

**Pakistan: Financial System Stability Assessment,
including Reports on the Observance of Standards and Codes on
the following topics: Monetary and Financial Policy Transparency,
Banking Supervision, and Securities Regulation**

This Financial System Stability Assessment on **Pakistan** was prepared by a staff team of the International Monetary Fund and the World Bank as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on June 8, 2004. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of **Pakistan** or the Executive Board of the IMF.

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Financial System Stability Assessment

Prepared by the Monetary and Financial Systems and Middle East and Central Asia
Departments

Approved by Ulrich Baumgartner and Saleh Nsouli

June 8, 2004

- This Financial System Stability Assessment is based on two visits to Pakistan during February 16–27, 2004, and April 7–15, 2004 as part of the joint IMF-World Bank Financial Sector Assessment Program (FSAP). The FSAP findings, which are based on data available at the time of the second mission, were discussed in a wrap-up session with the authorities on April 16, 2004.
- The FSAP mission included A. Rennie (Head, World Bank), S. K. Wajid (Deputy Head, IMF/MFD), J. I. Canales-Kriljenko, V. Prokopenko, E. Loukoianova, E. Warrack, N. Jayawardane (all IMF/MFD), and A. Schimmelpfennig (IMF/MCD); N. Annamalai, A. Demirguc-Kunt, J. Gallardo, M. Khan, R. Hinz, and R. Lester (all World Bank); K. Bell (formerly Canadian Office of the Superintendent of Financial Institutions), F. Hashim (Bank Negara Malaysia), J. Farrell (formerly New Zealand Securities Commission); M. Long (formerly World Bank), S. Hashemi (CGAP), and O. Hassler (World Bank) also contributed to the mission's findings.
- The FSAP team received excellent cooperation from the authorities. Meetings were held with the State Bank of Pakistan (SBP); the Ministry of Finance (MOF); the Securities and Exchange Commission of Pakistan (SECP); the Karachi and Islamabad Stock Exchanges (KSE; ISE); professional associations; and individual banks, insurance companies, investment and securities firms, development finance institutions, specialized financial institutions, rural and microfinance institutions, accounting firms, pension providers, and credit information agencies. The mission's assessment was also based on the analysis of relevant statutes and regulations as well as responses to FSAP questionnaires, and drew upon the self assessments conducted by the authorities and the work previously done by the IMF and World Bank in the financial sector.
- The financial sector has undergone considerable reforms in recent years that have resulted in a sounder and more efficient financial system. The nationalized commercial banks have been largely privatized and their financial position and resiliency to credit, market and liquidity risks have improved. Rapid growth of credit to the private sector and exuberance in stock markets are the main emerging risks. There is a need for consolidation and liberalization of the insurance sector and strengthening of the related regulatory regime. Likewise, the financial sustainability and proper legal and regulatory framework of pension schemes need to be strengthened. The privatization and legal reforms in the financial sector and efforts to broaden sustainable and cost effective outreach of financial services to the underserved segments of the population need to be continued.
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GLOSSARY

ADB	Asian Development Bank
AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
BCO	Banking Companies Ordinance
BCP	Basel Core Principles
BID	Bank Inspection Department
BPD	Banking Policy Department
BSD	Banking Supervision Department
CAR	Capital Adequacy Ratio
CDC	Central Depository Company
CIRC	Corporate and Industrial Restructuring Corporation
CIS	Collective Investment Schemes
CMAD	Corporate and Media Affairs Department
COT	Carry Over Transactions
CP	Core Principles
DFI	Development Finance Institution
DPCO	Debt Policy Coordination Office
EOBI	Employees Old Age Benefits Institution
FB	Foreign Banks
HBFC	House Building Finance Corporation
IASB	International Accounting Standards Board
ICP	Investment Corporation of Pakistan
IDBP	Industrial Development Bank of Pakistan
IFC	International Finance Corporation
IMF	International Monetary Fund
IOSCO	International Organization of Security Commissions
ISE	Islamabad Stock Exchange
KSE	Karachi Stock Exchange
LSE	Lahore Stock Exchange
MCCR	Minimum Continuing Capital Requirement
MFI	Microfinance Institutions
MOC	Ministry of Commerce
NBFC	Non-bank Financial Companies
NBFI	Nonbank Financial Institutions
NBP	National Bank of Pakistan
NCB	Nationalized Commercial Bank
NCSS	National Clearing and Settlement System
NIC	National Insurance Company
NIFT	National Institutional Facilitation Technology
NIT	National Investment Trust
NPL	Non-performing Loans
NSS	National Savings Schemes
PIB	Pakistan Investment Bond
PB	Policy Board
PRCL	Pakistan Reinsurance Company Limited
PSCB	Public Sector Bank

RTGS	Real Time Gross Settlement System
SBP	State Bank of Pakistan
SECP	Securities and Exchange Commission of Pakistan
SLIC	State Life Insurance Corporation
SME	Small- and Medium-sized Enterprises
SMEB	Small- and Medium-sized Enterprise Bank
SRO	Self-Regulated Organizations
TFC	Term Finance Certificates
ZTB	Zirati Taraqiati Bank

I. OVERALL STABILITY ASSESSMENT

1. **Major reforms in the financial sector have resulted in a more resilient and efficient financial system that is better placed to absorb significant macroeconomic shocks.** The reforms have been implemented in conjunction with progress on a broader macroeconomic stabilization and structural agenda. The infancy of the reforms and the deepening role of the financial system in the economy, however, underscore the importance of continued supervisory vigilance and efforts to further strengthen the system.
2. **An important achievement in the last decade has been the transformation of a largely state-owned and weak banking system into a healthier, primarily privately-owned system.** This has been facilitated by restructuring of major banks, ongoing consolidation, strengthening of regulatory capacity, and improvements in transparency, corporate governance, and credit culture. As a result, quasi-fiscal responsibilities of financial institutions have been reduced sharply. The reform efforts are reflected in improving financial soundness indicators, greater resiliency to credit, market and liquidity risks, and good compliance with international supervisory standards. Consolidation of these gains, however, is likely to take more time.
3. **Increased liquidity in the system has recently led to a rapid increase in credit to the private sector that could be problematic if sustained.** While increased lending and intermediation is a normal complement to higher real economic growth, financial institutions and their supervisors need to ensure that this does not compromise credit quality and undermine banks' balance sheets, especially since much of the credit growth is in areas where banks are relatively inexperienced. The State Bank of Pakistan (SBP) has made considerable strides in strengthening its supervisory capacity and is well positioned to manage the associated risks. However, the changes are relatively recent and yet to be tested through a complete credit cycle in the new environment.
4. **The securities markets have benefited from recent reforms, but may be vulnerable to systemic risks.** The improved macroeconomic situation, low interest rate environment, and excess liquidity have fueled a rapid rise in Pakistan's stock markets. The highly leveraged and speculative trading through the "badla" system, coupled with the lack of supervision of market intermediaries, could potentially threaten systemic stability. The planned phase-out of the system is therefore welcome. While efforts have been made to achieve compliance with international norms in the supervision of securities markets, the Securities and Exchange Commission of Pakistan (SECP) needs additional resources and capacity to effectively carry out its broad mandate.
5. **Credit to previously underserved markets such as consumer, housing, small- and medium-sized enterprises (SME) and agricultural sectors has expanded markedly and is now being provided by a broad range of financial institutions.** Large segments of the economy, however, continue to operate with little formal credit. The authorities will need to continue their efforts to promote new business models and technologies that will broaden access to financial services in a sustainable and cost-efficient manner. This will require some adaptation of relevant regulations.

6. **To consolidate recent structural reforms and protect the system from future policy reversals, the process of privatization and legal reforms needs to be continued.** The government should divest its remaining stake in banks. Plans to privatize Small- and Medium-sized Enterprise Bank (SMEB), Industrial Development Bank of Pakistan (IDBP), House Building Finance Corporation (HBFC), Investment Corporation of Pakistan (ICP), and National Investment Trust (NIT) should be expedited. The government should reconsider its continued ownership of the National Bank of Pakistan (NBP) and the three public insurance companies. The progress achieved thus far can be solidified by revising key financial sector legislation, most notably the SBP Act and Banking Companies Act, in accordance with best practice to avoid relapsing into past practices and unwarranted government interference.

7. **The reform process does not appear to be equally advanced across all segments of the financial sector.** Insurance penetration is very low relative to other countries at Pakistan's income level, reflecting a number of factors, including a history of nationalization and instability, and weak consumer protection and awareness. There is a need for further consolidation and liberalization of the industry, and a more market/solvency-based regulatory regime to develop the industry to its full potential.

8. **A number of issues in pensions require the authorities' attention, including the financial sustainability and regulatory oversight of the present schemes.** The pension system for civil servants and Employees Old Age Benefits Institutions (EOBI) entail substantial direct and indirect liabilities for the government that need to be addressed and a comprehensive legal and regulatory framework needs to be established for private occupational and personal pensions in order to protect pension savings.

9. **Progress has also been made on improving financial market infrastructure and practices.** The framework for liquidity management is transparent and monetary policy instruments are flexible and market-based. The mission also found a high degree of observance in most areas of the IMF's Code for Good Practices on Transparency in Monetary and Financial Policies. The planned introduction of the Real Time Gross Settlement System (RTGS) should contain systemic risks from this source and improve the efficiency of the payments system.

Key recommendations

The banking sector

- Revise the SBP Act and the Banking Companies Ordinance to address the concerns noted in the Basel Core Principles assessment, especially ensuring legal authority of the SBP to conduct consolidated supervision.
- Adopt market risk-related capital charges and consider tightening specific provisioning requirements.
- Develop a strategy to privatize NBP and continue divestiture from the capital of other banks.

Nonbank financial institutions and markets

- Conduct a formal review to determine whether SECP has adequate resources and capacity to fulfill its mandate, expedite the adoption of margin financing rules, and review the legal provisions governing insider trading.
- Establish a comprehensive legal and regulatory framework for private occupational pensions, providing for, inter-alia, custodial requirements, funding and investment standards, reporting and valuation standards, and prohibitions on self dealing and transactions with related parties.
- Review the roles of the state-owned insurers and place the State Life Insurance Company (SLIC) on a pari passu basis with the rest of the life insurance sector. Clarify the legal roles of Ministry of Commerce (MOC) and SECP in the insurance sector and provide the SECP with on-site inspection capacity and powers to require prompt corrective action.
- Develop a more comprehensive debt policy and related risk management system, and make the Debt Policy Coordination Office (DPCO) fully functional.
- Align NSS rates more closely with market rates and develop market-based alternatives to the present schemes.
- Resolve IDBP, through privatization, merger or closure, in the least cost manner.
- Launch title regularization programs, reform registration services, and lower property and mortgage registration duties.

Financial infrastructure and information system

- Establish a clear legal framework for private credit bureaus, enabling them to provide more comprehensive credit information.
- Establish a clear legal mandate for SBP to oversee the payments system and provide rules on netting and real time settlement.
- Promulgate a single law to provide a comprehensive legal framework for Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT).

II. MACROPRUDENTIAL ENVIRONMENT AND FINANCIAL STRUCTURE

A. Macroeconomic Background and Vulnerabilities

10. **Considerable progress has been made in macroeconomic stabilization and on the structural agenda.**¹ Real GDP growth has progressively strengthened, inflation has been subdued, and the overall fiscal deficit and public debt have been brought down markedly. The current account position has become comfortable, complemented by large reserve accumulation. International capital markets have shown an appetite for Pakistan's sovereign debt. Dollarization related risk has also diminished substantially relative to levels seen in the past.

11. **While macroeconomic stabilization has helped to limit vulnerabilities and improve performance in the financial sector, the outlook remains subject to a number of risks.** Credit to the private sector has been expanding very rapidly (28.5 percent in 2003). While this reflects the buoyant economy, if sustained, it may portend future credit quality problems. In addition, the widely expected increase in interest rates and tighter liquidity conditions may adversely impact banks' balance sheets. Additional sources of risk are a sharp run-up in oil prices and slowdown of remittance inflows which have been unusually high, most likely due to a one-time portfolio shift. A change in the international political environment could lead to a drying up of funds.

B. Financial and Regulatory Structure

12. **Pakistan's financial system is relatively sophisticated and diversified, although it remains dominated by commercial banks.** There is an active stock market and a variety of institutional investors and other nonbank financial institutions, including development finance institutions (DFIs), investment banks, mutual funds, and insurance, leasing, housing finance, and Islamic finance companies. As of end-September 2003, commercial banks' assets were 54 percent of GDP, compared with 57 percent of GDP for all financial institutions (Table 1). The capital market, insurance, and other nonbank intermediaries and instruments are relatively small. There remains considerable potential for their development.

13. **Important reforms in the financial sector have been implemented during the last decade.** These include returning to market-based monetary and exchange rate policies, diminishing role of the state through privatization of nationalized commercial banks, improving corporate governance, disclosure, and transparency, and adopting a modern regulatory framework.² The authorities have also sought to promote consolidation in the industry by significantly increasing minimum capital requirements. As a result, mergers and

¹ The macroeconomic developments are described in detail in the Staff Report for the Eighth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility (IMF Country Report No. 04/211).

² Following the nationalization program of 1974, nationalized commercial banks (NCBs) were dominant in the Pakistan banking system and in the early 1990s such banks held more than 90 percent of the system's assets.

acquisitions have taken place both within and across banks and nonbank financial institutions (NBFIs).

