sound macroeconomic management through monetary and exchange rate policies. The partial or uneven success in attaining the last goal particularly in the last three years can be ascribed to the weakness in the fiscal policy.

The steps that have been taken to stimulate competition and improve the market structure consist of lowering entry barriers, abolishing interest rate ceilings, privatizing government owned banks, promoting mergers and consolidation of financial institutions, enlarging the economies of scope for banks, liberalizing bank branching policy and removing direct credit regulations.

In the realm of financial institutions strengthening, incentive structure is so designed that the bank owners stand to make substantial losses in the event of insolvency arising from excessive risk taking. Capital adequacy requirements and loan loss provisions fulfill this role. Limiting bank holdings of excessively risky assets, preventing lending to related parties, requiring diversification and making sure those banks have appropriate credit appraisal, evaluation and monitoring procedures in place are all driven by this consideration.

Corporate governance code and best practices have been prescribed for the banks by the SBP. Adverse selection in bank entry is avoided and the individuals likely to misuse bank do not get bank licenses. Fit and proper criteria and character stipulations, financial back-up and past track record are scrutinized carefully for the controlling shareholders, directors of the boards, chief executives and senior management of the banks.

One of the positive developments in Pakistan's financial infrastructure has been the evolution of the payment system from the traditional cash and paper-based modes of payments to a network of more sophisticated, technologically driven systems. "Although cash continues to be the dominant mode of settlement of payments especially in rural areas, non-cash modes of payments have increased in

volume over time”². The banking sector has invested heavily in IT infrastructure in the last decade that has resulted in increased acceptance of e-banking as the preferred retail payment instrument. As of end June 2010, the number of real-time on-line branches constituted 73 percent of total bank branches and 31 percent of total electronic transactions. ATM-based transactions are gaining popularity and now account for over 50 percent of electronic transactions. These electronic transactions constitute one third of the total transactions and have grown by 22 percent compared to paper transactions that grew at about a rate of 2 percent only. Similarly, the implementation of the Real Time Gross Settlement (RTGS) system by the SBP has facilitated automation of large value transactions thus reducing the settlement risk. The legal infrastructure in Pakistan however remains weak and is a hindrance to financial sector growth. Reforms and legal infrastructure and enforcement are therefore necessary.

Last but not the least is the macroeconomic imbalances in fiscal and external accounts spanning over last three years that pose system-wide challenge to financial stability in Pakistan. Large public sector borrowing to finance budgetary deficits as well as losses of state-owned enterprises has added to the vulnerabilities of the banking system. The smugness of the banks who charge higher than market prices for activities such as commodity financing have shifted to low risk weighted assets in their portfolio by lending to the government and thus showing higher capital adequacy ratios and larger profits could have serious repercussions on economic growth, employment, financial inclusion and price stability in the future. This is the sore point that has put the financial stability most at risk.

The way forward

The way forward should be paved by paying serious attention to correction of macro-economic imbalances, particularly fiscal deficit. Unless substantial additional tax revenues are mobilized and loss making public enterprises are privatized the situation is likely to remain highly precarious. It is only when fiscal position is restored to a sustainable level, future financial system would boost investor confidence. Financial system is based on trust and can only flourish if government ensures fiscal prudence and transparency. In this sector the collapse of an individual institution harms not just the shareholders and employees of that institution but a host of other innocent by-standers. This systemic risk makes the financial sector quite unique and distinct.

The rationale behind financial deregulation that freer markets produce a superior outcome does not work in actual practice because lending is more pro-cyclical and

² State Bank of Pakistan (2010), Financial Stability Review 2009-2010 (December).

downturns are more severe. While the need is to restrain excessive risk taking in upturns and discourage excessive conservatism when credit to companies and households is most needed the banks lend far too much in the upturns and far too little in the downturns. In the boom, borrowers' credit worthiness looks promising, the value of assets goes up and lenders are willing to accept a broad range of collaterals. Cheap availability of credit encourages leverage which further boosts asset prices that, in turn, leads to further leverage. In the downturns, borrowers have to cover up the short fall arising from the falling asset prices and have to come up with more collateral. Forced sales of assets further weaken the borrower's capacity as the realized prices are only a fraction of the face value. Regulations on capital ratios force greater prudence in booms and cushion deleveraging during a bust.

