Reforms of Public Sector Banks – Case Study of Pakistan [1]/

ISHRAT HUSAIN

The reforms of public sector banks in Pakistan should be examined in the overall macroeconomic context, against the backdrop of the financial sector reforms implemented during the last decade and the strengthening of the Central Bank's capacity to regulate and supervise these banks. It is only when the macroeconomic situation took a turn for better, the financial sector reforms were vigorously pursued and the State Bank of Pakistan achieved autonomy and competence that the public sector banks began to show some demonstrable results. Unless these pre-requisites are in place it is hard to imagine that any meaningful progress could have been possible.

This paper is divided into five sections. The first section briefly summarizes the macroeconomic situation. Section II describes the financial sector reforms while Section III focuses on the Central Bank's Capacity building efforts. The main theme of the paper i.e. Reforms of Public sector banks is discussed in Section IV while the concluding session offers some lessons for other developing countries.

I. Macroeconomic Context

Banking sector reforms can not be successfully implemented and sustained in absence of a favorable and stable macroeconomic environment. Pakistan's track record in macroeconomic management and

---

[1]/ A paper prepared for the World Bank Conference on "Transforming Public Sector Banks" at Washington D.C. on April 9, 2003.

governance during the 1990s has been dismal. The new government which came to power in October 1999 embarked upon a serious program of macroeconomic stabilization, structural reforms, good governance and establishing credibility with the international financial institutions. Despite several major exogenous shocks including September 11, mobilization of troops on the Indian borders, severe drought and domestic violence the country has been able to make a dramatic turnaround in its economic indicators. Fiscal retrenchment of about 3 percentage points of GDP and primary surplus on budget, inflation down to 3.5 percent, current account turning surplus, debt indicators moving in the direction of sustainability, foreign reserves rising from $ 1 billion to $ 10 billion covering almost one year's imports, lowering of interest rate structure, exchange rate appreciating by 6 percent rather than following the historical 10 percent annual depreciation, record growth in workers' remittances and Foreign direct investment likely to reach the $ 1 billion mark amply demonstrate the seriousness of the efforts made during the last three year period. GDP growth rate is inching forward to 4.5 percent this year and is expected to reach 6 percent in the next two years. This will have an impact on reduction of poverty which has doubled during the decade of 1990s. The progress in trade and tariff reforms, tax administration, financial sector, privatization and deregulation has been quite significant but it is still a long way to go before it makes a difference. Corruption at higher levels of decision making has almost disappeared as strong accountability mechanism was able to secure successful conviction of several hundred politicians, senior bureaucrats, business men who were previously untouchable. Devolution of administrative, functional and financial responsibilities and powers to local governments despite teething problems is beginning to show desirable results as far as choice of development projects is concerned. Civil Service, Police and Judicial reforms are underway but will take some time to took hold. Poverty targeted interventions and social sector development has been given high prio rity and poverty reduction has been recognized explicitly as a major policy objective unlike the past where it was swept under the rug.

Pakistan has, successfully completed the stand-by program with the IMF in 2000-01drawing all the three tranches on time. It is currently implementing the medium term Poverty Reduction and Growth Facility (PRGF) and has so far drawn six tranches on time under this facility. It is for the first time that the country, known as a one-tranche country, has demonstrated such higher degree of responsible performance and adhered to the course steadfastly notwithstanding most difficult internal and external conditions.

Table I summarizes the changes in the major macroeconomic indicators between October 1999 and October 2002.

II. **Financial Sector reforms**

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.

Although the World Bank assisted reforms in the financial sector initiated in early 1990s had made some headway the situation deteriorated in the mid 1990s.

The World Bank's assessment of the financial sector aptly summarizes the situation prevailing at that time: "In late 1996, Pakistan's banking system was on the verge of a crisis. Non performing loans had reached alarming proportions. Liquidity problems had begun to emerge as disintermediation spread and banking losses mounted. Most cases of loan defaults remained unresolved in an ineffective court system. Political interference vitiated the financial intermediation function of the banking system and borrowers expected not to repay loans they took, specially from the state-owned banks. Overstaffing and over-branching and undue interference by labor unions in bank personnel and operations resulted in large operating losses. Poor disclosure standards abetted corruption by window-dressing the true picture of banks". (World Bank, Financial Sector update, May 31, 2000)

The foreign exchange market was highly regulated by the SBP through a system of direct 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.