14. **The SBP and the SECP are largely responsible for the regulation and supervision of financial institutions.** The Banking Companies Ordinance (BCO) establishes the SBP as the authority responsible for the supervision, regulation, and licensing of commercial banks and DFIs. Most other financial institutions are regulated by the SECP, while the stock exchanges operate as self-regulated organizations (SROs). Legal and regulatory authority for other financial activities—insurance and pensions—is diffused and, in some respects, ineffective. The legal and regulatory framework for microfinance banks (MFBs) is comprehensive and provided by the Microfinance Ordinance of 2001.

III. STABILITY, SOUNDNESS, AND DEVELOPMENT OF THE FINANCIAL SYSTEM

A. Commercial Banks

Structural features

15. **The divestiture of state ownership in commercial banks has substantially changed the structure of the banking sector.** As of September 2003, the share of private banks—defined as banks with a majority domestic or foreign private ownership—in the total assets of the banking system had increased to 59 percent from 34 percent at end-1999. With the subsequent privatization of Habib Bank, this share increased further to more than 75 percent. The largest bank in the country, NBP, with a market share of approximately 20 percent, remains state-owned. Its privatization prospects are uncertain at this stage, although the government sold some 23 percent of its ownership in the bank during 2001–03.

16. **Privatization of state-owned banks has accompanied broader financial liberalization and increased competition.** Key measures have included changes in the legal framework, permission to open private banks, elimination of bank-by-bank credit ceilings, and removal of caps on lending rates of banks. The liberalization spurred rapid growth in the number of commercial banks in the early 1990s, which increased to more than 40 by 1995.³ At the same time, concerns emerged about the health and soundness of some of the institutions and about the risk of further proliferation of weak banks. Accordingly, in 1995 the authorities imposed a moratorium on the licensing of new banks, which remains in force except for Islamic banks. To promote scale economies and efficiency and achieve better oversight, the authorities also sought to consolidate the banking sector by increasing the minimum capital requirement from PRs 500 million to PRs 750 million as of end-December 2001 and further to PRs 1 billion (around US\$17 million) as of end-December 2002.

³ Foreign banks had operated in niche markets before liberalization. Their market share increased during the 1990s.

17. **Steps have been taken to promote Islamic banking products and services.** Islamic banking has been introduced in parallel with conventional banking in response to the rulings by the Shariat and Supreme Courts, requiring that the financial system be transformed to operate in accordance with the Sharia. The precise meaning of this requirement remains under legal review leaving some ambiguity regarding the legal status of Islamic banking. Nonetheless, the SBP is pursuing a three-pronged strategy: (i) licensing fully fledged Islamic banks that transact only in Sharia compliant products and services; (ii) allowing conventional banks to carry out Islamic banking through separate dedicated subsidiaries; and (iii) permitting existing commercial banks to set up dedicated branches for Islamic banking.

18. **Thus far, Islamic banks do not constitute a significant part of the banking system, accounting for between 1-2 percent of the total assets of the banking sector.** One fully-fledged Islamic bank is operational and several commercial banks have opened branches to carry out Islamic banking. The SBP is the regulator of Islamic banks, which are currently subject to the prudential requirements applicable to commercial banks as well as additional requirements adapted to Islamic banking. In light of the growing range of Islamic instruments, the SBP is developing a framework for the supervision and regulation of Islamic banks and working on other aspects, including audit and accounting standards, and instruments for monetary operations with Islamic banks.⁴

Performance and efficiency

19. **Financial soundness indicators of commercial banks have been improving in recent years** (Table 2). Banks' average capital adequacy ratio (CAR)—capital-to-risk weighted assets—improved from 11.3 percent in December 2001 to 13.1 percent as of September 2003, with 22 banks registering ratios above 15 percent. This reflects better profitability, fresh injections of capital—especially in state-owned banks prior to privatization—increased share of government securities carrying zero risk weight in banks' portfolios, and revaluation of assets, in particular, fixed interest rate instruments.⁵

20. **In the past, high non-performing loans (NPLs) constrained banks' earning potential and posed a major threat to their capital positions.** While the aggregate NPL ratio—share of gross NPLs in total loans—for the banking system has been on a downward trend, it is still high and concentrated in the largest banks.⁶ The recent decline in the ratio has been helped by various recovery drives, promulgation of a foreclosure law, restructuring of loans, issuance of write-off settlement guidelines, and the takeover of some large NPLs by the newly established Corporate and Industrial Restructuring Corporation (CIRC). The flow

⁴ The adequacy of supervision for Islamic banking was also taken into account in the Basel Core Principles assessment.

⁵ Banks are allowed to count 50 percent of balances in such revaluation accounts toward tier II capital. The decline in interest rates in recent years has helped boost banks' balances in revaluation accounts.

⁶ The aggregate ratio of NPLs to total loans ranges from 0.4 percent to 35.1 percent. Asset quality of the five largest banks is weak, with the ratio of NPLs to total loans ranging from 15 percent to 35 percent.

of new NPLs has declined significantly, with a substantial share of NPLs pertaining to old loans (more than three years overdue).⁷ Provisioning against NPLs is also improving, although a collapse in collateral values against secured loans which banks are allowed to use—albeit under strict rules—to offset required provisioning could adversely affect banks’ balance sheets.

21. **Profitability indicators show improvement.** After being negative in 2000 and 2001, return on equity turned around to 13.1 percent in 2002, and further to 22.1 percent during the first three quarters of 2003, comparing favorably internationally. Apart from increased business volume, profitability was also helped by substantial retrenchment of personnel, closure of numerous unprofitable branches, and higher non-interest income reflecting fee-based activities and capital gains.

22. **Notwithstanding the banks’ improved performance, the recent very rapid growth in bank credit to the private sector poses some risks.** While the outstanding stock of credit to the corporate sector has been generally stable, bank lending to small- and medium-sized enterprises and households, has been increasing rapidly. The share of personal loans, primarily auto loans, mortgages, and credit cards, which was negligible in the mid-1990s, has risen to 12 percent of total bank credit (as of September 2003). Experience in other countries suggests that very rapid credit growth often leads to lax credit evaluation and loan quality problems. Concerns are underscored by the challenges that the former nationalized banks still face, including developing a credit evaluation culture for lending to new sectors—such as housing and consumer goods—timely recovery of defaulted loans, and the maintenance of some loss-making branches in the “unbanked” areas. While SBP regulations require banks to hold general reserves against consumer loans, the current specific provisioning requirements are not as stringent as in many other countries and the authorities could consider tightening them.⁸

Stress tests

23. **Results of the stress tests suggest that the banking system could withstand shocks consistent in severity with historical experience** (Box 1 and Table 3). The analysis gauged the sensitivity of banks’ balance sheets to credit, market, and liquidity risk. Exposure to credit risk is assessed by the impact on banks’ capital of a deterioration in loan portfolios under various provisioning assumptions; susceptibility to market risk was measured by the effect on banks’ capital of exchange rate, interest rate, and equity price movements; and liquidity risk was gauged by the impact of withdrawals of liquid liabilities. Only in the extreme scenarios, especially one where all shocks occur simultaneously, the capital

⁷ A large stock of old NPLs reflects banks’ reluctance to write off these loans even after 100 percent provisioning because they fear that this may compromise their legal position in the loans recovery process.

⁸ For example the rules allow loans that are up to one year overdue—depending on the initial maturity—to be classified as “other assets especially mentioned” with no requirement for specific provisioning. While there is no uniform definition of classified loans or prescribed levels of associated provisions in several countries, such as, Argentina, Czech Republic, Kuwait, Malaysia, Philippines, etc., the rules are tighter.

adequacy ratios of the 12 largest banks would decline below 1 percent and some banks would become insolvent.

24. **While the stress test results are somewhat comforting they should be interpreted cautiously.** Most banks have enough capital to withstand increases in NPLs of more than 70 percent, assuming a provisioning rate for these marginal NPLs of 100 percent (Figure 1). However, weaker banks experience capital adequacy problems in the face of relatively modest NPL increases, suggesting that banks on the lower end of the capital adequacy and asset quality spectrum deserve closer attention by supervisors. Moreover, in the new environment of private sector-dominated banking, sensitivity analysis based on historical experience of shocks may be of reduced accuracy.

Banking supervision

25. **The SBP has made major strides in enhancing its supervisory capacity in recent years, bringing it broadly in line with international standards.** The system has a high degree of compliance with Basel Core Principles for Effective Banking Supervision (Annex). The BCP assessment also indicates that the SBP has an array of powers to control the risks assumed by banks, has issued appropriate prudential regulations, adopted sound methods for on-site and off-site supervision, and has the power to require a wide range of remedial measures. In addition, the SBP has adequate resources and the quality of its staff has been significantly upgraded in recent years.

26. **The upgrading of the supervisory structure is relatively recent and remains to be tested over a longer period.** There are also areas of less than full compliance of supervisory standards that relate to certain legal provisions regarding the independence of the regulator, arrangements for consolidated supervision, and provisions for country risk. At this stage, this does not pose a major risk to the stability of the financial system, since compliance is high, in particular, with the principles dealing with prudential regulation and few banks belong to complex financial groups for which consolidation is a major issue. The pending comprehensive review of the BCO by a Law Review Commission should be used to address deficiencies in full compliance of the Basel Core Principles concerning legal provisions.

Box 1. Results of the Stress Tests

Stress tests were based on detailed bank balance sheet data as of September 2003 provided by the SBP. Stress tests were performed separately for: (i) each of the 12 largest commercial banks—accounting for 83 percent of the banking system in terms of assets; (ii) three groups of commercial banks—public sector (5 banks), local private (17 banks), and foreign (14 banks); and (iii) the banking system as a whole.

Credit risk. The banking sector as a whole, as well as most of the largest banks, would be able to absorb the losses from various credit shocks without their capital falling below the minimum prudential level, although one bank is already insolvent. The shocks were a 35 percent increase in NPLs stemming from a deterioration in the borrowers' financial condition bringing the NPL ratio to the previous historical high; a tightening of loan classification/provisioning rules requiring 10 percent additional provisioning; and a 40 percent decline in the value of collateral—mostly real estate—held by banks against their NPLs. Under the first shock, the CAR of 4 banks, representing 16 percent of the system, would fall below the minimum regulatory requirements, although it would remain above 6 percent.

The simultaneous occurrence of these three shocks would, however, reduce the solvency ratio of many banks, especially public sector commercial and local private banks to below 8 percent. While none of the banks become insolvent, the capital adequacy ratio of two banks, including the second largest Bank would decline seriously to below 5 percent.

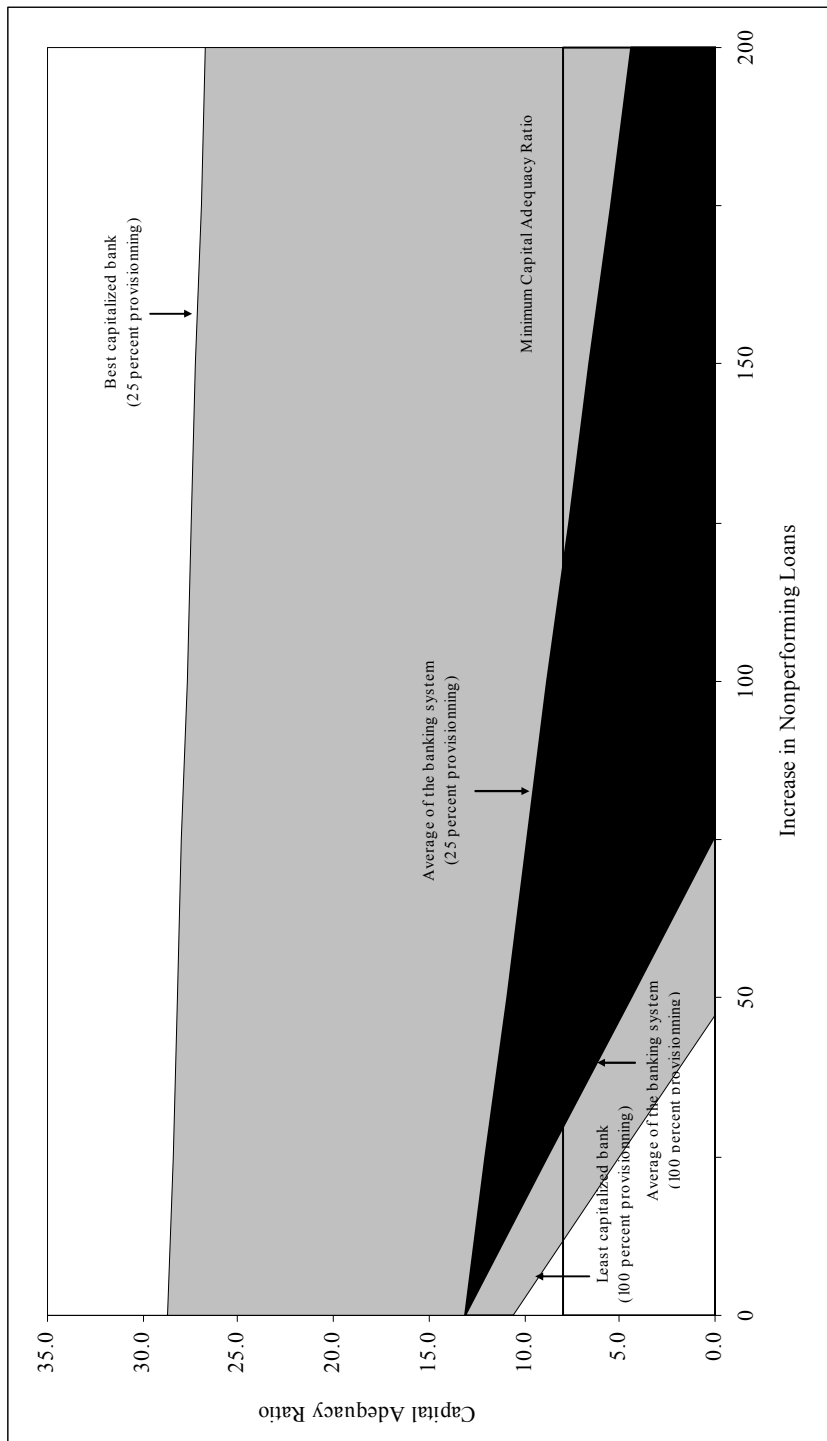
Market risk. The banks were found to be sufficiently capitalized to withstand direct effects of substantial volatility of the exchange rate and interest rate. As of September 2003, foreign currency deposits at banks were only 8 percent of total deposits, while foreign currency loans averaged 15.2 percent for the banking sector as a whole. The net foreign exchange open position of the banking sector was 23 percent of capital. The indirect exposure of banks to exchange rate fluctuations did not seem to represent a major source of concern. As to the interest rate risk, only public sector commercial banks would experience a rather substantial decrease in capital, especially in the event of an increase in the interest rate in outlying maturities.