In order to avert the systemic risk to the global financial system a clear and well coordinated regulatory system has therefore to be put in place. The regulatory arbitrage that so visible in case of the U.S. has to give way to a strong body that is responsible for regulating and supervising all systemically important financial institutions irrespective of the nature of their business or product range. The U.S. regulatory architecture was, according to Hank Poulson, "a patchwork of financial regulatory agencies with uneven and inadequate treatment and enforcement".³

In case of Pakistan, regulatory and policy reforms in the financial sector that began in early 1990s have made a difference which helped the country weather the shocks of 2008 crisis. But it is equally important that we do not remain complacent but prepare ourselves for the future challenges. This paper, building upon the strong foundations of Pakistan's regulatory framework, suggests that there are at least nine such issues that have to be confronted and addressed in the future. In some cases such as the first issue – who is responsible for financial stability – there are no clear cut answers but in others such as extending the reach of financial sector through diversification and financial inclusion, specific measures are known but implementation is lagging behind. These nine critical issues which together form the way forward are discussed in the following paragraphs:

i) Who is responsible for financial stability?

The global financial crisis has taught the lesson that the focus of central banks has to expand from only monetary stability to encompass financial stability. The challenge for the central banks, rooted deeply in past traditions and practices that emphasized inflation and inflation targeting, is to determine how

³ Hank Poulson (2009), Wire News Stories.

best this twining can be done without overwhelming their capacity. Whether the central banks can have the sole responsibility for financial stability or they should contribute towards it along with other players is an unsettled question. What the recent experience has shown that in the event of a crisis the central bank is the first port of call for troubled banks. As a lender of last resort, overseer of the payment systems, provider of liquidity into the financial markets and supervisor of individual banks the responsibility for macro prudential oversight or financial stability ought to reside in the central bank. But it must also be recalled that it was the fiscal authorities that took the lead during the recent crisis by making substantial capital injections, purchasing toxic assets, and providing guarantees of all kinds. Ultimately the lender of last resort obligation is also discharged by the government.

Fiscal-Monetary Coordination Board provided under the SBP Act could fulfill this responsibility but collective mechanisms such as Boards and Committees dilute responsibility and are notorious for slow and delayed actions while the resolution of crisis situations required timely and prompt responses. It is therefore not obvious as to where the responsibility for financial stability can best be located. This question needs further examination and analysis based on empirical evidence.

ii) Risks of over-regulation

One of the natural responses to the recent crisis is to bring about new forms of regulations and regulatory agencies to fill in the gaps and overcome the weaknesses deficiencies in the existing system. This can, however, be taken too far. It is true that the shadow banking system in the U.S. has to fall in line with the banking system, systemic risk arising from “too big to fail” financial institutions has to be contained and consumer protection has to be paid attention. But a proliferation of oversight functions accompanied by new capital and liquidity requirements may impose additional costs upon the system. There is a danger that financial innovation may be shunned and the pricing of credit due to the additional regulatory burden may fortify the trend toward financial exclusion, i.e. more households and businesses withdraw from borrowing as their cost of funding becomes exorbitant due to cost of these new regulations. Pakistan has therefore to be careful in designing new regulations as the coverage of regulatory waterfront is quite extensive and there are no apparent significant holes. The shadow banking system in Pakistan is theoretically covered by extensive regulations. It is another story that in practice there is a wide gap between the supervision of the banks and non-bank financial institutions. But this should not lead us to the wrong path. We don't have to necessarily follow all that Dodd-Frank legislation or the EU

rules are going to stipulate and prescribe. With very little space for financial innovation available in this country, treading on the path of the U.S. or Europe would do great harm by destroying even this limited space and shutting doors for sensible and benign innovations in the future. Basel III has to be applied not mindlessly but after testing, adaptation and modifications to suit Pakistan's own requirements.

