FINANCIAL SECTOR REFORMS IN PAKISTAN

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The reform of the financial sector in Pakistan should be examined in an overall macroeconomic context, against the backdrop of the overall strategy of reforms implemented during the last decade and the strengthening of the Central Bank's capacity to regulate and supervise the financial sector. It is only when the macroeconomic situation took a turn for the better, that structural reforms were vigorously pursued and the State Bank of Pakistan achieved autonomy and competence that the financial sector began to show some demonstrable results. Without these pre-requisites in place, it is hard to imagine whether any meaningful progress could have been possible.

Banking sector reforms cannot be successfully implemented and sustained in the absence of a favourable and stable macroeconomic environment. Pakistan's track record in macroeconomic management and governance during the 1990s was dismal. The Musharraf government, which came to power in October 1999, embarked upon a serious program of macroeconomic stabilization, structural reforms, good governance and the establishment of credibility with international financial institutions. Despite several major exogenous shocks, including September 11, the mobilization of troops on the Indian border, severe drought and incidents of terror attacks, the country has been able to make a dramatic turnaround in its economic indicators. This included fiscal retrenchment of about 3 percentage points of the GDP and a primary surplus on budget, inflation receding to 4 percent, the current account pointing a surplus, debt indicators moving in the direction of sustainability and foreign reserves rising from $1 billion to well over $12 billion (covering almost one year's imports). In addition, this period witnessed the lowering of the interest rate structure, the appreciation of the exchange rate by 6 percent rather than following the historical 10 percent annual depreciation and a record growth in workers' remittances. All this amply demonstrates the seriousness of efforts made during the last four years. The GDP growth at 6.4 percent this year is very encouraging. A

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sustained growth rate of about 6 percent will have a positive impact on the level of poverty, which had doubled during the decade of the 1990s. The progress in trade and tariff reforms, tax administration, the financial sector, in privatization and in deregulation has been quite significant, but it has still some way to go before it makes a visible difference. Corruption at higher levels of decision making has almost disappeared as a strong accountability mechanism was able to secure successful convictions of several hundred politicians, senior bureaucrats and businessmen who were previously considered untouchable. The 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 under way but will take some time to take hold. Poverty targeted interventions and social sector development has been given high priority and poverty reduction has been recognized explicitly as a major policy objective, unlike the past when it was swept under the rug.

Pakistan had, successfully completed its stand-by program with the IMF in 2000-01, drawing all the three tranches on time. It is currently implementing the medium term Poverty Reduction and Growth Facility (PRGF), which will come to end towards the end of this year. It is for the first time that the country, known as a “one tranche country”, has demonstrated such a high 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 1999-2000 and 2003-2004.

TABLE – I

CHANGES IN KEY MACROECONOMIC INDICATORS

	1999- 2000	2003-04
GDP Growth Rate	4.2%	6.4%
Inflation	5.7%	4.6%
Fiscal Deficit/GDP	6.1%	4.0%
Current Account/GDP	-3.2%	+1.9%
Domestic Debt	Rs. 1,579 Billion	Rs. 1,977 Billion
External Debt	$ 38 billion	$ 35 billion
Remittances (per month)	$ 82 million	$ 323 million
Exports (BOP)	$ 7.8 billion	$ 12.4 billion
Tax Revenues	Rs. 406 billion	Rs. 601 billion
Foreign Direct Investment	$ 470 million	$ 949 million
Foreign Exchange Reserves	$ 2.0 billion	$ 12.3 billion
Unemployment	6.0%	8.3%

Pakistan possesses a wide spectrum of financial institutions – Commercial banks, specialized banks, national savings schemes, insurance companies, development finance institutions, investment banks, stock exchanges, corporate brokerage houses, leasing companies, discount houses, micro-finance institutions and Islamic banks. They offer a whole range of products and services both on the assets and liabilities side. Financial deepening has intensified during the last several years but the commercial banks are by far the predominant players accounting for 90 percent of the total financial assets of the system.

Among the commercial banks, 12 foreign and 20 domestic banks together hold 80 percent of the banking system assets – a feat that is unparalleled among developing countries. Foreign banks enjoy the same facilities and same access as the domestic banks and there is no preferential treatment for domestic institutions. Unlike many countries, foreign banks can have 100 percent ownership, can open their branches or establish local subsidiary with full ownership. Foreign companies are also provided level playing fields as they can raise finances of all types and tenures from the domestic banking system.

The above structure of banking system has resulted from a number of deep-rooted reforms that have taken place in the last five years.