Regarding the equity price risk, the majority of largest banks would suffer a substantial decline in their regulatory capital in case of a hypothetical crash of the stock market by 50 percent (the average CAR of the 12 largest banks would fall to 4.9 percent, with only four of these banks having CAR of above the required minimum). Although the magnitude of that shock would be substantially stronger than the largest monthly or quarterly decline in the KSE Index recorded over the last five years, it is plausible in light of the sharp market appreciation over the last two years (the KSE Index increased by 250 percent between December 2001 and December 2003).

Combined credit and market risk. A simultaneous occurrence of shocks on credit quality, exchange rate, and interest rate would have a substantial impact on the capital position of banks, especially public sector commercial banks. A synchronous depreciation by 25 percent, a deterioration in the quality of 50 percent of unhedged loans in foreign currencies (100 percent provisions), and an increase in interest rates of outlying maturities (by 100, 300, and 500 basis points) would reduce the CAR of public sector commercial banks to 4.7 percent, assuming the shocks are additive and enduring. If in addition to the above assumptions, there is a 40 percent decline of the stock market, the capital adequacy ratio of the banking sector would fall to 2.9 percent, while the capital position of public sector commercial banks would turn negative (-4.8 percent). Government injection of capital equal to 1 percent of GDP would then be required to restore the capital adequacy of these banks.

Liquidity risk. Results of stress tests for liquidity risk indicate considerable capacity at banks to withstand a substantial “run” on liquid liabilities. The results show that even a 20 percent run on liquid liabilities would not result in liquidity shortage and liquidity coverage as measured by the ratio of liquid assets to liquid liabilities would remain adequate.

Figure 1. CAR of Commercial Banks Adjusted for Variations in NPLs
(in percent)



B. Capital Markets

Structure and recent trends

27. **Pakistan’s capital markets have grown, but remain relatively narrow and shallow relative to the larger regional markets.**⁹ Market capitalization reached US\$16.5 billion at the end of 2003 equivalent to about 24 percent of GDP. While there are 693 listed shares, trading is highly concentrated, with just over half in the top 10 shares, and 95 percent in the top 30. The total investor base in the country, while increasing, is less than 0.5 percent of the population. There are three mutual stock exchanges,¹⁰ a National Clearing and Settlement System (NCSS) and a Central Depository Company (CDC), 278 registered brokers, a modest but growing mutual fund industry, and two registered rating agencies.

28. **Prices in the Karachi Stock Exchange (KSE) have recently shown strong gains, with the KSE-100 index up by 270 percent over the past 26 months.** This reflects a number of factors, including improved economic growth, consumer demand, and corporate earnings; record low interest rates; high liquidity in the markets, and a better regulated and more transparent market. The current level of market capitalization, if maintained, will make Pakistan eligible for inclusion in the Morgan Stanley MSCI index, which should attract some renewed inflows from overseas.

29. **The importance of the COT, or “badla” system in the stock market poses a risk to market stability.** “Badla” is essentially a facility for financing share purchases extended by brokerages and banks which allows buyers to obtain highly leveraged positions in the market. The extent of leverage through such non-bank financing for COT is not transparent and underlying security transactions are typically speculative. This creates scope for market manipulation and increases systemic risk. The SECP has recently instituted rules for “badla” trading, which have reduced the risks, and is developing margin financing rules which are expected to replace COT shortly. Appropriate margin trading rules should be rapidly adopted. In addition, the SECP should obtain independent expert advice on the adequacy of clearinghouse and investor protection funds and enhance investor protection by strengthening rules for the segregation of client assets in brokerage accounts.

30. **The SECP has demonstrated a commitment to high regulatory standards, as reflected in the assessment of compliance with the IOSCO Principles (Annex).** The Commission has a broad mandate, which has recently been expanded to cover most nonbank financial institutions (NBFIs), but it does not currently conduct onsite inspections of

⁹ In the region, India has a much more developed market with a capitalization of US\$280 billion (more than 50 percent of GDP) as of end-2003. Malaysia’s market capitalization of US\$127 billion was more than 130 percent of GDP as of end-2002.

¹⁰ Karachi Stock Exchange (KSE), Lahore Stock Exchange (LSE), and Islamabad Stock Exchange (ISE). KSE is by far the most active and almost all companies listed on LSE and ISE are also listed on KSE.

regulated entities unless there are indications of malpractice. In view of the developments in the stock market and ongoing introduction of new instruments and intermediaries, the SECP should commence a regular program of on-site supervision. As a step toward reinforcing its supervisory capacity, the SECP should undertake a formal review to determine whether it has the resources to perform its functions.

Market development

31. **Further development of capital markets could support more rapid economic growth.** More developed and efficient securities markets, including both equity and debt, can also help to reduce systemic vulnerabilities in a bank-dominated financial system. The small but growing mutual fund industry, which has been dominated by two public sector fund managers, offers significant potential for expanding the retail investor base. The privatization of one of the two public sector investment funds and government's announced intention to privatize the other--National Investment Trust, by far the largest collective investment scheme--are welcome.

32. **The corporate bond market is small and has significant potential for growth.** Development of the bond market has been hampered by the distortions caused by the high yields on National Savings Schemes (NSS) instruments, which effectively served as a benchmark for the corporate bond market. As a step toward removing this distortion, the authorities have introduced a formula linking yields on NSS instruments to those on Pakistan Investment Bonds (PIBs).¹¹ The prohibition on investment in NSS by institutions in 2000 subsequently led to a significant increase in corporate issuance. Further alignment of NSS rates with prevailing yields on comparable investments, and market-based alternatives to the present scheme, could promote market development and should be considered. One alternative would be to replace existing NSS instruments with retail marketable securities sold through subscriptions or auctions rather than on-tap.

33. **The relative underdevelopment of contractual savings also inhibits the development of the securities market.** Studies show a strong causal relationship between the level of development of life insurance and pensions and capital market deepening. The planned introduction of private pension savings accounts presents significant scope for development of the capital markets, but needs to be properly regulated to protect the pension savings of individuals.

34. **A growing retail investor base will require quality investor support services and better information about the market.** Individual investors do not always have access to adequate information to make informed decisions, and are not fully aware of such matters as the duties of investment advisers, rights of security holders and availability and reliability of

¹¹ The formula was revised in April 2004, effective July 1, 2004, to provide a more transparent and closer alignment with PIB yields.

complaint services. The SECP, stock exchanges, and broker dealers can all play a greater and more effective role in educating investors.

C. Insurance

35. **The insurance sector, with total premium income of PRs 26 billion in 2002 and total assets of PRs 126 billion as at December 31, 2002, is highly underdeveloped.** Insurance premiums per capita of \$1.0 for life and \$1.7 for nonlife, compare with \$11.3 and \$3.0 for India and \$5.2 and \$6.6 for Indonesia. There is scope for substantial development of the sector within an appropriate regulatory framework. Among other things, this is likely to entail ongoing liberalization of the sector, combined with further moves towards a more market/solvency regulatory and supervisory regime. Immediate challenges include the continuing rationalization of an overpopulated non-life sector and adjusting to new international accounting and solvency norms.¹²

36. **The Insurance Ordinance 2000 has introduced a number of laudable reforms, but has also omitted a number of elements that are key to a modern risk-based supervisory regime.** The latter include limited prompt corrective action power, lack of on-site supervision capacity and in-house specialist skills. There is a need to clarify the division of responsibilities between the MOC and SECP. There now seems to be a consensus that regulatory and supervisory responsibility for insurance should lie with SECP and that oversight relating to ownership and governance of the public sector insurers should rest with MOC.

37. **The future of the three public sector insurers also needs to be reviewed.** There appears little benefit in maintaining the government monopoly of National Insurance Company (NIC) and the authorities might consider developing an exit strategy. It also seems highly desirable that the government limit its exposure to contingent risks entailed by Pakistan Reinsurance Company Limited (PRCL), possibly by finding a private sector partner. Given its central role of the State Life Insurance Company (SLIC) in mobilizing funds for long-term investment, some form of arms-length ownership that does not distort the contractual savings market may be justifiable.

D. Pension Funds

38. **Pakistan has the basic elements of a diversified multi-pillar pension scheme that can provide old age income support and contribute to long-term social and economic stability.** The system comprises: (i) civil servants pensions; (ii) the EOBI, currently providing mandatory defined benefits coverage for the workers of private sector enterprises with 10 or more employees; (iii) a variety of provident funds and pension schemes sponsored and operated by larger private employers; and (iv) a nascent market in personal pensions

¹² Empirical research shows a negative correlation between overall insurance capacity in a country and the degree of fragmentation of its insurance sector.

offered through contractual savings and insurance products. The pension system for civil servants and EOBI entail substantial direct and indirect liabilities for the government that need to be addressed.

39. **The scope of private employer sponsored pension arrangements is not clear, as there is no centralized reporting requirement.** Although the SECP is assigned general authority, there is currently no direct oversight or supervision of these schemes, pointing to a potential regulatory gap. Proper regulation of these arrangements to provide, inter-alia, custodial requirements, funding and investment standards, reporting and valuation standards, and prohibitions on self dealing and transactions with related parties should be ensured.

E. Improving Access to Financial Services

40. **Until the late 1990s, the authorities' approach to providing credit to underserved markets was to channel subsidized resources through public DFIs or directed credit.** These policies were largely unsuccessful, but liberalization and better regulatory environment, coupled with increased liquidity and competition in the market, are producing more encouraging results. Lending to previously underserved markets has risen substantially in the past two years, and commercial banks have now overtaken the public specialized banks in providing agricultural, SME and housing finance.

41. **Notwithstanding the broadening of credit availability, further expansion of outreach is needed.** In 2003, it is estimated that bank credit reached 15 percent of all farms, and SMEs obtained just over 7 percent of their financing from banks and other financial institutions.¹³ In order to scale-up lending in a sustainable and cost-effective manner, the banks and Non-Bank Finance Companies (NBFCs) will need to adopt new products and technology, including modern programmed lending tools and credit scoring models, particularly in the SME sector. Credit information systems can also play a key role in this regard.

42. **Access to financial services for the poor through microfinance institutions (MFIs) is an important component of the government's poverty alleviation strategy.** Increasing access on a sound, sustainable basis will require a concerted effort at building retail capacity, performance based funding with appropriate incentives, and greater transparency. The regulatory framework for MFIs seems sound—they are not subject to any interest rate caps and applicable prudential rules are generally in line with best practice. However the minimum capital requirements seem high (PRs 500 million, or US\$8.8 million for a national license) and could discourage entry—lower requirements apply to district level banks, but they are still high.

¹³ Investment Climate Survey, World Bank, March 2003. Surveys of SMEs indicated they received 7 percent of their working capital and 7.3 percent of investment finance requirements from banks and other financial institutions (versus 13.3 percent and 23.6 percent respectively for larger firms). By far the greatest source of finance for both small and large firms was retained earnings.

F. Development Finance and Specialized Institutions

43. **Prior to 2000 Pakistan had an extensive network of government owned and managed specialized banks and development finance institutions that suffered from corruption, mismanagement and inefficiency.** Since the late 1990's the government has accelerated reforms of the DFIs. A number of them have been closed or merged, and others are being restructured. The remaining entities have a mandate to provide funding to the underserved areas of the economy and are to operate on a commercial basis with no new funding from government. It is planned that, SMEB, IDBP and HBFC are to be restructured and fully privatized and the Zarai Taraqiati Bank (ZTB) is to be partially privatized.

44. **The general policy on DFIs is commendable and rapid implementation of the specific plans for individual institutions is encouraged.** HBFC should be privatized, or its assets sold. IDBP should be resolved (privatized, merged or closed). Given its mounting operational losses, a quick resolution is important. The remaining DFIs are small, accounting for only a small share of the financial system.