iii) Consolidation of regulation and supervision

The relationship between regulators and consolidated financial institutions will be impacted by the relative skills, organizational capacity and managerial abilities of the regulatory and supervisory bodies. The SBP has over time equipped itself with the skills, capacity, enforcement and decision making tools and, technological resources that places it ahead of other regulatory bodies. The cultural change that has promoted the values of merit, integrity, reward for performance and competitive levels of compensation have minimized the risks of regulatory capture. On the other hand, the SBP has evolved a trusting partnership with the banks a collective body where it consults and listens to their viewpoints before making policies, rules and regulations. At the same time it does not hesitate in taking stern and strong penal actions against individual banks found guilty of infractions and violations of the regulations. The Supreme Court's historic verdict of upholding the governor's decision to suspend the first ever banking license in the history of the country has conferred a powerful instrument in the hands of the SBP and has thus created a strong deterrence effect. The new legislation pending with the Parliament will further enhance the legal powers of the SBP for disciplining the recalcitrant owners and managers of the banks. On the other hand, the SECP that has been given the task of regulating and supervising non-bank financial institutions (NBFIs) – 5-10 percent of the total assets of the financial system – has not been able to equip itself so well. Thus, in cases where financial conglomerates are emerging on the scene which would bring banking, investment banking, asset management, insurance, etc., under one umbrella there is an urgent need to have a consolidated regulator and supervisor. Leaving aside the turf fights an objective appraisal would suggest that this function can best be performed by the SBP. In defense of this argument we can draw comfort from the fact that the new coalition government in U.K. has decided to abolish FSA and give back the regulatory powers back to the Bank of England.

iv) Legal infrastructure

Despite the fact that Pakistan has a Banking Companies Ordinance in force for quite some time, separate banking courts and tribunals to adjudicate the cases,

a Banking Ombudsman to settle disputes between customers and the banks and the National Accountability Bureau to take action against those indulging in malfeasance the legal infrastructure for financial sector has been found wanting in many respects. Billions of rupees of loans are stuck because of the protracted litigation, delays, adjournments and stay orders granted by the courts. Where the decrees have been awarded in favor of the banks the speed of execution is too slow and recovery quite poor. A new Foreclosure Law that enabled the banks to recover their dues without recourse to the courts in certain instances has become ineffective as one of the Courts has suspended its operation. Bankruptcy Law that should have come into effect to allow orderly settlement of bank loans at the time of the cessation of ongoing concern has not yet seen the light of the day. The SBP Act that strengthens the legal and enforcement powers of the central bank has not yet been passed by the Parliament. The Act on De-mutualization of stock exchanges that will remove the conflict of interest in the governance and ownership structure of the stock exchanges is kept pending due to pressures from vested interests. These weaknesses in the legal infrastructure are a major impediment in the way of financial sector efficiency and outreach and have to be removed sooner than later.

v) *Credit rating agencies*

Another glaring example of infrastructure deficiency exposed by the recent crisis is the inherent flaw in the well established credit rating agencies that have driven the process of risk management in the financial sector. The sub-prime mortgage market was fuelled by the credit rating agencies certifying securitized tranches of individual loans of weak credit to be safe. The financial institutions such as the insurance companies and hedge funds bought these securities because of this certification. Until the 1970s the credit rating agencies sold their assessments of credit risk to their subscribers only. But regulatory change introduced by the U.S. SEC in 1975 allowed that the credit risk assessment of these agencies would be used in establishing capital requirements on SEC regulated financial institutions. This change was adopted by other regulators, official agencies and private institutions for the issue of securities, private endowments, foundations and mutual funds for asset allocation. Naturally, this led to an expansion in the demand for credit ratings by these agencies. These credit rating agencies shifted their business model from selling to subscribers only to selling to issuers of securities. This conflict of interest, it was argued, can be contained because the companies would care for preserving their reputational capital which would suffer if they indulged in malpractices or misuse in awarding ratings. However, this theoretical assumption proved to be wrong as the explosive growth of

structured and securitized financial products particularly their packaging and rating intensified the conflict of interest problem. In Pakistan, there are only two rating agencies but limited competition and conflict of interest considerations dictate that a more robust and reliable system has to take its place.