Reforms were pursued vigorously since 2000 and covered seven important areas: financial liberalization, market-based pricing, development of long term instruments, dealing with non performing loans, revision of banking laws, strengthening of Corporate governance.

First, liberalisation of the financial sector has been the major policy agenda of all Governments since the late 1980s. Since then, various reforms were undertaken to enhance efficiency of the financial system to keep pace with the global developments. These reforms were aimed at reducing segmentation of financial markets, introducing competition in the financial sector, strengthening capital base of financial institutions and switching over to indirect, market-based and relatively more efficient monetary and credit policy. Many of the results of liberalization so far have been impressive. This sector which was fully dominated by nationalized commercial banks has been opened up to the private sector and 14 new domestic private commercial banks and 16 private investment banks have been established. In addition, there are 19 foreign commercial banks operating in the country. Three out of the five nationalized commercial banks have been privatized. By December, 2002, the share of nationalized commercial banks in total deposits has shrunk to 37.8 per cent while their share in total loans and advances has also declined to 41 per cent. It must, however, be conceded that since 1997, these banks have carried out more aggressive and pro-active marketing. If Habib Bank is successfully privatized this year the market share of public sector banks will decline to 20 percent and 80 percent banking assets will be under the control of the private banks. This is a remarkable feat for a country which only a decade ago had almost 90 percent of banking assets under Government Ownership and Control. A few countries in the region have accomplished such a feat.

Second, pricing and remuneration for most of financial services are now determined by banks on competitive basis. There are no directions from the State Bank of Pakistan. There were subsidized lending rates for priority sectors and the rate paid by the Government on its borrowing through the banking system was artificially pegged at below market rates. Banks and other financial institutions are now free to set their lending and deposits rates. Although this raises a different set of issues for borrowers and depositors, at least the arbitrary control of the State Bank has been eliminated. Government has to pay market based interest rates on debt raised through the banking system.

During last three year, significant reform has taken place in the National Savings Scheme (NSS) which was creating some distortions in the financial system. Institutional Investors have been debarred from participating in the NSS. Second, the rate of return has been linked to the market determined benchmark i.e. Pakistan Investment bond yields. Third, tax exemptions have been eliminated except for those at the lowest end of the spectrum. Further reforms of NSS are underway.

Third, the sources of long-term financing for investment had gradually dried up in Pakistan, as the Development Financial Institutions such as NDFC, IDBP etc., were no longer able to provide large volumes of credit. Foreign lines of credit are also no longer available. We were faced with a paradoxical situation whereby institutional investors such as Insurance Companies, Benevolent Funds, Pension Funds were desirous of a market based long-term paper in order to avoid the high transactional costs involved in rolling over their investment in short term paper. But the sponsors of investment projects had difficulties in accessing long tenor funds except to approach the commercial banks. To fill in this gap, the State Bank launched the long-term paper of varying maturities. This paper i.e. Pakistan Investment Bonds serves as a bench mark for the yield curve for Corporate Debt Market.

Corporate debt in form of Term Finance Certificates have doubled in last one year and reached almost a level of Rs 28 billion ($ 500 million). The pace has accelerated and Rs 10 billion of new issues were floated in FY 02 (US $ 170 million). This is still an insignificant amount in relation to equity market but the rate of growth is very encouraging. These bonds are not redeemable before maturity but are allowed to be traded freely in the secondary market. Secondary market activity would also be strengthened as and when tradable detachable coupon option is introduced.

Fourth, the nationalized commercial banks and development finance institutions have been facing the increasing quantum of non-performing assets. Some of them are willful and reflects collusion between the bankers and the borrowers at the expense of the poor savers and honest loan payers, while the others may be due to Government's inconsistent policies, pure commercial setbacks or external shocks and inability of the entrepreneurs to adjust against the increasing competition in markets. This large stock of NPLs has not only negatively affected the balance sheet of the large banks but also considerably affected the industrial sector of the country as many viable units had to be shut down.

The quantum of non-performing loans(NPLs) by the end of December, 2002 amounted to around Rs. 266 billion an increase of Rs. 45 billion from Rs. 221 billion in end December, 1999. As a ratio of gross advances these NPLs account for 24.9 percent compared to 25.7 percent three years ago. But as the provisioning against these loans has been enforced rigorously the net NPL to advances ratio has declined to 12 percent from 16 percent.