45. **A number of measures have been taken to promote housing finance.** These include: new simplified foreclosure procedures; relaxation of restrictions on bank lending to the sector; and tax incentives. Although these have contributed to the recent surge of mortgage loans, the volume of total lending in this area remains low—at under 1 percent of GDP—and there remain significant obstacles. Some obstacles, such as banks' limited experience in this area, can be addressed through training and should be resolved as banks move up the learning curve. Other impediments, such as weaknesses in property and security rights administration, are more deeply rooted and will be more difficult to resolve.

IV. SYSTEMIC LIQUIDITY AND PUBLIC DEBT MANAGEMENT, CRISIS MANAGEMENT, AND SAFETY NETS

A. Liquidity Management and Markets

46. **The framework for systemic liquidity management is transparent.** The SBP seeks to “secure monetary stability and the soundness of the financial system.”¹⁴ A publicly disclosed monetary program is designed to achieve low inflation, currently defined as 4 to 5 percent average annual CPI inflation. At the operational level, an important role is assigned to interest rates and the nominal exchange rate, with the discount rate and the cut-off rate for government securities auctions serving as implicit policy rates. Exchange rate fluctuations are kept within tight limits. A variety of exchange and capital controls allow the authorities a degree of independence in affecting interest rates given the managed exchange rate.

¹⁴ See SBP Act, section 9A.

47. **The instruments for managing domestic liquidity are market-based, flexible and relatively well developed for an emerging market at Pakistan's stage of development.**

The monetary policy framework and operations of the SBP are publicly disclosed and explained on a regular basis. The SBP is considering the implications for its monetary operations of the growing, but still small, Islamic banking sector. It will also need to consider the implications of the planned RTGS system for liquidity management.

48. **The authorities might explore the feasibility of introducing some form of inflation targeting as a framework for monetary policy.** Adoption of an inflation target, or a suitable range, could provide additional discipline for consolidating the gains in reducing inflation in recent years. At the same time, adoption of a full-fledged inflation targeting would be premature at this stage. Such a framework would require a clear legislative mandate for the SBP, greater exchange rate flexibility, robust methods for short-term inflation forecasting and a well understood transmission mechanism for monetary policy. The latter may be especially challenging in an environment of financial deepening and diversification.

49. **The SBP has effectively managed the sizeable inflows of foreign exchange in recent years.** Inflation has remained low although the partially sterilized intervention has accelerated the money growth rate. The inflows have led to substantial accumulation of foreign exchange reserves at the SBP. The authorities' strategy of partly relying on external managers is appropriate, but requires finding a conservative balance between rate of return on the placements of foreign exchange reserves and risk. The authorities might also consider developing a strategic plan for an orderly liberalization of the remaining capital controls.

50. **The money market can be further developed by promoting a market for interest rate swaps and preannouncing a schedule for PIB auctions,** especially following the prohibition of investment by institutional investors in NSS.

B. Lender-of-Last Resort and Bank Resolution

51. **The authorities have been effective in undertaking lender-of-last resort functions and dealing with distressed banks.** Provision of emergency liquidity support is considered on a case-by-case basis, while instances of occasional liquidity needs of banks that have acceptable collateral are handled through the discount window at a penalty interest rate.¹⁵ While past episodes of bank distress suggest that the constructive ambiguity in lender-of-last resort policies has been effective, the SBP might consider setting out formal internal procedures for providing emergency liquidity support to banks, specifying the terms and conditions for such loans, and limiting the acceptable collateral to marketable government securities.

¹⁵ Frequent access to the discount window is discouraged by administrative means.

52. **Adequate procedures are in place for dealing with distressed banks.** The SBP has prepared a Problem Bank Manual that sets out progressive actions that should be taken in the case of a problem bank, ranging from signing of Memorandum of Understanding (MOU) with the bank on remedial actions to liquidation. The establishment of the CIRC with legal powers to takeover NPLs of NCBs and DFIs has been another positive factor in dealing with difficulties in banks' balance sheets. As of March 31, 2004, some 738 cases with a total outstanding amount of PRs 132 billion had been referred to the CIRC, of which it had acquired 234 amounting to PRs 47 billion. Of the latter, 192 involving an outstanding amount of PRs 31 billion, had been resolved.

C. Deposit Insurance

53. **Plans to establish a formal deposit insurance scheme aimed at promoting financial stability and protecting small depositors need to be approached with caution.** Deposit insurance is a double-edged sword. While it could help curb the tendency of depositors to flee at first signs of trouble at an institution, it also risks reducing the discipline on the insured institution and encouraging more risk taking. These considerations need to be balanced in the design of any deposit insurance scheme. The deposit insurance agency should be run independently, free from political interference; the premium structure and coverage should ensure appropriate incentives and financial viability; and membership should be compulsory to prevent adverse selection, and insolvent institutions should not be included.

54. **It would be important to ensure that the main institutional and other weaknesses are adequately addressed prior to the introduction of any deposit insurance scheme and certain technical aspects of the SBP's proposal need to be considered further.**¹⁶ Establishment of the fund at the SBP could potentially create a conflict of interest between the SBP's role as lender-of-last resort and as the manager of the fund. Avoiding this would require providing for appropriate firewalls in the fund's corporate structure. The proposed coverage seems generous, while the level of proposed premium is influenced heavily by the impact on banks' profitability and appears low by international standards. The proposed seed funding is at half the required amount estimated by the SBP, and itself needs to be considered in the context of the limited fiscal space. There is also the potential for an expansion of the scope of the scheme.

D. Public Debt Management

55. **The authorities' public debt management strategy is focused on debt reduction and lowering interest costs.** Both objectives are necessary given Pakistan's high debt to

¹⁶ The proposal seeks to initially establish a Deposit Insurance Fund managed by the SBP with mandatory participation of all commercial banks operating in Pakistan. It will protect deposits up to PRs 100,000, equivalent to 3.8 times per capita GDP and covering 94 percent of all accounts up to this amount and 52 percent of the total value of deposits. It envisages a flat premium of 0.02 percent of total insurable deposits to be paid by the covered institutions and a seed funding of PRs 5 billion to be provided by the government.

GDP ratio and high interest expenditure to revenue ratio. Pakistan's debt management practices largely follow the IMF-World Bank Public Debt Management Guidelines, although they can benefit from greater emphasis on risk management and implications for financial stability. A more comprehensive risk-based approach would also take into account not only interest lost but also other factors such as currency exposure, cash flows and bunching of maturities. The authorities are developing a risk management system to address these considerations.

56. **Risks related to external debt are contained, since this debt is largely long-term, concessional multilateral or bilateral.** The banking sector has a significant and growing exposure to domestic government debt: at December 2003, net claims on government constituted 32 percent of net domestic assets, up from about 20 percent in 2000 (but well below levels observed in emerging market countries that have experienced banking crises stemming from government insolvency). In part, the exposure to the government reflects excess liquidity of banks and insufficient alternative lending opportunities.

V. FINANCIAL SECTOR INFRASTRUCTURE

A. Payments System

57. **Major efforts to modernize the payments infrastructure in the financial sector will help curtail systemic risks.** An automated check clearing system (NIFT), established in collaboration with the private sector, has been operational since 1997. The SBP is now in the process of establishing a RTGS to replace the current manual book-entry system for the settlement of interbank lending, net settlement of checks, and the settlement of cash leg of government securities transactions. As the RTGS is being introduced, the FSAP did not undertake a formal assessment of the CPSS Core Principles for Systemically Important Payment Systems.

58. **There remain, however, deficiencies in the legal framework for payment system oversight.** At present, there are no provisions in the law regarding the finality of payment and zero hour rule, which are important to ensure the safety and soundness of the payment system. This would become important with the introduction of the RTGS and the expansion of the membership of participating institutions. The SBP Act should be amended to add a chapter to deal with payment systems. The SBP's liquidity management facilities would also need to be adapted to the proper functioning of the RTGS.

B. Legal Issues

59. **Though major efforts have been undertaken by the government to update and improve the legislative framework, there remains a need to repeal, amend and update laws.** In particular, the State Bank of Pakistan Act of 1956, amended in 2002, contains provisions that, inter alia, authorize the government to supersede the central board and allow the Federal Government to liquidate the Bank. It would be desirable to revamp the SBP Act to better reflect the current functions, powers and objectives of SPB. There are also a number

of issues in the Banking Companies Ordinance 1962, amended in 2001 (BCA), that need to be addressed to enhance the legal framework.

60. **The introduction of the Debt Recovery Ordinance in 2002 has set the stage for improving debt repayment.** Under the new legislation, banks may recover debt through summary procedure, and sell mortgaged property without intervention of the court. While this has generally had a positive effect on borrowers' attitude, creditors have been reluctant to use the summary procedures, citing inability to register mortgaged property in the name of the new owners and cases where borrowers have been able to obtain injunctions to stop the sale.

61. **The legal provisions governing insolvency and debt restructuring require updating.** Since there is no stay on secured creditors for debt workout and the court approval for debt workout is cumbersome, debt restructuring is not popular. Liquidation and winding up of companies is governed by the provisions in the Companies Ordinance, but the bankruptcy rules that govern the details of liquidation are more than 80 years old. The average time taken for liquidation ranges from 10–15 years. The authorities are in the process of revamping the insolvency laws of Pakistan.

C. Credit Information, Corporate Governance, and Accounting and Auditing

62. **Pakistan has relatively well developed credit information systems.** In 2001, SBP made credit ratings compulsory for all banks and NBFIs and required them to disclose them to the public. The main sources of credit information are an on-line credit information bureau operated by the SBP and two privately operated credit registries. Information sharing now prevents loan defaulters from receiving credit from banks. However, the rapid growth in consumer lending is likely to require more comprehensive credit information sharing with a broader range of creditors, such as utilities and retailers, and the development of other credit reporting products such as identity verification and credit scoring.

63. **Regulations in the area of corporate governance are extensive and comprehensive.** In addition to the detailed corporate governance provisions in the Company Ordinance, the Securities Commission of Pakistan issued a detailed Code of Corporate Governance in March 2002 for all listed companies that is broadly in line with OECD Principles, and in March 2003 issued a code for insurance companies. Prudential Regulations for Commercial Banking issued by the State Bank prescribe detailed standards of corporate governance for board of directors, management and shareholders of banks and DFIs.

64. **Accounting and auditing standards are of a high and internationally acceptable quality at least in larger corporations and financial institutions.** The accounting framework follows International Accounting Standards. All registered companies are required to have their accounts audited and submit the statutory returns promptly. The Institute of Chartered Accountants of Pakistan (ICAP) is a SRO, and plays an active role in ensuring quality. The SECP has also been proactive in strengthening the financial reporting

framework and the reliability of audits, and there is close collaboration between SBP bank examiners and bank auditors.

D. Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT)

65. **A detailed assessment of compliance with the FATF 40+8 Recommendations on AML/CFT is scheduled to be conducted by the Asia-Pacific Group on Money Laundering in August, 2004.** The APG will prepare a ROSC which will be presented for the information of the Fund/Bank boards. Pakistan currently has several laws that deal with various aspects of anti money laundering and combating the financing of terrorism. A comprehensive legal and institutional framework is currently in preparation. The SBP has developed two Prudential Regulations now in force concerning “Know Your Customer” and “Anti-Money Laundering Measures.” The SECP has also taken a number of relevant measures and has established an Anti-Money Laundering Unit. The authorities are urged to complete and implement the comprehensive legal and institutional framework for AML/CFT currently under preparation prior to the APG assessment.

Table 1. Pakistan: Asset Structure of the Financial Sector, 2000–03

Financial Institutions	2000	2001	2002	2003 1/
	(in billions of rupees)			
Commercial Banks	1,696	1,835	2,127	2,380
- o/w public	902	945	878	980
- o/w private	514	565	969	1122
- o/w foreign	280	325	281	277
Specialized Banks	112	107	98	n.a.
DFIs	92	61	69	n.a.
Investment Banks	42	28	23	25
Leasing Companies	39	46	44	45
Modarabas	16	16	17	14
Housing Finance Companies	22	24	22	21
Mutual Funds	26	24	29	12
Discount Houses	2	1	2	n.a.
Venture Capital Companies	1	0	0	n.a.
Insurance Companies	n.a.	23	n.a.	12
Pension Funds	n.a.	n.a.	n.a.	n.a.
All Financial Institutions 2/	2,046	2,165	2,432	2,510
	(in percent of total)			
Commercial Banks	82.9	84.8	87.5	94.8
- o/w public	44.1	43.7	36.1	39.1
- o/w private	25.1	26.1	39.8	44.7
- o/w foreign	13.7	15.0	11.5	11.0
Specialized Banks	5.5	4.9	4.0	n.a.
DFIs	4.5	2.8	2.8	n.a.
Investment Banks	2.0	1.3	1.0	1.0
Leasing Companies	1.9	2.1	1.8	1.8
Modarabas	0.8	0.7	0.7	0.6
Housing Finance Companies	1.1	1.1	0.9	0.8
Mutual Funds	1.3	1.1	1.2	0.5
Discount Houses	0.1	0.1	0.1	n.a.
Venture Capital Companies	0.0	0.0	0.0	n.a.
Insurance Companies	n.a.	1.0	n.a.	0.5
Pension Funds	n.a.	n.a.	n.a.	n.a.
All Financial Institutions	100.0	100.0	100.0	100.0
<i>Memorandum Items:</i>				
Commercial Banks (in percent of GDP)	49.5	50.6	52.9	54.1
All Financial Institutions (in percent of GDP)	59.8	59.7	60.5	57.0

Source: SBP

1/ As of September 2003.