vi) *Minimum capital requirements and capital adequacy*

The Minimum Capital Requirements (MCR) and Risk-Weighted Capital Adequacy Ratios (CAR) should be interpreted carefully and linked to the purposes for which they have been devised. The banks are obliged to meet minimum levels of capital to reduce the costs if the banks fail. They also should have a capital buffer to continue their operations when they suffer losses. The MCR is a signal for the weak banks with low equity capital, poor human resources, rudimentary technology, limited network, fewer products and services that these banks will have either to increase their equity capital base or merge with other banks in order to survive or exit from the industry. About twenty banks in Pakistan account for more than 90 percent of banking business while the remaining twenty for less than 10 percent. These weak banks are highly vulnerable to exogenous shocks and their failures can cause tremors for the banking system imposing unnecessary burden on public finances (in case it is decided to bail them out) or on their depositors who may lose faith in the banking system and could trigger a run on other banks deposits. In all fairness, owners and shareholders of these banks ought to bear this burden and MCR stipulation is aimed at transferring this burden to the shareholders in the event of bank failure. Capital Adequacy Ratio (CAR), on the other hand, establishes the link between equity capitals the bank holds in relation to its assets that have different risk weights. An observed rise in the CAR without understanding its underlying dynamics may lead to misleading conclusions. In Pakistan, the aggregate risk-weighted CAR of the banking system has risen to 14 percent as compared to the minimum required ratio of 10 percent. This change in the ratio may give a false impression to a naïve observer that the capital strength of the banks has improved. In actual fact, this higher observed ratio has risen due to a shift in the asset composition of the banks away from riskier private sector loans to zero or low risk weighted lending to public sector agencies, quasi-fiscal financing and investment in government securities. This distortion in the allocation of bank's assets away from productive sectors to financing government deficits is nothing to be celebrated about and as a matter of fact should be discouraged.

vii) *Financial inclusion and diversification of assets, products, services and customers*

It is a matter of concern that there has been a slowdown in financial deepening in Pakistan in the recent years. M2 to GDP ratio that had risen from 36.6 percent to 46.7 percent by FY07 has fallen to 40.1 percent by FY11 and private sector credit to GDP ratio that had reached 28.5 percent in FY07 from 17.8 percent is now down to 20.6 percent. Consequently, accumulated financial savings as a proportion of GDP have fallen from the peak of 67.4 percent to 53.1 percent and domestic savings ratio from 18.1 percent to 9.9 percent.⁴ These trends are disturbing as they imply increased dependence on uncertain, highly volatile foreign savings and / or a reduced level of investment rate. In an economy that has been stagnating for last three years it would be highly damaging if the investment rate is allowed to decline and GDP and per capita incomes consequently stagnate.

The injection of almost Rs.300–400 billion in the rural economy through higher producer prices of major agricultural crops and livestock products in last two years can be tapped by the banks and financial institutions as a source of financial savings. Of course, a large chunk of this will translate into additional purchasing power that will propel demand for consumer goods but at least one-third of the additional incomes can be mobilized in form of savings by microfinance banks, specialized banks, mutual funds and rural branches of commercial banks. The mobilization of these savings can also be used by the financial institutions to diversify their assets, products, services and customer base making greater use of easily accessible technology such as mobile phones. This will not only avoid concentration of risks in particular sector or counter parties but diversified portfolios suffer lower losses. “Large segments of the economy, population and geography remain underserved by the organized financial system. There is need to extend the reach of the financial system and better serve small entrepreneurs and households, especially in the SME, agriculture and service sectors which account for most of the country’s GDP and employment generation but presently receive a relatively small share of total credit”⁵. The objective of financial inclusion can best be served by penetrating these geographical areas that have not so far been reached by the financial institutions. Islamic banking, low cost housing finance and microfinance are the attractive routes through which the aim of financial inclusion can be served. There is a growing demand for Islamic

⁴ State Bank of Pakistan (2010), *Financial Stability Review 2009-10* (December).

⁵ State Bank of Pakistan (2008), *Pakistan 10-year Strategy paper for the Banking Sector Reform*.