The Banking sector, which was fully dominated by Nationalized Commercial Banks (NCBs) until a few years ago, has been opened up to the private sector. Four of out five largest NCBs have been privatized. While the ownership and management of the banks by private sector is one pillar of the reforms, the other pillar is a strong regulatory environment. Private banks are prone to taking excessive risks in their lending as their own capital is much lower in relation to the depositors' money. They can realize the large upside potential from high-risk assets while the defaults and losses in event of downside scenario are borne disproportionately by the depositors. It is the responsibility of the central bank as a regulator to be extremely vigilant and take prompt timely action to prevent the bank managers and owners from assuming excessive risks. The Central Bank in Pakistan has strengthened its capacity by acquiring new skills, upgrading the quality of the existing human resources base, adopting technology and re-engineering business processes. The banking regulation and supervision are risk-based and are fully compliant with the international standards and codes prescribed by Basle Committee. The risk management practices are being modified to conform to Basle II rules. The financial soundness indicators show a healthy and sound banking system with high degree of financial stability.

Along with strong regulation, supervision and enforcement, a number of measures have been taken to put best corporate governance practices in the system by prescribing 'fit and proper' criteria for Chief Executives, members of the Boards of Directors and top management positions. Accounting and audit standards have been brought to the International Accounting Standards (IAS) and the International Audit Codes. External audit firms are rated according to their performance and track record and those falling short of the acceptable standards are blacklisted. These practices were put in place in Pakistan long before the scandals of Enron, World Call and Pramalat had shaken the corporate world.

The banking sector has now diversified its product base and carried out a lot of innovation. They have expanded their out reach to agriculture, SMEs, mortgage financing and consumer financing. Not only that this diversified lending portfolio mitigates risks but it also raises the purchasing power of a large segment of population that was completely shut out from credit markets. Pakistan's auto industry has expanded its car production by a multiple of five times in the last four years as auto financing enabled a vast number of middle class income earners to purchase the cars on monthly installments.

The affordability of these new products by the middle class became possible as the prudent fiscal and monetary policies pursued by the Government left a lot of liquidity in the banking system. The healthy competition among banks, lower taxation and reduction in non-performing loans brought about a lowering of average interest rate from 14 percent to 5 percent. The Government, by reducing its fiscal deficit and public sector enterprises by making cash profits, freed up loan-able funds for the use of the private sector. The Central Bank by pursuing an accommodating monetary policy did not mop up excess liquidity and helped the businesses and consumers to access funds at historically record low levels.

Pricing and remuneration for most of the financial services are now determined by banks on a competitive basis. There are no directions or interventions by the State Bank of Pakistan or the Government. Prior to the reforms, there were subsidized lending rates for priority sectors and the rate paid by the Government on its borrowing through banking system was artificially pegged at below market rates. Banks and other financial institutions are free to set their own lending and deposit rates. Government and public sector enterprises have to pay market based interest rates on debt raised through the banking system.

The Government has, however, extended the yield curve by raising funds for longer maturity i.e. up to 20 years. These bonds, called Pakistan Investment Bonds, act as the benchmark for corporate debt market. Insurance companies, Benevolent Funds, Pensions Funds, Provident Funds that have strong appetite for investment in these long dated instruments can now find avenues to match their liabilities. At the same time well-reputed corporates with long gestation projects can now issue bonds to raise funds of preferred duration. These bonds are not redeemable before maturity but are allowed to be traded freely in the secondary market. A number of multinational companies have raised long-term funds through corporate bonds.

Karachi Stock Exchange (KSE) is a major source of raising equity funds. With a market capitalization having around $25 billion and 100 listed companies, the turnover at KSE is one of the highest among the emerging markets. KSE has been one of the best performing markets as a number of reforms were introduced to increase transparency, improve disclosure, strengthen risk management and establish strong corporate governance. IOSCO standards are faithfully applied and enforcement capacity of the Securities and Exchange Commission of Pakistan (SECP) has been upgraded.

The foreign exchange market was highly regulated at one time through a system of direct exchange controls over suppliers and users of foreign exchange. All restrictions have since been removed and there has been a major and perceptible liberalization of foreign exchange regime with full current account convertibility and partial capital account convertibility. Foreign investors can now bring in and take back their capital, remit profits, dividends and fees without any prior approval and directly through their banks. Similarly, foreign portfolio investors can also enter and exit the market at their own discretion.

Conclusion:

In cataloging the above list of initiatives and measures it is not implied that we have attained and reached the end of the reform process, 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 it in remaining sound and healthy, under varying market conditions and unanticipated exogenous shocks – external or internal.

A joint IMF-World Bank Mission consisting of 16 experts drawn from all over the world visited Pakistan in February and April 2004 to carry out a comprehensive assessment of the Financial Sector in Pakistan. The FSAP Mission, which reported its findings to the Executive Board of IMF, was very positive about Pakistan's banking system and the SBP. The Mission concluded that:

"far reaching reforms have resulted in a more efficient and competitive financial system. In particular, the predominantly state-owned banking system has been transformed in to one that is predominantly under the control of the private sector. The legislative framework and the State Bank of Pakistan’s supervisory capacity have been improved substantially. As a result, the financial sector is sounder and exhibits an increased resilience to shock”.

These reforms have created a healthy competitive environment and at the same time, strengthened the capacity of the regulator to oversee and supervise the banking system in an effective manner. The agenda for future reforms is even more daunting and challenging than whatever modest achievements we have made so far.