2/ The data may not reflect exactly total assets of financial institutions due to unavailability of information on several sub-categories of small financial institutions.

Table 2. Pakistan: Financial Soundness Indicators for the Banking Sector, 1999–2003
(in percent)

	Dec-99	Dec-00	Dec-01	Dec-02	Sep-03
Capital Adequacy					
Regulatory capital to risk-weighted assets	12.2	11.4	11.3	12.6	13.1
Tier I capital to risk-weighted assets	10.3	9.8	9.7	9.7	10.9
Capital to total assets	5.0	4.9	4.6	6.1	6.2
Asset composition and quality					
NPLs to gross loans	22.0	19.5	19.6	18.0	16.1
Provisions to NPLs	46.6	53.9	53.2	58.3	63.0
NPLs net of provisions to capital	117.4	96.7	100.7	54.5	41.8
Earnings and Profitability					
ROA (after tax)	-0.3	0.0	0.0	0.8	1.4
ROE (after tax)	-6.2	-0.3	-0.3	13.8	22.1
Net interest income to gross income	54.3	61.2	68.9	67.4	58.2
Noninterest expenses to gross income	76.9	71.6	62.7	57.3	50.4
Personnel expenses to noninterest expenses	57.0	54.3	52.6	51.4	50.1
Non-interest income to total income	17.6	16.5	14.5	18.1	30.9
Liquidity					
Liquid assets to total assets	38.7	37.5	39.9	47.0	48.6
Liquid assets to total deposits	48.2	48.0	50.3	60.2	59.4

Source: SBP.

Table 3. Pakistan: Summary of Stress Tests Assumptions and Results 1/
(based on the end-September 2003 data)

	Group 1	Group 2	Group 3	Group 4	Group 5
Capital Adequacy Ratio Before Shock	11.9	14.1	10.3	22.3	13.1
Liquidity Ratio Before Shock	51.6	58.2	46.1	43.6	50.5
	Capital Adequacy Ratio After Shock				
Credit Risk					
An increase in NPLs of 35 percent	9.5	11.3	8.3	20.1	10.8
A shift in categories of classified loans	11.3	12.6	10.2	22.2	12.5
A 50 percent decline in the value of real estate collateral	10.2	11.1	9.3	22.3	11.5
A combination of the above three shocks	6.1	6.4	6.0	19.4	7.8
Exchange Rate Risk					
A depreciation of 25 percent	12.8	15.8	10.6	22.5	13.9
An appreciation of 20 percent	11.1	12.7	10.1	22.2	12.5
Interest Rate Risk					
An increase by 300 basis points	11.0	11.0	10.8	21.1	12.1
An increase in rates of outlying maturities (by 100, 300, and 500 basis points)	10.7	9.0	11.5	20.1	11.7
Equity Risk					
A decline in equity values by 20 percent	9.2	10.4	7.9	21.8	10.5
A decline in equity values by 50 percent	4.9	4.3	4.2	21.1	6.4
Combined Scenario					
A depreciation of 25 percent and a deterioration in quality of 50 percent of unhedged FX loans (100 percent provisions)	8.3	10.2	7.8	20.5	10.2
A depreciation of 25 percent, a deterioration in quality of 50 percent of unhedged FX loans (100 percent provisions), and an increase in interest rates of outlying maturities (by 100, 300, and 500 basis points)	7.0	4.7	9.1	18.2	8.8
A depreciation of 25 percent, a deterioration in quality of 50 percent of unhedged FX loans (100 percent provisions), an increase in interest rates of outlying maturities (by 100, 300, and 500 basis points), and a 40 percent decline in equity values.	0.8	-4.8	4.1	17.1	2.9
	Liquidity Ratio After Shock				
Liquidity Risk					
A 10 percent withdrawal in liquid liabilities	46.2	53.5	40.1	37.4	44.9
A 20 percent withdrawal in liquid liabilities	39.5	47.7	32.6	29.5	38.1

Source: SBP and staff estimates.

1/ Group 1 comprises the 12 largest commercial banks. Group 2 comprises the public sector commercial banks. Group 3 comprises the local private banks. Group 4 comprises foreign banks. Group 5 comprises all commercial banks.

OBSERVANCE OF FINANCIAL SECTOR STANDARDS AND CODES—SUMMARY ASSESSMENTS

This annex contains summary assessments of international standards and codes relevant for the financial sector. The assessment has helped to identify the extent to which the supervisory and regulatory framework is adequate to address the potential risks in the financial system.

The following detailed assessments of standards were undertaken: Basel Core Principles for Effective Banking Supervision (BCP)—by Mr. Keith Bell (external expert, formerly with the Office of Superintendent of Financial Institutions, Canada) and Ms. Faizah Hashim (Central Bank of Malaysia); the International Organization of Securities Commission (IOSCO) Objectives and Principles of Securities Regulation—by Mr. John Farrell (formerly with the New Zealand Securities Commission) and Mr. Muddasir Khan (World Bank); and the IMF's Code of Good Practices on Transparency in Monetary and Financial Policies—by Mr. Jorge-Ivan Canales Kriljenko (IMF), Mr. Keith Bell, and Ms. Faizah Hashim. The assessments were based on the authorities' answers to questionnaires and work during the FSAP missions.

Pakistan's compliance with international supervisory standards is generally high. The SBP has made considerable progress in recent years to achieving and maintaining high regulatory standards. There are only few areas where there is less than full compliance. While the SECP has also achieved a relatively high degree of compliance with the IOSCO principles, there appears to be a need for additional resources and institutional capacity building at the SECP to enable the Commission to carry out its broad mandate. Transparency practices regarding monetary policy formulation and implementation and banking supervision are generally in line with best practices.

A. Basel Core Principles for Effective Banking Supervision

Main findings

66. The BCO establishes the SBP as the authority responsible for the supervision, regulation and licensing of banks and certain designated NBFCs. The State Bank of Pakistan Act, 1956 (as amended), the Bank's Nationalization Act, 1974, the Financial Institutions (Recovery of Finances) Ordinance, 2001, the Companies Ordinance, 1984 and Statutory Regulatory Orders (SROs) also govern the activities of participants in the banking system. The SBP has made progress toward establishing a bank supervision system at the level of international best practice and achieves a degree of compliance with most of the Core Principles. It is understood that a comprehensive revision of the BCO by the SBP's Banking Law Review Commission is currently underway. This could be used to address certain deficiencies in observance of the Core Principles.

Preconditions for effective banking supervision, CPI

67. The general legal, business and accounting framework within which banks operate and banking supervision takes place has been improved as the result of a series of reforms implemented since 1997. The SBP has been restructured, separating its core central bank functions (monetary policy and supervision) from its non-core functions (currency circulation, securities issue, treasury) and transferring them to a subsidiary under the SBC Banking Services Corporation Ordinance, 2001. The SBP's role in supervising the banking sector has been strengthened. There remains, however, the capacity of the Federal

Government to give directions to the SBP in certain circumstance. Section 17(6A) of the State Bank of Pakistan Act, 1956 provides that the SPB shall—as and when directed by the Federal Government—purchase, hold and sell shares and debentures of any banking company as defined in Section 5 of the BCO, or of any financing corporation or institution. Sec. 52(1) provides that: “If in the opinion of the Federal Government, the Bank fails to carry out any of the obligations imposed on it by or under this Act the Federal Government may by notification in the official Gazette declare the Central Board to be superseded, and thereafter the general superintendence and direction of the affairs of the Bank shall be entrusted to such agency as the Federal Government may determine and such agency may exercise the power and do all acts and things which may be exercised or done by the Central Board under this Act.” Further, for historical reasons (i.e., the SBP was the chosen agency to hold the shares of banking companies nationalized by the Federal Government in 1974) it remains a substantial and, in some cases, the major shareholder of record in those former public sector commercial banks that have now had some portion of their ownership privatized. This creates an apparent conflict between its role as regulator and that of owner.

68. Amendment to the BCO to establish and enforce a Minimum Continuing Capital Requirement (MCCR) for banks (PRs 1 billion—about US\$17.4 million), a risk-weighted capital adequacy ratio (in excess of 8 percent) and strict enforcement of Prudential Regulations have led to re-capitalization and consequent improvement in the health of the banking system. To combat the high proportion of non-performing loans (NPLs) in the portfolios of the PSCBs an asset management company, Corporate and Industrial Restructuring Corporation (CIRC), was established to clean up banks’ balance sheets. Other measures have included a transparent mechanism of write-off of bank loans whose recoverability is almost zero after realizing the value of collateral. Banks have also increased their provisions against NPLs. As a result of these measures, the ratio of net NPLs to capital of the commercial banks has fallen from 117.4 percent at December 31, 1999 to 41.8 percent at September 30, 2003.

69. The DFIs, providing subsidized credit, have been liquidated, merged or shut down, reducing from twelve to four, the latter working in areas of SMEs, agriculture, industrial investment and housing finance. The Financial Institutions (Recovery of Finances) Ordinance, 2001, was promulgated to facilitate the process of mortgage foreclosures and expeditious settlement of banking disputes. The government has restructured the PSCBs by introducing professional management and independent Boards of Directors.

70. Market discipline is fairly effective, primarily because the greater efficiency of the Local Private Banks (including those PSCBs recently partially privatized) and the Foreign Banks (FBs) prevents the market being overwhelmed by the remaining large major PSCB. It remains a central tenet of the government’s financial sector reform program that there continue to be consolidation in the banking sector through restriction on entry (achieved through a moratorium on the granting of licenses for commercial banks), mergers, acquisitions and liquidations (achieved by imposition of a MCCR of PRs 1 billion as above) so that a few—but stronger—banks provide a full range of services.

71. The SPB has an array of powers to control the risks assumed by the banks and as indicated above, its independence has been enhanced. The SPB has exclusive and extensive authority to license, supervise and inspect all institutions. It also has power to establish—and enforce—prudential safety and soundness standards and regulations. The SBP appears to possess a sufficient number of staff—and the required infrastructure—to provide timely, comprehensive on and off-site supervision to the current group of licensed banks and non-bank financial institutions. However, the current regulatory framework provides that entities in the same group may be supervised by different regulators with, for example, a bank being supervised by the SBP and its leasing and investment banking subsidiaries being supervised by the SECP. The anomalies that such an arrangement present warrant consideration.

72. The legal protection normal for employees of a bank regulator performing their functions in good faith is present in the Pakistan legislation.

Licensing and structure, CPs 2–5

73. The BCO defines permissible activities of “banking companies” and the term “banking” itself, and all institutions using the term “bank” and its derivatives must be regulated by the SBP or companies specifically authorized by the SBP to do so. Criteria for establishing banks and approving the scope of their operations address the appropriate considerations. The SBP has the authority to review and give approval to proposed significant corporate acquisitions by banks and to consider the risks involved for the bank and to their supervisory interests. There is, however, no requirement that the incorporation of a subsidiary by a bank be brought to the attention of the regulator for its approval, although the SBP officials charged with supervision of banks indicate that it is standard procedure for banks to advise the SBP of any intent to incorporate a subsidiary in order to ascertain the SBP’s reaction thereto and, further, to keep the SBP well apprised of any change in their business strategies.

74. The SBP does have the specific legal authority to require its prior review of, and approval for, the proposed acquisition of a significant shareholder interest in an established bank.

Prudential regulations and requirements, CPs 6–15.

75. Market-risk related computations and capital charges are not in force in Pakistan. Risk-weighted capital adequacy requirements are in place (applied on both a “solo” and consolidated basis). As of February 27, 2004, only three specialized banks (all owned by the federal or provincial governments) together with one bank recently transferred to new ownership (which has committed to contribute the necessary capital) failed to meet the required minimum 8 percent risk-weighted capital ratio. Also at that date only the three specialized banks, together with a few small, foreign-owned banks had a capital base of less than PRs 1 billion. The small, foreign-owned banks are all in the final stages of transfer to new owners; such transfers—together with the necessary capital injection to meet the MCCR—are to occur by June 30, 2004.

76. The SBP has issued rules and regulations that provide instructions and requirements for lending and investment policies and procedures for banks as well as the related internal control systems. Other, more specific, credit-related directives which establish policies and procedures for asset quality classification and for provisioning, credit concentrations and connected lending have also been issued and provide substantive guidance for bank operations (CPs 7–11).

77. The SBP has recently provided guidance to banks—and will be determining in the course of on-site inspections conducted in the current year’s inspection program—whether there are risk management processes in place for market and other material risks (CPs 12 and 13).

78. The SBP pays close attention to the membership of a bank’s policy and executive bodies, the procedures for making decisions and delegating powers, the quality of internal control and the resources made available for it and the practical procedures for informing the decision making body (CP 14).

Money laundering, CP 15

79. Presently, there is no law that specifically and comprehensively addresses money laundering (and the financing of terrorism). A comprehensive legal and institutional framework is currently in preparation and in the draft law now being finalized a comprehensive definition of money-laundering will be incorporated, guided by best practice internationally. The SBP has taken a lead in developing two Prudential Regulations now in force concerning “Know Your Customer” and other Anti-Money Laundering Measures (CP 15).