Microfinance with attractive products that can cater to the needs of those at the bottom of the pyramid.

Infrastructure financing and housing finance are other products which have not yet taken off in Pakistan. There is a real problem for the banks of mismatch between their short term deposits and long term loans for these sectors. But REITS, pension funds, provident funds, endowment funds, municipal bonds, insurance companies and long-term Islamic Sukuk can resolve this problem and fill in the gap. The progress in this field has so far been too slow. A more proactive regulatory stance is badly needed to nurture these two types of products.

viii) Risk management

The crisis also revealed clearly that the models used by the banks and financial institutions to capture the real risks were either flawed or inadequate. There was not sufficient available data in regard to the new instruments. The behavioral relationships based on the past observed data proved to be unstable or invalid under the pressure points triggered by the crisis. The underlying assumptions and the estimated probabilities turned out to be wrong. Sudden, abrupt and quantum changes in asset prices and their consequences for liquidity and solvency were never taken into account in these risk models. Underestimation of optimistic calculation of risks also led to under pricing of risks, a more relaxed credit extension regime and unsustainable leverage levels. With the hindsight, after the enormous damages were caused to the financial system across the globe it became apparent that if that the models used by the financial institutions were correctly calibrated they could have revealed amplification rather than mitigation of risks.

In Pakistan, risk management is still in its infancy and therefore it won't be too difficult for the regulators to introduce new risk measures such as leverage ratio and new risk models. The limited leverage ratio would make it difficult for the boards managements and others to indulge in excessive risk taking on the strength of borrowed money. The allocation of risks between the owners and shareholders of the financial institutions and the society, particularly tax payers, would thus undergo a change. Under Basel III rules, capital requirements for trading book exposures, complex securitizations and exposure to off-balance sheet vehicles have to be enhanced substantially, for better risk coverage

ix) Capacity building of regulator

It must be remembered that the change of ownership from public sector owned and managed to privatized banks, imposes new burden on the regulators. As the private owners and managers of the banks have limited stakes of their own (6 to 8 percent of equity in the total capital available for deployment) they can take excessive risks with depositor's money. The upside potential from this excessive risk taking will be appropriated solely by the owners (large dividends) and the managers (high performance bonuses) but the downside risks will fall upon the shoulders of the depositors or the state. The regulator has thus to remain vigilant all the time to ensure that the private owners and management of the banks do operate within the defined risk parameters, observe the standards, guidelines and codes diligently, comply with prudential regulations and norms, follow the best corporate governance practices and do not deviate from the instructions given from time to time.

The competencies and caliber of the staff working in the regulatory institutions, the use of technology to produce an updated management information system on real time and the re-engineering of business processes and systems are the tools whereby the regulators can remain on the top of the potential problems.

The other challenge for the regulators in the coming years will be to keep pace with the financial innovations and comprehend the risks involved in these complex products. The tendency to keep all these complex products off the market may be an easy way out, but a serious damage will be done to the growth of financial markets and products that may retard the process of competitiveness and efficiency in the financial sector. The way forward is to develop capacity within the SBP to understand and assess the content, characteristics, embedded risks and the accounting of this ever growing array of financial instruments particularly derivatives, hedge products and other similar products that are likely to appear in the future. The regulators have to insist that there are common standards for valuation of assets and liabilities (whether mark-to-market accounting should be applied across-the-board) and there are common yardsticks for measurement. The transparency and disclosure standards have to be kept under constant watch and suitably up-graded so that the innovations are obligated to furnish the full range of information required evaluating the risks. While the regulators should not stifle financial innovation from flourishing, they should have the capacity to understand the risks and make the market participants aware of these risks.

Conclusion

Pakistan's regulatory framework has withstood the test of time well since the reforms were implemented. But as time passes it had to be modified and strengthened to meet the future challenges in a way that it does not stifle innovation and growth, does not severely raise the cost and access to credit and does not constrain the process of financial inclusion. Nor should it be so rigid that it enables the market players to circumvent the regulations and pursue alternatives that are less desirable. A balancing act, quite difficult to achieve in practice, will be required to meet the objectives of financial stability, growth and financial inclusion.

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