The factors responsible for this increase in the quantum of non-performing loans as well as the ratio and the associated provisioning requirements need some elaboration:

(i) The State Bank of Pakistan has introduced and enforced more rigorous standards for classifying loans including additional classification for non-recovery on due date so that the balance sheets of the banks are strengthened and the overall health of the financial sector is improved.

(ii) The valuation methods of collaterals underlying the classified loans have been brought in line with international practices. The banks can now take into account only the minimum realizable value of assets mortgaged or pledged for determining the provisions. The realizable value shall be the value that could currently be obtained by selling the mortgaged/pledged assets in a forced/distressed sale conditions. This mark-to-market valuation is more meaningful than the previous system which overstated the value of collaterals pledged by the borrowers and invariably provided an optimistic picture for risk management purposes. The banks have been asked to earmark additional provisions against the revised valuation of collaterals and thus strengthen their balance sheets.

(iii) While the five major domestic Commercial Banks have brought down their non-performing loans from 36.8 per cent of total advances in June, 1998 to 25.8 per cent in December, 2002, the largest single change has been in the category of specialized banks. The non-performing loans of the two banks in this category have risen from Rs. 19.3 billion to Rs.78.8 billion due to a significant change in the basis of reporting. Some of the public sector specialized banks were reporting only default or overdue portion of their non-performing loans instead of total outstanding amount of such loans. This adjustment has resulted in addition of Rs. 45 billion of loans being classified as non-performing loans which were not shown as such in the period prior to September, 2000.

A multi-track strategy is being followed to address the issue of stock of NPLs. First, **Corporate & Industrial Restructuring Corporation** (CIRC) has been established through an ordinance promulgated on 22nd of September 2000. The Corporation has been empowered to take over the non-performing assets of the nationalized commercial banks (NCBs) and development financial institutions (DFIs) exceeding Rs. 30 million and to ultimately liquidate non-performing assets and stuck up loans by auctioning the underlying physical assets to the highest bidder.

Second, a Committee has been formed to restructure those units which are non-operational due to unsustainable debt burden but are otherwise financially and economically viable. By extending the maturity, grace period or partial remissions, the Committee is making attempts with the voluntary cooperation of the borrowers and lenders to find solutions that can result in resumption of debt servicing. Third, the Central Bank has issued guidelines under which long standing loans in the loss category with almost zero probability of recovery can be written off in a transparent manner to the extent that there is a shortfall between the proceeds realized from sale of collaterals and the amount outstanding on the books of the banks. Fourth, those found willful defaulters are referred, after a due process of law, to accountability courts.

Fifth, there is almost a consensus that enforcement of financial contracts cannot take place unless the legal and judicial process is strengthened. The banking courts system needs to be revamped and reoriented to facilitate loan recovery more expeditiously. Training of judicial officers assigned as heads of banking courts was held by the State Bank and infrastructure, logistic support to the banking court is being strengthened. These measures will help in the disposal of the backlog of cases.

The recovery laws themselves should facilitate the process of mortgage foreclosure and early settlement of banking disputes. On the request of the State Bank, the Federal Government constituted Banking Laws Review Commission in April 2000 to review the legal problems and legislative needs of the financial sector, modify the existing legislation regarding the financial sector where required and to propose drafting of new laws.

One of the major pieces of new legislation which has been enacted is the Foreclosure law. This law will help in the repossession of property by the banks and facilitate growth of mortgage financing. A new law on Bankruptcy has been drafted and circulated for stake holder consultation.

III. Strengthening the Capacity of the Central Bank

The capacity of the State Bank of Pakistan in supervision and regulations of banks has been upgraded significantly during the last four years and radical improvements have been brought about in the supervisory methodology. In this regard, a number of initiatives have been taken to follow a risk based supervision approach which is based on internationally recognized **CAMELS framework** for off-site and on-site evaluation of risk inherent in the activities of banks. The initiatives taken to strengthen the supervision and prudential regulations are described below.