Methods of ongoing supervision, CPs 16–20

80. This group of principles relates to the supervisory methods that should be applied, both on-site and off-site and the necessity to evaluate these methods qualitatively and on an ongoing basis. This group includes the necessity of supervising banks on a consolidated basis. Four departments are involved in the delivery of the SBP’s program of banking supervision: (a) the Banking Supervision Department (BSD), which reinforces the on-site inspections conducted by; (b) the Bank Inspection Department (BID); (c) the Banking Policy Department (BPD) responsible for policy issues; and (d) the Islamic Banking Department.

81. The BSD comprises various divisions organized along functional lines. Its off-site Monitoring Division assesses the overall soundness and stability of individual banks as well as the aggregate and provides an early warning system using traditional measures to highlight potential problems in banks so that prompt corrective action can be taken. The off-site monitoring system produces a pre-inspection package for inspectors, highlighting potential problem areas and other concerns to be addressed on-site. For this purpose, the division prepares periodic reports, which usually consist of a bank’s unconsolidated balance sheet, income statement and supporting schedules. Information from these reports is compiled into statistical reports showing a variety of standard ratios computed from the unconsolidated

financial statements, together with commentary. The Risk Management Division is responsible for ongoing monitoring of inherent risk in various business lines, products, individual banks and the whole banking sector. It also monitors the liquidity and cash reserves maintained by the banks, the level of existing capital and the adequacy of capital standards and the sensitivity in changing scenarios. The Risk Management Division also issues guidelines to banks to help them establish an appropriate risk management framework.

82. The BID carries out both comprehensive and targeted on-site inspections, which are planned in consultation with the BSD and conducted using standardized, written procedures set out in a comprehensive inspection manual published in 1999. The SBP implements a standardized “CAMELSS” (i.e., Capital; Assets; Management; Earnings; Liquidity; Sensitivity to Market Risk; Systems) approach for rating the overall condition of a bank under its Uniform Bank Grading System (CP 16).

83. Regular, formal contacts (“Prudential Meetings”) between the SBP and management of banks have not been an integral part of the SBP’s coordinated on- and off-site supervisory activities. However, meetings with bank managements have been held on an “as required” basis throughout the supervisory cycle (usually lasting approximately 12 to 18 months) and meetings are always held with top management at the conclusion of an on-site inspection and with the entire Board of Directors of the bank should the situation warrant (reports of inspections are always delivered to all members of the Board of Directors of a bank). In January 2004, a practice has been instituted to strengthen interaction between the SBP and the Board of Directors and Senior managements of banks/DFIs, as well as the banks’ external auditors, whereby meetings will be held with them at least once per calendar year and more frequently with banks/DFIs accorded an “unsatisfactory” rating (CP 17).

84. The SBP has full authority to request any information needed in the exercise of its supervision. The various prudential reports, prepared on an unconsolidated basis, are submitted primarily in machine-readable form to the off-site Monitoring Division, where they are promptly reviewed for accuracy prior to undergoing supervisory analysis. The latter determines the need for any required follow-up. (Work is well advanced on a system to receive institutions’ data centrally by electronic (on-line) means) (CP 18). The SBP has the legal right of full access to all bank records or information. In addition to its on-site inspections, the SBP can utilize the reports of the external auditors as a significant tool of supervisory information should it so wish. Licensees are required to produce audited financial statements but the SBP’s prior approval for the selection of such auditors is limited to its establishment of a panel of auditing firms (currently numbering 33) judged capable of performing the audit of three categories of banks (CP 19).

85. Consolidated supervision has yet to be developed in Pakistan. It is recommended that legislative changes be considered to facilitate the SBP’s effective supervision on a consolidated basis. It is also recommended that legislative changes be made to permit expressly that the SBP may exchange, for appropriate supervisory purposes, confidential information with other governmental authorities, and supervisory authorities in foreign host countries (CP 20).

Information requirements, CP 21

86. Banks are obliged to prepare financial statements and various reports in precise conformity with the SBP's formats. Annual audited financial statements are required to be drawn up in accordance with accounting standards issued by the International Accounting Standards Board (IASB) and interpretations issued by the Standing Interpretations Committee of the IASB as adopted in Pakistan. (International Accounting Standard 39: *Financial Instruments: Recognition and Measurement* and International Accounting Standard 40: *Investment Property* are not applicable to banks in Pakistan.) Accounting Standards are modified as required for application to Islamic financial institutions. The SBP ensures that information provided from bank records is verified periodically through on-site inspections.

Remedial measures and exit, CP 22

87. The State Bank of Pakistan Act provides the SBP a wide range of corrective measures in the event a bank conducts operations without due regard to safety and soundness or fails to comply with the BCO and the SBP's Prudential Regulations. Such measures include, depending on the circumstances: (a) imposition of a directive; (b) replacement of directors and senior managers; (c) imposition of a moratorium on a bank's operations pending its restructuring; (d) removal of a bank's license to conduct banking business; and (e) effecting the exit of bank from the industry through the seeking of a winding-up order. (In recent years, the SBP has acted to remove three smaller banks from the industry using a variety of the methods available.) Further, the BCO provides capacity for the SBP to seek the levy of monetary penalties on either banks or members of their managements for willful infringement of legislation and regulations applicable to banks (See also CP 1(4)).

Cross-border banking, CP 23–25

88. These principles are all related to cross-border banking issues, such as cooperation between home and host country supervisors and exchange of information, consolidated supervision on a global basis, and equal treatment of foreign banks. The SBP has the authority to supervise the overseas activities of locally-incorporated banks but has not recently conducted inspection of overseas branches due to the limited nature of such operations and the cost involved. Such inspections have, however, been isolated, given the comparative lack of international activity on the part of Pakistan banks (CP 23). Neither the BCO nor the State Bank of Pakistan Act provides the SBP the express power to share confidential supervisory information with other government authorities, as well as with the host country supervisory authorities for the foreign operations of Pakistani banks (CP 24). Local branches of foreign banks are subject to the same prudential, inspection, and reporting requirement as domestic banks (CP25).

Table 1. Recommended Action Plan to Improve Compliance of the Basel Core Principles

Reference Principle	Recommended Action
Objectives, Autonomy, Powers, and Resources (CP 1 (1) and CP1 (3))	Provide explicit authority in the BCO for sharing information with domestic and foreign supervisory agencies. Also, Consider repealing Sections 17 (6A) and 52 (1) of the SBP Act that reduce the autonomy of the SBP.
Investment Criteria (CP 5)	Consider introducing regulation explicitly requiring a banking company to seek SBP approval for making investment in a subsidiary in the financial sector and that defines the rules for acquisitions for major investments in Pakistan or abroad. Establish criteria for the approval/rejection of such investments.
Country Risk (CP 11)	Consider issuing guidelines setting out requirements that banks have information and management systems that allow for proper identification, monitoring and controlling of country and transfer risk.
Consolidated and Globally Consolidated Supervision (CP 20 and CP 23)	Consider providing the SBP with explicit authority to conduct consolidated supervision and to review the overall activities of a bank conducted through its subsidiaries, both domestic and overseas.

Authorities' response

89. The authorities, broadly agreed with the assessment and noted that some areas for further strengthening identified in the assessment, such as the revision of the SBP Act to strengthen the autonomy of the SBP, are being addressed in the context of the review of the SBP and banking legislation undertaken by the Banking Law Review Commission. The Commission has already prepared a draft of the revised SBP Act which is under active consideration of the MoF. In addition, regarding the need for certain requirements noted in the assessment of Principle 5, the authorities note that the legal framework of the BCO is supplemented by SBP guidelines issued in March 2003 regarding due diligence by banks and DFIs for the purposes of merger/amalgamation and by BPD Circular 7 on setting up of subsidiaries by banks.

90. Regarding market risk related computations and capital charges, the authorities note that the SBP's (BSD) is working on this issue and a circular in this regard, based on the recommendations of the Basel Committee, has been drafted and will be issued shortly. They also observed that some areas of non-compliance, such as country risk, at present are not highly relevant due to low exposure of domestic banks and other limitations on investments abroad.

B. Summary Assessment of Implementation of IOSCO Objectives and Principles of Securities Regulation

91. This assessment was undertaken in February 2004 as part of the joint IMF-World Bank Financial Sector Assessment Program for Pakistan. The assessors were Mr. John

Farrell (formerly with the New Zealand Securities Commission) and Mr. Mudassir Khan (World Bank).

Information and methodology used for assessment

92. The assessment was based on the law and practice regarding the regulation of securities and investments, the constitution, functions and powers of the securities and companies regulator--the Securities and Exchange Commission of Pakistan (SECP), the regulatory and surveillance arrangements adopted by SECP in fulfilling its statutory mandate, and procedures adopted by firms in complying with the law. The assessors considered whether Pakistan had implemented the International Organization of Securities Commissions (IOSCO) Objectives and Principles of Securities Regulation.

93. The background document reviewed for the assessment include: selected Pakistan statutes, rules, regulations, guidelines, orders and codes; the IOSCO self-assessments prepared by the SECP; the IOSCO guidance notes on assessment process and procedures; and various IOSCO reports, resolutions and news releases. The assessors paid close attention to the explanatory notes accompanying the IOSCO statement of Objectives and Principles. It also considered the IMF's Code of Good Practices on Transparency in Monetary and Financial Policies—Securities Regulation.

94. The assessors had extensive discussions with SECP Commissioners and officers, firms representative of the various categories of firms registered to undertake securities and investment business including stock exchanges and broker members, Central Depository Company and National Clearing Company, asset managers and investment advisers providing services to collective investment schemes, and independent professional advisers such as chartered accountants and lawyers. In the time available, the mission did not meet with listed company representatives, consumer groups or independent commentators.

Institutional and market structure

95. The SECP is the statutory body responsible for the regulation of securities and insurance business and companies in Pakistan. It is a member of IOSCO and as such was a party to the IOSCO resolution adopting the Statement of Objectives and Principles in September 1998. There is a Policy Board (PB), established by statute, which gives advice to the Government of Pakistan on matters concerning the securities and is responsible, among other things, for approving SECP budgets and regulations and for the oversight of the SECP's performance.

96. There are three registered stock exchanges in Pakistan: KSE, Lahore Stock Exchange (LSE) and ISE. Market capitalization of KSE, the exchange on which equities are most actively traded, on December 31, 2003, was PRs 951.5 billion (US\$17.2 billion), equivalent to around 23.7 percent of GDP. Market capitalization of LSE on December 31, 2003 was

PRs 937.3 billion (US\$16.9 billion), equivalent to around 23.3 percent of GDP.¹⁷ Almost all companies that are listed on ISE are also listed and their shares traded on KSE or LSE. There is a National Clearing Company and a Central Depository Company through which virtually all the actively traded securities are cleared and settled. There are 278 registered brokers, 130 corporates and 148 individuals, but not all of these are active. Of the 702 KSE listed securities 394 are described as “actives.” Of these, some 60 are in default, although KSE continues to provide a market, reportedly for the benefit of minority shareholders.

97. On average in 2003 the 10 most active securities accounted for 53 percent of turnover by volume, the 30 most active securities accounted for 95 percent of turnover. In 2003 the value of new shares issued to the market was PRs 44.9 billion (say US\$775 million–US\$110million in 2002). There are 14 one-month single stock futures contracts traded on the KSE (open interest as at December 31, 2003 PRs 5.3billion. The SECP has approved regulations for a national commodities market and an over-the-counter securities market but neither of these is yet operational.

98. There are 28 listed debt instruments (corporate bonds known as term finance certificates (TFCs)) with a total face value of PRs 27 billion and a market value slightly larger. There are two registered rating agencies. Listed debt securities must be rated. TFCs are issued to, and for the most part held by, institutional investors. The public market for corporate bonds issued by non-government owned companies is inactive.

99. Collective investment scheme business is modest though increasing. There are 9 open-ended funds administering assets valued at some PRs 40 billion (US\$700 million) and 37 closed-ended funds administering some PRs 4.1 billion. (US\$72 million). Of a total population of 140 million people in Pakistan no more than 200,000 have invested in a public market for securities.

General preconditions for effective securities regulation

100. The first precondition for effective securities regulation is a sound regulatory policy. Pakistan is committed, with the support of the Asian Development Bank (ADB), to a capital market development program. The particular emphasis of the program is on the development of non-bank financial markets and institutions, including more generally of regulatory policy. The immediate objectives of the program are: (i) to strengthen investor confidence through improved governance, transparency and investor protection; (ii) to increase the depth and diversity of financial intermediation through new capital market issues for saving and investment; (iii) to improve operational efficiency and risk management of intermediaries; and (iv) to reduce financial sector vulnerabilities.

¹⁷ There may be overlap between data for KSE and LSE due to companies being listed on both stock exchanges.

101. The legislative process should be secure and not subject to challenge. The rules of law on due process and the rules of natural justice, or equivalent, should be firmly in place. The law courts should be accessible, efficient, reliable, skilled in commercial law matters and unbiased. Investors should be educated and generally alert to their rights. The financial press should be informed and responsible. The taxation system should be financial product neutral.

102. There should be effective rules of law or market on access of new entrants to the market. There should be a diversity of market participants. The impediments to market competition which in Pakistan arise from certain tax laws that are not product neutral, the mutual structure of the stock, and the desirable securities market rules aimed at preventing unscrupulous individuals from participating in the markets.

Main findings

103. SECP is an active and energetic regulator. It has extensive powers to monitor market institutions and market practice. It has achieved a high degree of compliance with the IOSCO Principles. A robust program of review of relevant law and practice is underway and the authorities are strongly committed to achieving and maintaining high regulatory standards.