(a) To strengthen the capital base of banks and achieve international consistency, the SBP has enforcing the Basle system of defining **minimum capital requirements** for banks. All banks are required to maintain capital and unencumbered general reserves, the value of which is not less than 8% of the risk weighted assets. Recently, **minimum paid-up capital requirement** for banks have been doubled from the existing Rs. 500m to Rs. 1 billion (US $ 17 million) and this goal was achieved by end-December 2002. A banking company which is unable to meet the capital requirement shall stand descheduled and converted into a non-scheduled bank. Similarly, the minimum capital requirement for investment banks and housing finance companies/discount houses has been raised to Rs.500 million and Rs.300 million respectively.

(b) Banking supervision is designed to ensure that banks operate in a safe and sound manner. It is traditionally carried out through a combination of both off-site monitoring and on-site inspections. The SBP is carrying out **continuous off-site monitoring** through periodic reports submitted by banks to identify those institutions which reflect a high probability of financial difficulty so that policies and corrective actions can be designed and implemented at once. On the basis of these reports, quarterly off-site surveillance report of each bank is generated wherein their performance is evaluated under the CAELS framework which involves analysis of five-group of indicators such as Capital, Asset quality, Earnings, Liquidity and

Sensitivity to other risks. Early detection of banking crisis or identification of a problem bank is a prerequisite for an effective banking supervision. Although no system can guarantee non-occurrence of bank failure, a good supervisory system can reduce the. probability of such events. Timely identification through early warning indicators facilitates timely detection leading to prompt corrective actions.

(c) Timely and **effective enforcement actions** are amongst the key functions of supervision of financial institutions. Recently, this function has been revitalized through implementation of the observations outlined in the on-site inspection reports prepared under the newly introduced CAMELS rating system. SBP's inspection skills have improved with the recruitment of young professionals and training imparted through an international consulting firm. The on-site inspection reports received are more specific and focused than before thereby facilitating specific and targeted remedial actions. Based on the ratings allotted to the various financial institutions, enforcement actions are initiated depending on the severity of the ratings. Institutions showing adverse ratings are required to submit time bound action plans.

The enforcement action has been institutionalized with the introduction of a comprehensive problem bank manual and on-site inspection manual. These manuals provide guidance for detailed diagnosis and enforcement actions. Implementation of these manuals has only started recently and will take some time to take full effect.

(d) Globalization of financial and capital markets has created pressure for truly **international accounting standard**s, including disclosure requirements. These pressures for change come from users and practitioners of financial statements as well as from regulators and international agencies. SBP has also adopted the international accounting standards, and the banking companies are required to prepare their financial statements in accordance with these standards effective from year ending 31 December, 1997. Under these revised forms of financial statements it is now mandatory for the banks to report the details of the parties and the amounts of the loans which have been written off during the year. They also have to disclose provisions made for bad and doubtful debts. Compliance with these standards coupled with thorough audit by the external auditors can increase the credibility of financial statements. However, keeping in view the ever-changing nature of the banking business as well as adoption of new accounting standards, the format is being updated to bring about greater transparency and increased disclosure.

(e) To assess the status of compliance by the banks with the **core principles,** all banks engaged authorized audit firms for assessing the status of compliance with core principles prescribed under Basle agreement. The auditors have since submitted their report to the State Bank. The results indicate that majority of the banks are either compliant or largely compliant with most of the core principles. However, some of the banks are lacking in compliance with certain principles and the State Bank is in touch with those banks for achieving the compliant status.

(f) An other important development to improve public disclosure is introduction of credit rating. **Credit rating** is an independent opinion about the credit quality and capacity of an entity to meet its obligation of timely repayment. Credit ratings disclosed to the general public is considered as a measure of transparency and as such it holds immense value for investors, creditors, financial institutions, issuers and regulators alike. Therefore, the entire process of credit rating brings about overall improvement in the financial sector. Accordingly, State bank has made credit rating compulsory for all banks and NBFIs from July 2001. However, branches of foreign banks, whose operations at global level are credit rated by Standard and Poor, Moody's and Fitch-IBCA and have minimum credit rating of A3/A- are exempted from credit rating process in Pakistan. In view of this mandatory requirement, Banks/NBFIs listed on the Stock Exchange(s) will be required to disclose their credit rating to the public besides publication of annual reports.