104. There are two immediate challenges:

- SECP is involved in preparing and promoting new law, surveillance and monitoring for compliance with the law, enforcement of the law, adjudication on offences, appeals (possibly to the exclusion of the courts), and it may have a financial interest as beneficiary in its own adjudications involving monetary amounts. SECP must be assiduous in maintaining high degrees of transparency in all its operations to demonstrate that its decisions particularly those which affect the rights of citizens and corporations are backed by good communications on its policies on interpretation and implementation and are taken in a fair and open-minded way;
- SECP has very important and very extensive responsibilities. It must be able to demonstrate to all its stakeholders including the investing public that it plans well for the use of its powers, including allocating the necessary resources, reports on its performance by reference to its plans, and demonstrates that it has adequate resources and makes good use of them.

Regulator: Principles 1–5

105. The responsibilities of SECP as regulator are clear and objectively stated, generally in the law. SECP is operationally independent and accountable in the exercise of its functions and powers. The assessors do not consider that the Policy Board intrudes on the operational independence of SECP. SECP has adequate powers to perform its functions, although based on available information it was not possible to conclude that it had proper resources and capacity for this purpose. More formal and transparent processes for planning and accounting for SECPs regulatory work, including the allocation of appropriate resources are recommended. Broadly speaking SECP adopts clear and consistent regulatory processes. It

should undertake a formal review of its processes and consider whether there are further opportunities to issue useful guidance notes and policy statements. SECP staff are expected to observe high professional standards.

Self-regulatory organizations: Principles 6–7

106. The regulatory regime makes appropriate use of SROs. These are subject to SECP oversight and observe standards of fairness and confidentiality. It is recommended that SECP and the exchanges enter into an MOU relating to the coordination of work, cooperation, and the exchange of information, also that the exchanges, like SECP, should have more formal and more transparent processes for planning and reporting on their regulatory work.

Enforcement: Principles 8–10

107. SECP has comprehensive inspection, investigation and surveillance powers. It has comprehensive enforcement powers. However it has not demonstrated that it has ensured an effective and credible use of these powers.

Cooperation: Principles 11–13

108. SECP has wide powers to share both public and non-public information in its possession with domestic and foreign counterparts. It has not yet established the necessary mechanisms for sharing non-public information, at least with foreign counterparts, but is working on this. It does seem that the SECP has the power to undertake inspections or investigations at the request of foreign counterparts, it can merely communicate information already in its possession from inspections or investigations undertaken in accordance with the law.

Issuers: Principles 14–16

109. The law provides for full, accurate and timely disclosure of financial results and other information to shareholders of companies and interest holders in collective investment schemes. There is no equivalent requirement to disclose information to holders of debt securities such as corporate bonds. The obligation of an issuer of debt securities to the public to appoint a trustee is incomplete. The policy of the law is that shareholders of a company should be treated in a fair and equitable manner. However the powers of minority shareholders under the Companies Ordinance may be difficult to exercise, the laws about company takeovers are not yet effective as the necessary statutory regulations have not yet been enacted, and the substantial security holder disclosure laws are not particularly effective. It is material to this that there is some evidence of shareholding concentrations among listed companies, cross-shareholdings and inter-company debt. Accounting and auditing standards are of a high and internationally acceptable quality.

Collective Investment Schemes (CISs): Principles 17–20

110. The regulatory system sets standards for the eligibility and regulation of those who wish to market or operate a CIS. There are rules governing the legal form and structure of CISs and the segregation and protection of client assets. These require disclosure as necessary for the particular investor to evaluate the suitability of a CIS for and the value of the interests. They ensure a disclosed basis for asset valuation and the pricing and redemption of units. It is recommended that SECP review the adequacy of the valuation and pricing rules and practices. Prices may not necessarily reflect the value of the underlying assets of a scheme.

20. Market Intermediaries: Principles 21–24

111. Regulation provides for minimum entry standards for market intermediaries. There are initial and ongoing capital and other prudential requirements. There are no rules for the segregation and protection of the assets and money of clients in the hands of intermediaries. SECP does not have a mature system for planning its monitoring and surveillance work and assessing its performance at the end of the planning period. Subject to these two matters market intermediaries must comply with standards for internal organization and operational conduct to protect the interests of clients and ensure proper management of risk. The assessors do not consider that Pakistan has adequate procedures for dealing with the failure of a market intermediary, at least in the case of intermediaries that are not members of a stock exchange.

Secondary Market: Principles 25–30

112. The establishment of trading systems is subject to regulatory authorization and oversight. There is ongoing supervision which aims to ensure that the integrity of trading is maintained. Regulation promotes transparency of trading. Regulation is designed to detect and deter manipulation and other unfair trading practices. However the assessors are unable to form a view on the adequacy of resources committed to these four matters. In addition, the assessors have queried whether insider trading law is adequate to deal with those who benefit from insider trading but are not insiders as defined, in particular, tippees of insiders.

113. Regulation aims to ensure the proper management of large exposures, default risk and market disruption, although as observed elsewhere in this note client money and assets are not segregated and protected in the hands of intermediaries and the assessors have questioned procedures for dealing with the failure of a market intermediary (see CP 21–25 above). It is recommended that SECP and the exchanges take independent advice on the adequacy of financial arrangements for managing the failure of an intermediary or market disruption.

Recommended actions

114. The recommended plan of actions to improve observance of the IOSCO Objectives and Principles of Securities Regulation is set out below.

Reference Principle	Recommended Action
Principles Relating to the Regulator (CP 1–5)	<p>CP2: FG should review its procedures for the appointment of commissioners and PB members with the aim of making them more transparent and so assisting FG to ensure that appointments meet the expectations of the SECP Act.</p> <p>CP 2: The annual report and statement of accounts of SECP should both be readily available to the general public. There should be a formal statement of accounts for the statutory fund.</p> <p>CP 3: SECP should have formal plans for its monitoring and surveillance work and for its investigation work into incidents of market malpractice, formal plans for the allocation of staff to undertake this important work, and procedures for assessing performance at the end of the financial year. Similarly the SROs for which it is responsible, in particular the stock exchanges, should have equivalent plans and procedures. This is important in demonstrating its contribution to ensuring better standards of market behavior, better standards of disclosure of prescribed and other material information, better standards of corporate governance, and the elimination of unfair trading practices.</p> <p>CP 4: SECP should undertake a review of its regulatory processes and identify areas in which it would be helpful, in support of its commitment to clear and consistent regulatory processes, to issue a guideline or make a public statement. This will assist market participants in dealing with the Commission. It will also help to ensure that processes throughout the organization are consistent and fair.</p> <p>CP5: SECP should establish a formal procedure for assuring itself of employee and commissioner compliance with the rules of law and provisions of the Service Manual about professional standards.</p>
Principles of Self-Regulation (CP 6–7)	<p>CP 6: The exchanges, like SECP (see recommendation under CP 1–5 above), should have formal plans for their monitoring , surveillance and investigation work and formal procedures for assessing performance and reporting publicly on this.</p> <p>CP 6: SECP should consider formalizing its relationship with the exchanges by entering into an MOU on cooperation and the exchange of information, which</p>

Reference Principle	Recommended Action
	<p>would be publicly available.</p> <p>CP 6: SECP should clarify the statutory authority under which the National Clearing Company acts if it is to continue to exercise self-regulatory powers including the power to make regulations.</p>
<p>Principles for the Enforcement of Securities Regulation (CP 8–10)</p>	
<p>Principles for Cooperation in Regulation (CP 11–13)</p>	<p>CP 11: SECP should take early action to finalize its detailed arrangements for entering into information-sharing arrangements with foreign counterparts. It should conclude the necessary arrangements for gaining access to confidential client information of the banks where this is material to its responsibility as a securities regulator.</p> <p>CP 13: SECP should seek the necessary statutory authority to assist foreign counterparties in their inquiries, in particular, to use its powers of inspection and investigation at the request and for the purposes of a foreign counterpart.</p>
<p>Principles for Issuers (CP 14–16)</p>	<p>CP 14: Some of the language of the law of financial reporting, for example, the prescribed annual financial statements of a company under the Companies Ordinance, appears out of date. Given the increasing importance of financial statements in monitoring the condition and performance of companies and schemes, particularly listed companies and schemes, SECP should as time allows review the law with a view to updating the financial reporting obligations of issuers.</p> <p>CP 14: Provision should be made in the Ordinance for the appointment of a trustee for debt security holders, whether or not the securities are secured, to receive information and otherwise to act for security holders. Explicit provision should also be made in the Ordinance for the disclosure of information about the trustee and the trust deed in the prospectus.</p> <p>CP 15: SECP should review the provisions of the Listed Companies (Substantial Acquisition of Voting Shares and take-overs) Ordinance 2002 about the disclosure of shareholding in a listed company and consider whether with amendments they could better achieve their statutory purpose. This is all the more important where shareholding ownership is concentrated and there is evidence of inter-company shareholding by listed companies.</p>

Reference Principle	Recommended Action
	<p>CP 15: SECP should take early action to propose rules under the takeovers provisions in the Ordinance about such matters as the content of a public offer, mode of payment and minimum price.</p> <p>See also CP 1–5.</p>
Principles for Collective Investment Schemes (CP 17–20)	CP 20: SECP should review the rules and practices of the market relating to the valuation of assets and pricing and redemption of interests in a CIS.
Principles for Market Intermediaries (CP 21–24)	<p>CP 21: SECP should review the law about the regulation of non-corporate providers of investment services to the public in Pakistan.</p> <p>CP 23: SECP should review the status of client money and assets held by intermediaries and consider what additional protection is needed.</p> <p>CP 24: SECP should review the procedures available to it for dealing with the failure of a non-bank finance company, particularly where the new prudential regulations apply.</p> <p>See also CP 1–5.</p>
Principles for the Secondary Market (CP 25–30)	<p>CP 28: SECP should review the rules about insider trading to ensure that they can be enforced effectively in particular cases.</p> <p>CP29: As noted under CP 21–24 SECP should secure the enactment of appropriate rules of law about the segregation and protection of client money and assets held by intermediaries.</p> <p>CP 30: SECP should seek confirmation of the statutory authority of the National Clearing Company to act as a self-regulator with the power to make, with SECP approval, and to enforce regulations.</p> <p>CP 30: SECP should in due course address the status of those listed issuers which stand outside the national clearing and settlement system.</p> <p>See also CP 1–5.</p>

Authorities’ response

115. While agreeing with many of the recommendations, the authorities provided the following comments:

116. Recommendations on CP 2: The Federal Government exercises a transparent procedure for appointments and expectations regarding the law are met. The law provides for

release of annual report to the public and submission of the same to the Federal Government. The statement of accounts is only required to be furnished to the Federal Government which subsequently makes both the documents public by Gazette notification. The annual report is of interest to the public and is placed on the Commission's Website. The statement of accounts reflects the status of the fund.

117. Recommendation on CP 3: The SECP has inspection, investigation, surveillance and enforcement systems in place and is constantly upgrading these to ensure compliance with the laws.

118. Recommendation on CP 4: The regulatory processes are under constant review.

119. Recommendation on CP 5: A Code of Ethics and Conduct for employees of the Commission has been prepared and it lays down the professional standards that Principle No. 5 states.

120. Second recommendation on CP 6: The regulatory framework, i.e., Securities and Exchange Commission of Pakistan Act, 1997 and the Securities and Exchange Ordinance, 1969 as well as the Memorandum and Articles of Association of the stock exchanges facilitate timely exchange of information and cooperation between the SECP and the stock exchanges. Thus there is no bar on sharing information and as such no formal requirement on the part of the two parties to sign an MOU. However, the same may be considered.

121. Third recommendation on CP 6: The SECP will look into this suggestion.

122. Recommendation on CP 11: Internationally, MOU has been signed by the SECP with Sri Lanka. Arrangements with other foreign counterparts will be entered into as well. As regards jurisdiction of the SECP to obtain information/ records of all funds and assets transferred into and out of bank and brokerage accounts relating to securities transactions, it is submitted that under Section 33A of the Banking Companies Ordinance 1962, all banks and financial institutions are prohibited from divulging any information relating to affairs of its customers except as required by law. However, the banks can be ordered to produce any document under Section 21 (4) (b) of the Securities and Exchange Ordinance 1969 by the person appointed under Section 21 of the Securities and Exchange Ordinance 1969.

123. Also, the SECP and the SBP have signed a MOU that sets out parameters for close coordination in supervision of banks, DFIs and NBFCs operating in Pakistan. The SECP and the SBP will share information and work towards the holistic development of the financial sector. The two regulators have agreed to provide each other the necessary information for granting authorization, and to assist each other by verifying or supplementing any information submitted by or to any bank/DFI/NBFC. The SEC and SBP have agreed to provide on request relevant information on material developments or supervisory concerns in respect of the operations of a financial institution, to respond to requests for information on regulatory systems, and to inform each other about significant changes, particularly those which have a material bearing on activities of a bank/DFI/NBFC.

124. Recommendation on CP 13: The regulatory system allows for assistance to be provided to foreign regulators. The provisions relating to information sharing, assistance and cooperation are included in a MOU signed with the foreign regulators on a case-by-case basis. However, the provisions relating to information sharing, assistance and cooperation are similar to the IOSCO MOU.

125. The SECP and the Securities and Exchange Commission of Sri Lanka have signed a MOU which sets forth a statement of intent of the two regulators to establish a framework for mutual assistance and to facilitate the exchange of information between them in order to enforce/ensure compliance with their respective securities and futures laws and regulatory requirements. The authorities agreed to promote mutual assistance and exchange of information to enable them to effectively perform their respective duties according to the law.