(g) There was overlap between the SBP and SECP as far as the regulation and supervision of non-banking financial institutions were concerned. The resulting ambiguity and regulatory arbitrage were creating some problems in the smooth functioning of these institutions. The SBP and SECP formed a joint task force which recommended that there should be a clear division of responsibilities between the two regulators. Accordingly, it was decided to transfer the NBFIs to SECP and keep only the banking companies under the purview of SBP. A new model of Non-bank financial companies (NBFC) was developed under which mergers and consolidation of leasing companies, investment banks, asset management companies, discount houses etc. could be facilitated and a cost effective, competitive environment created for NBFCs. The new rules regarding the NBFCs have been notified recently and a spate of mergers and acquisitions is taking place.

(h) The State Bank of Pakistan has been restructured in January 2002 when its retail banking functions carried out in 16 offices throughout Pakistan were hived off to an independent subsidiary. The State Bank and its management are now able to concentrate on the Core central banking functions of monetary policy, supervision and regulation of the financial sector, foreign exchange management and payment systems. Technology up-gradation by automating its processes and data bases, human resource development by embarking on recruitment of professionals and massive training of all staff, improvement of physical environment to make the working conditions more pleasant and delegation of powers and authority are the key ingredients of this plan for renewal, restructuring and strengthening of State Bank of Pakistan.

In cataloging the above list of initiatives and measures it is implied that we have attained a stage of nirvana. Nor that we should become complacent. In this fast changing and dynamic world of financial liberalization, global market integration and private capital flows it would be imprudent on our part if we do not remain ever vigilant and agile. We have to adapt ourselves to the changing requirements of the banking industry and help them in remaining sound and healthy under varying market conditions and unanticipated exogenous shocks — external or internal. Thus, the agenda for future reforms is even more daunting and challenging than whatever modest achievements we have made so far.

IV. Reforms in Public Sector Banks

In 1974 the dynamic and well functioning banking industry which was larged owned by the private sector was nationalized in the name of breaking up concentration of power in the industrial sector in few hands. This unfortunate decision gave a major setback to the banking sector development in the country but it took more than twenty seven years before the sector was once again opened up to the private sector. By that time, the predominance of public sector in banking and non-bank financial institutions, coupled with the instruments of direct monetary control, had led to financial sector inefficiency, crowding out of credit to the private enterprises, deteriorating quality of assets and rising vulnerability of financial institutions.

At the beginning of the 1990s public sector bank accounted for 92 percent of total assets and almost the same proportion of deposits. “With the government as the main player in the arena, supported by passive supervisors and a few large sized nationalized banks and DFIs, private sector participants were sidelined and financial savings from the households were diverted to the government and priority sectors. There were hardly any markets in the true sense of the word i.e. market where players’ interaction resulted in pricing and cleaning. Financial markets, after nationalization of commercial banks, were not equating the supply of funds according to their demand, rather than a set of distortion was being imposed through the system of financial repression characterized by credit rationing and other controls”. (SBP, Financial Sector assessment, 1990-2000: Karachi, 2002)

In early 1997, the Central Bank and the Ministry of Finance designed and started to implement a banking reform program with the assistance of the World Bank. The aim of this program was to arrest the flow of bad loans, curtail loss making and conserve the assets of the nationalized commercial banks (NCBs) and Development Finance institutions (DFIs) while they were being prepared for privatization. Market distortions were to be reduced to increase the efficiency of financial intermediation and legal and judicial processes strengthened to enable a more effective enforcement of financial contracts.

Seven areas of reforms in the public sector banks – improved governance structure, professionalization of management, internal controls and systems, downsizing of work force, curtailment of irresponsible trade union practices, recapitalization of banks – were undertaken during the last five years.

Since Pakistan's banking sector problems stemmed from a failure of governance and a breakdown of credit culture the State Bank of Pakistan laid great emphasis on improving the governance structure of these banks. The Pakistan Banking Council (PBC) which was set up to supervise the public sector banks and later proved to be the main vehicle for political interference in the affairs of these banks was abolished. The SBP was given the exclusive legal powers to regulate and supervise the public sector banks. The appointments of the Chief Executives and the Boards of Directors require prior clearance by the SBP. The composition of the Board was also changed from serving officials of the Ministry of Finance to reputable individuals of strong caliber drawn from the private sector – academics, businessmen, lawyers, accountants, former bankers etc. The new management was drawn from amongst professionals of highest integrity, competence and proven track record so that they can provide the overall leadership and direction. The fit and proper test has been devised to ensure that the Directors and Chief Executives appointed to lead these banks meet the criteria prescribed in the test. The new management and boards were insulated from undue interference and all new loan approvals were made on the basis of accepted credit appraisal and screening methods.

There was a clear demarcation of responsibilities of the management and the Board. While the Board will formulate policies, monitor performance and oversee the operations it will desist from interfering in day-to-day operations of the banks. The Chief Executive will be responsible and accountable for the operations.

The internal audit, controls and systems were strengthened within the banks along with a more defined role for external auditors. State Bank has developed transparent criteria through which it evaluates the performance of the external auditors. They are then rated and placed in categories A, B and C. The banks of different capital and asset base can appoint auditors from these approved panels. For example, a large size bank can only draw upon the category A. The delisting of two major accounting firms (from among the Big five) by the SBP created a strong demonstration effect in upgrading the quality of external auditors.

The Trade Unions in public sector banks had played a havoc in harassing, black mailing the senior management and indulging in malpractices and corruption. This had not only given rise to widespread low morale among the banking staff but also resulted in financial losses, administrative laxity and poor governance. The Banking Companies Ordinance was amended whereby the illegal activities of these Unions were curbed. This had a salutary effect on the subsequent performance of the banks.

There has been a major downsizing of the labor force in every one of these banks and closing down of unprofitable branches. It involved up-front costs in form of voluntary separation packages to those who opted for early retirement. These costs were financed under two loans provided by the World Bank in 1997 and 2001 but the benefits from this restructuring were substantial. The head count in the three large banks was cut by almost one half of the work force serving in 1996. New recruitments were discontinued except for senior managerial positions at the top echelons. As a result of these efforts the profitability of the banks has improved and cost income ratios have declined to significantly between 2000 and 2002 and are comparable to international benchmark of 0.50.

	Cost/Income Ratios		
	2000	2001	2002
Habib Bank Ltd.	0.83	0.71	0.63
National Bank of Pakistan	0.62	0.52	0.49
United Bank of Pakistan	0.70	0.66	0.62

The balance sheets of these banks were also cleaned up and the accumulated losses were wiped off by injection of new equity in Habib Bank and United Bank. In return, the banks were obligated to contain expenditure, reduce work force, reclassify loan portfolio and introduce transparent lending policies. Quantifiable milestones were put in place and these were monitored by the SBP on a regular basis. This cleaning up and restructuring not only averted the collapse of these banks but also helped in their subsequent privatization.

These banks were no longer required to participate in directed credit schemes. Export finance and local manufactured machine financing were transformed into market-based non-concessionary instrument. The subsidies on foreign currency deposit (FCD) schemes were discontinued and the mandatory requirement to surrender all FCDs raised by the banks to the Central Bank was abandoned. Product pricing and fees structure were det4rmined by the banks themselves on the basis of competitive requirements of the market.

WHAT STILL NEEDS TO BE DONE?

First, although, the country has achieved a **more competitive market structure** with the establishment of new private commercial banks, the expanding market share of foreign banks and the privatization of the three nationalised commercial banks, the efficiency of the banking sector has not yet improved. One of such measures of efficiency is the spread (in weighted average term) between the lending rates and deposit rates, this spread has, in fact increased from 2.4 percent in 1989-90 to 7.1 percent in 1999-2000. While deposit rates remained stagnant at around 7-8 percent, the lending rates increased from 10.60 percent in 1989-90 to 14.50 percent in 1999-2000. Real deposit rates were negative for quite some time during this period while real lending rates did not move with the movement in inflation rate. It is also important to note that the deposit and lending rates are not comparable during 1989-90 and 1999-2000 due to larger degree of market imperfections in the earlier period. Increase in lending rates were imminent as banking structure moved away from financial repression caused by high SLR, tap system of treasury bills, credit ceilings and subsidized and directed credit towards a market based interest rate structure built around auction of government securities, low SLR and open. market operations. The main factors responsible for stagnancy in deposit rates were increased administrative cost of financial institutions involved in liberalisation process, overstaffing and increasing volume of non-performing loans and defaults. The increased cost of inefficiencies was passed on partly to the borrowers in the form of higher lending rates and partly to depositors as the rate of return on deposits was reduced. This trend has an important bearing on the pattern of income distribution, national saving, investment as well as on the growth of the economy. High lending rates increase the cost of borrowing thus, discouraging investment, while low deposit rates encourage consumption rather than saving, resulting in high debt-to-GDP ratio, increased debt serving liabilities, lower economic growth and harsh consequences for vulnerable and the poor of country. Thus, the banking sector has to take measures to improve its efficiency and reduce the spread between the lending and deposit rates. The prevailing real interest rates on borrowing of 6 per cent are not conducive to growth of fixed capital formation in this country and need to be lowered.