126. First recommendation on CP 14: The Companies Ordinance has been amended in 2002 and the financial reporting obligations have been further strengthened. Moreover, the SECP ensures that disclosures of financial results are timely and imposes penalties for defaults.

127. Recommendation on CP 21: An Investment Adviser has to be a corporate entity licensed by the SECP. No individual/firm is authorized to render such services.

128. Recommendation on CP 23: There are arrangements in place to keep client assets separate at all times from the assets of the market intermediary (broker). As regards segregation of client securities, the market intermediary (broker) may open sub-accounts, as part of the accounts of the broker, on behalf of the sub-account holders so as to record the title of the sub-account holders to book-entry securities in such sub-accounts. In addition, the clients may avail the Investor Account Services (IAS) of the Central Depository Company and open separate investor accounts. The broker can only enter book-entry securities beneficially owned by clients in his own account on written authorization of his clients.

129. A general requirement to protect client securities that applies to all types of accounts including the “omnibus” accounts is provided for in section 24(2) of the Central Depositories Act, 1997 (CDA 1997) which places an obligation on the market intermediary not to handle or authorize or permit any handling of book-entry securities beneficially owned by such clients and entered in his account without the authority of his client.

130. Moreover the broker is required to maintain back office records of securities held in the group account (“omnibus account”) on behalf of his clients. The broker is required to verify/reconcile the activity taking place during that business day with reference to any holding of book-entry securities entered in any holding forming part of the account family (including the group account) of the broker.

131. Under chapter 13 of Central Depository Company of Pakistan Limited Regulations (CDC Regulations), Central Depository Company conducts a periodic audit of back office records of the broker in order to monitor compliance with the CDA 1997 and the CDC

regulations. It thereby ensures that securities held in group account are reconciled with the back office record showing the transactions conducted and securities held in the group account and proper authorization for handling of securities has been obtained from the client thereof.

132. As regards segregation of client money, the draft Margin Financing Rules, 2004 forwarded to the Federal Government for approval, propose that deposit of margin of client in form of cash by the market intermediary (broker) shall be kept in a separate bank account.

133. Moreover, the SEC is in the process of drafting Regulations for Proprietary Trading. The regulations, once in place, will ensure explicit segregation of client accounts and broker/proprietary accounts.

134. Recommendation on CP 28: The SECP has started the review of legal provisions pertaining to insider trading and security disclosure.

135. Recommendation on CP 29: Please refer to the comments on CP 23 on segregation and protection of client money and assets held by intermediaries.

C. Observance of IMF's Code of Good Practices on Transparency in Monetary and Financial Policies—Monetary Policy

General

136. The SBP observes most of the good practices on transparency in monetary policy recommended by the IMF. The assessment of the observance of the Code of Good Practices on Transparency in Monetary Policy in Pakistan was conducted as part of the Financial Sector Assessment Program (FSAP). For this purpose, a joint International Monetary Fund–World Bank mission visited Pakistan during February 16–27, 2004, and April 7–15, 2004. The monetary policy transparency assessment was conducted by Mr. Jorge Canales-Kriljenko (IMF), while that on financial policies by Mr. Keith Bell.

Main findings

137. Most of the good practices about the clarity of roles, responsibilities, and objectives of the monetary authority are observed. The ultimate objectives and institutional framework of monetary policy are defined in the SBP Act and clarified through a variety of means. In particular, the SBP Act establishes that the SBP's Central Board of Directors shall "secure monetary stability and the soundness of the financial system."¹⁸ In its preamble, the Act further states that the SBP will be constituted to secure monetary stability and "fuller utilization of country's productive resources." As in many other developing countries, the Act does not define precisely the terms "monetary stability," which has given in practice

¹⁸ See SBP Act, section 9A.

leeway to the authorities in adopting differing frameworks over time. Nevertheless, the ultimate objectives are clarified through a variety of means. The annual monetary program, which is publicly disclosed, is designed to achieve low inflation, currently defined as 4 to 5 percent average annual CPI inflation.¹⁹ In addition, monetary policy also seeks to smooth exchange rate fluctuations, support economic growth, and maintain financial sector stability, but the track record in disinflation is consistent with these objectives being subordinated to the inflation one. In addition, the institutional relationship between monetary and fiscal operations and the agency roles performed by the SBP on behalf of the government are clearly defined.

138. While the good practice on the transparency about the ultimate objectives of monetary policy is technically observed, transparency would be improved by clearly defining the meaning of the term “monetary stability” and establishing a hierarchy of the multiple objectives of monetary policy in the SBP Act.

139. The process for formulating and reporting of monetary policy is open and transparent and all corresponding good practices are observed. The monetary framework, instruments, and any targets are publicly disclosed and explained through a variety of means. Information on the composition, structure, and functions of the permanent monetary policy making bodies is publicly disclosed. Changes in the setting of monetary policy instruments are publicly announced and explained in a timely manner. The SBP issues periodic public statements and on progress toward achieving its monetary policy objectives and the prospects for achieving them, including a monetary policy statement every six months as well as quarterly and annual reports. Public consultations take place for substantive technical changes to monetary regulations and regulations on data reporting by financial institutions to the SBP are publicly disclosed.

140. As recommended by the transparency code, a wide array of information on monetary policy is publicly available. Pakistan joined the International Monetary Fund’s General Data Dissemination System in November 2003 and comprehensive information on its statistical production and dissemination practices have been published on the IMF’s Dissemination Standards Bulletin Board. The SBP publicly discloses a summary of its balance sheet every week and detailed audited balance sheet according to internationally accepted accounting principles annually in SBP annual report. Market transactions (monetary operations) are reported on the same day. The Corporate and Media Affairs Department (CMAD) of the SBP has been assigned the responsibilities of maintaining public information services and appointed a Chief Spokesman for the State Bank of Pakistan. All the regulations issued by the SBP since 1992 in the form of circulars and notices are readily available to the public in the SBP’s website. Older regulations are available upon request.

¹⁹ The track record in achieving the inflation target in the programs has been relatively good, even when compared to some countries that have officially adopted inflation targeting.

141. The SBP follows all good practices on accountability and assurances of integrity of its staff. The State Bank of Pakistan is accountable to Parliament and subject to reviews conducted by Senate Banking Committee and National Assembly Banking Committee. The SBP Governor makes periodic appearances in Parliament and submits to Parliament the SBP's quarterly and annual reports. The SBP's audited financial statements prepared under international accounting standards are disclosed in the annual report. The statements include the balance sheet and profit and loss account, which contains information on the operating expenses and revenues. The profit and loss account identifies the dividend accrued to the Government of Pakistan and identifies the balance transferred to the government. Standards for the conduct of personal financial affairs of officials and SBP staff are established in the SBP Act and SBP Staff Regulations, both of which are publicly disclosed.

142. Some issues remain. First, the conditions under which the government may override SBP decisions in exceptional circumstances are not specified in legislation. The Federal Government can override SBP decisions by superseding the Central Board of Directors of the SBP with an agency chosen by the Federal Government (SBP Act, section 52). The government can take this measure if, in its opinion, the SBP fails to carry out any of the obligations under the SBP Act. The decision will be disclosed in the Official Gazette and the government would need to prepare a report for Parliament within three weeks explaining its decision. While the SBP Act publicly discloses the mechanism through which the government can override SBP policy decisions, the specific conditions under which the decision making body of the SBP can be removed by the Federal Government to override its decisions are not specified in the SBP Act and left to the arbitrary judgment of the Federal Government. The threat to replace the Central Board of Directors with an agency chosen by the Federal Government could significantly reduce the degree of independence of the SBP, and ultimately the transparency of the policy decision making process. The SBP Act should be modified to either eliminate the prerogative of the Federal Government to supersede the SBP's Central Board of Directors or by clarifying the instances where the SBP would fail to reach its objectives.

143. Second, the actual terms of the SBP advances to the federal, provincial, and local government are not publicly disclosed. Under the SBP Act, the maturity of advances granted to the government by the SBP cannot exceed three months and the range of interest rates on these advances are disclosed in the notes to the audited financial statements contained in the annual report. The actual detailed terms, including maturity, however, are not disclosed.²⁰ The terms and conditions, including maturity and interest rates, of individual SBP advances to the federal, provincial, and local governments should be fully disclosed on a regular basis.

²⁰ The aggregate amounts of government borrowings from SBP are publicly disclosed on monthly basis and contained in the summary SBP balance sheet disclosed weekly. They are also presented in the audited financial statements contained in the SBP annual report.

Table 2. Recommended Action Plan to Improve Observance of IMF’s MFP Transparency Code Practices—Monetary Policy

Reference Practice	Recommended Action
I. Clarity of Roles, Responsibilities and Objectives of Central Banks for Monetary Policy	
If, in exceptional circumstances, the government has the authority to override central bank policy decisions, the conditions under which this authority may be invoked and the manner in which it is publicly disclosed should be specified in legislation.	Modify the SBP Act to either eliminate the prerogative of the Federal Government to supersede the SBP’s Central Board of Directors or clarify the instances where the SBP would fail to reach its objectives.
The amounts and terms of credits, advances, or overdrafts to the government by the central bank and those of deposits of the government with the central bank should be publicly disclosed.	Publicly disclose the terms and conditions, including maturity and interest rates, of individual SBP advances to the federal, provincial, and local governments in an annex to the quarterly report.

Authorities’ response

144. The authorities generally agreed with the assessment, but did not provide written comments.

D. Banking Supervision

Main findings

145. The SBP observes most of the good transparency practices in the area of banking supervision.

Clarity of roles, responsibilities, and objectives

146. The institutional framework and objectives of the SBP and the SECP are clearly defined in the Banking Companies Ordinance 1962, SBP Act 1956 and Companies Ordinance 1984. SBP regulates and supervises the entire banking sector whereas Non Bank Financial Companies (NBFCs) comprising of relatively small portion of the financial sector are supervised by the SECP. The SBP is also the sole payment systems authority in the country.²¹ It regulates clearing houses for schedule banks and can enter into any clearing and

²¹ The legal framework for the payment and settlement systems includes the State Bank of Pakistan Act 1956, Banking Companies Ordinance 1962, Contract Act 1872, Negotiable
(continued)

payment arrangements with other countries. In order to ensure effective supervision, both the agencies have formal arrangements whereby the two agencies share information, exchange view before formulating new regulations and help each other for the development of supervisory resources. To accomplish these objectives, the two agencies meet quarterly or more frequently to discuss developments. This relationship has been formalized through an MoU signed between the two agencies which was publicly disclosed.

Open process for formulating and reporting of policies

147. The policies and process of policymaking are well-defined and transparent. Various departments of SBP devise policies relating to their function. Where there are no confidentiality considerations, the policies are discussed at various concerned fora and are finalized after taking into account comments/suggestions. As a standard practice, SBP consults with Pakistan Banks Association (PBA), Institute of Chartered Accountants of Pakistan and other stake holders on matters relating to regulation and supervision of banks. Draft regulations are placed on SBP web site for comments. Comments received are carefully considered while amending the regulation. Once a policy is formulated SBP ensures its strict compliance under the powers vested in it. Significant changes in financial policies pursued by SBP are properly disclosed in its quarterly and annual reports and through its circulars.

Public availability of information on financial policies

148. Information on financial policies is publicly available through a variety of means. An annual review on the performance of the bank sector is published in the Banking System Review. The Quarterly and Annual reports also cover in detail financial policies and developments. These reports are available at SBP website and can be purchased from Corporate and Media Affairs Department of SBP. A monthly Statistical Bulletin has several financial sector indicators. Prudential regulations, other general directives and guidelines issued by the SBP are available not only in printed form but also on the SBP website. Information on financial policies are often clarified by the Chief Spokesman of State Bank of Pakistan. The Spokesman is a senior official of the Corporate and Media Affairs Department (CMAD), which is in charge of providing public information services.

149. As examples of transparency in specific financial policies contemplated in the code, the deposit protection on publicly owned banks is widely known to the public, codified under the Banks (Nationalization) Act (1974), and time tested. It is also well known that there is no explicit deposit insurance guarantee scheme for private banks in the country. In addition, the arrangements for entertaining the complaints on any bank are known to the public at large.

Accountability and assurances of integrity by financial agencies

150. Some mechanisms for the accountability of financial policies are in place. While no public authority has been explicitly designated to report on the conduct of financial policies, the standing committees of the Parliament (public Accounts Committee/ Audit Committee) may call upon SBP officials to explain issues relating to economic and financial sector. Further SBP has an independent Board of Directors that also monitors its performance and the Monetary and Fiscal Policies Coordination Board is formed to coordinate between SBP's objectives and government policies. The SBP's audited financial statements, under international accounting standards, are included in the SBP annual reports.

151. Laws and regulations guide the conduct of personal financial affairs of officials and staff of SBP. Section 46 of SBP Act declares the employees of SBP public officers and subject to laws applicable on public servants. Section 53 of the same act binds the officers and servants of SBP to maintain secrecy. Further proper procedures are in place to establish the financial affairs of the employees as each year they are required to submit a statement containing details of their assets and liabilities.

Recommended next steps and authorities' response

152. The authorities observe good practices on transparency in banking regulations, accordingly the mission did not make any specific recommendations in this area. The SBP was in agreement with the mission's assessment.