Second, although the country has achieved a more competitive market structure, the legal risks for banks in the country are very high since the legal and judicial system is very costly due to the time it takes to get decisions executed. The legal and judicial system in Pakistan has become hostage to dilatory tactics of defaulters rather than a deterrent to defaulting. Due to weakening of the banking sector by these defaulters, the quasi fiscal deficit had to be financed by taxpayers as well as by the millions of poor in the country through consumption taxes. The combination of revised and streamlined laws simplified regulations, consistent application of laws and regulations along with a well functioning detection, investigation, prosecution and court system will minimize the legal risk and ensure expeditious disposal of cases and execution of decrees. The time lag between the award of the decree and the execution of decree is still too long and needs to be curtailed. The Law Reforms Commission and Banking Law Reforms Commission are addressing some of these issues but there is a consensus that unless the enforcement of contracts is ensured in a prompt manner other reforms carried out in the banking sector will remain stifled.

Third, privatization of the nationalized commercial banks and larger development finance institutions is a part of the Government's plan for the next 18-24 months. Habib Bank, Allied Bank and IDBP will be sold to strategic investors through competitive bidding. 20 percent of National Bank's shares have already been sold through listing on Stock Exchanges and further lots may be off loaded in future. This would bring in transparency in the process, fetch a realistic price to the government exchequer and enhance sale proceeds for national debt retirement and poverty reduction. In addition, it would deepen the capital market also. It must be realized that the size of these institutions, given the absorbing capacity of the private investors, demands a carefully designed process of privatization and 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. Moreover, the current drive to recover the defaulted loans also needs to be accelerated. However, privatization should not be considered as the sole remedy of removing all financial and administrative ills of these institutions. A hardened effort to improve the level of services would be most desirable to impart the fruits of privatization to the consumers.

Fourth, over the past few years, **e-commerce** has emerged on the global financial market as a major force, changing the way business is performed, not only from the consumers but also from business and organizational perspective as well. Changes in business practice, business models and customer service is becoming a necessity and not an after thought. Provision of merchant accounts to promote local trade on the Internet and facilitate payments over the net is the first step in this regard. We have to consider **e-banking** not only as a technological issue but also as a viable business proposition, as the number of Internet users in the country is growing exponentially. The State Bank and Government are acting as facilitators and problem solvers and the banks are gearing themselves to reap benefits from e-commerce. It is expected that by end 2004, a majority of bank branches will be offering e-banking services.

The growth of electronic commerce requires transparent, market-favorable regulation and legislation in certain areas. This presents challenges to the government, who must adapt national and international policies to the new digital economy. We must ensure that our laws, which were designed for an earlier business environment, do not unnecessarily impede the development of new and innovative services. Regulations are necessary to the extent that they do not hamper growth of new or existing markets. New regulations should also be flexible enough to cater for technology changes and new global environment. In other areas, the government should encourage industry self-regulation where industry practices are aligned with international practices.

The global nature of electronic commerce has made it necessary to ensure that local policies are developed in concert with international policies such as cross-border taxation and intellectual property rights. The government has to actively participate in regional and international forums to ensure the evolution of a regulatory and legislative framework, which encourages growth in electronic commerce. It has to lodge agreements with other countries on bilateral collaboration on e-commerce, e-learning and e-governance. To strengthen the adoption of e-Business and increase Electronic Commerce (EC) transactions among businesses, the Government has to provide various support schemes to companies venturing into electronic commerce.

V. **Lessons for other countries**

?? A long term vision and road map have to be sketched out before reforms are initiated

?? It takes almost a decade of consistent, uninterrupted efforts to bring about sustainable reforms

?? Autonomy and competence of the regulators have to be ensured both in legal and substantive ways

?? Macroeconomic environment has to be conducive and supportive

?? Public sector banks cannot be improved in absence of overall financial sector reforms

?? Political will to take unpopular and tough decisions such as large scale retrenchment is sine qua non for success

?? Strong professional management is required at all levels of decision making in restructured financial institutions

?? Proven international best experiences rather than ideological rhetoric are the best guide for building up support and implementing reforms.

TABLE - I

CHANGES IN KEY MACROECONOMIC INDICATORS

	October 1999	October 2002	Change in the Indicator
GDP growth rate	4.2%	4.5% */	Negative
Inflation	5.7%	3.7%	Positive
Fiscal deficit/GDP	6.1%	- 4.4% */	Positive
Current account/GDP	- 3.2%	+ 4.5%	Positive
Domestic Debt	Rs 1376 billion	Rs 1699 billion	Positive

External Debt	$ 37 billion	$ 36 billion	Positive
Remittances	$ 88 million per month	$ 199 million per month	Positive
Exports	$ 7.8 billion	$ 10.2 billion */	Positive
Tax Revenues	Rs 391 billion	Rs 471 billion	Positive
Rupee-Dollar Parity	Depreciating	Appreciating	Positive
Foreign Direct Investment	$ 472 million	$ 1 billion */	Positive
Foreign exchange reserves	$ 1.6 billion	$ 8.5 billion	Positive
Poverty Incidence	33%	Data not available but perhaps rising	Negative
Poverty related expenditure	Rs 133 billion	Rs 161 billion	Positive
Unemployment	6%	8%	Negative

Note: All indicators in Column 1 pertain to 1998-99 or October 1999. All indicators in Column 2 pertain to 2001-02 or October 2002. Those marked with */ pertain to projections for 2002-03.

TABLE – II

Banking Soundness Indicators

	CY 1999	CY 2000	CY 2001
Banking assets / GDP	56.3	57.4	56.8
Deposits / GDP	42.7	42.6	43.2

Loans / GDP	30.3	32.4	30.8
NPLs / advances	25.9	23.5	23.5
Net NPLs / Net advances	15.3	12.2	11.4
Capital adequacy ratio	10.9	9.7	8.8
Return on equity (adjusted)	7.5	6.0	9.1
Return on assets (adjusted)	0.4	0.3	0.4
Growth in advances (percent)	12.3	14.6	3.2
Growth in deposits (percent)	3.6	6.9	10.1

TABLE – III

Asset Quality of Public Sector Banks

(Rs in billion)

	CY-97	CY-98	CY-99	CY-00	CY-01	CY-02
Defaulted loans	86.5	75.5	72.6	74.4	83.1	76.8

(domestic)						
NPLs	105.0	104.6	126.9	122.8	125.8	111.9
Provisions made	55.9	58.5	62.4	73.2	72.4	71.9
Net NPLs	49.1	46.1	64.5	49.4	53.5	40.1
NPLs / Gross Advances	31.3%	29.6%	31.2%	26.5%	25.8%	24.8%
Net NPLs / Net Advances	17.5%	15.6%	18.7%	12.7%	12.9%	10.5%
NPLs / DGP	4.3%	3.9%	4.3%	3.9%	3.7%	3.0%
NPLs / Capital	-	128.1%	226.0%	128.6%	168.6%	75.6%

The position includes domestic as well as overseas operations, except that of defaulted loans.

Though UBL has been privatized but is included in CY-02 for consistency purposes.

In CY-01 NDFC was merged with the NBP.

BIBLIOGRAPHY

1. Asian Development Bank, “Financial Sector Strategy” (unpublished).

2. International Monetary Fund, Financial Sector Reforms in Pakistan (Washington DC, Oct. 21, 2002).

3. Ishrat Husain, The State of Financial Sector (Karachi, Institute of Bankers of Pakistan).

4. Ishrat Husain, Financial Sector in Pakistan: Future Strategic Direction (Karachi, May 2002)

5. Finance Division and Planning Commission, Interim Poverty Reduction Strategy Paper (Islamabad, November 2001).

6. Ministry of Finance, Economic Revival program. Review of Implementation Plan (Islamabad, November 2002)

7. National Institute of Banking and Finance, SBP Conference Proceedings on Financial System (Islamabad, July 2002.).

8. State Bank of Pakistan, A History of the State Bank of Pakistan, Vol. III (Karachi, 2003).

9. State Bank of Pakistan, Financial Sector assessment 1990-2000 (Karachi, 2002).

10. World Bank, Financial Sector update (Washington D.C. May 31, 2000).