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I. Introduction

The banking sector serves as the main source of resource mobilization in developing economies. Due to underdeveloped money markets and capital markets, limited availability of financial instruments and a lack of confidence in the financial system, banks become the dominant financial intermediary in the system. Given the bank's intermediary role in providing stability to the financial system, many emerging economies have implemented policies to develop and restructure the banking sector. These policies have included denationalization and privatization of banks, interest rate deregulation, a more efficient role of the central bank and the development of a system of self-disciplined bank management. Banks in Pakistan (and a couple of other South Asian countries) have followed and implemented similar reform policies in the 1990s to improve the banking sector to make them more efficient and profitable. Part of this was achieved by regulatory restructuring in line with the recommendations of Basel Accord. Another important feature of these policies was to design guidelines for 'best practices' known as, 'corporate governance of banks'.

The term "corporate governance" refers to the relationships among management, the board of directors, shareholders, and other stakeholders in a company. These relationships provide a framework within which corporate objectives are set and performance is monitored (Mehran, 2003). Corporate governance also provides a structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently (OECD, 1999).

Corporate governance is particularly important for banks, given the bank's important role in the financial sector. The rapid changes brought about by globalization, deregulation and technological advances are increasing risks in the banking systems. Moreover, unlike other companies, most of the funds used by banks to conduct their business belong to their creditors, in particular their depositors. Linked to this is the fact that the failure of a bank affects not only its own stakeholders, but may have a systemic impact on the stability of other banks. Theoretically, information asymmetry gives rise to agency problems and conflicts of interest between owners and managers. Good corporate governance is designed to address this problem. Further, government regulations and frequent interventions reduce the incentive for effective monitoring and at the same time make supervision (or supervisors) less effective. In this context, the corporate governance of banks becomes a more important challenge as compared to other firms.

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Internationally, the issue of corporate governance for banks has been recognized as one of the most important issues of the corporate sector. The OECD has produced a set of corporate governance principles that have become the core template for assessing a country's corporate governance arrangements. Similarly, the Basel Committee on Banking Supervision has made recommendations for the corporate governance of banks. Following the recommendations of the Basel Committee, OECD and the IMF, many developed countries have designed policies to implement best practice bank management.[1] Developing countries, especially emerging economies in the South Asian region followed the same recommendations and introduced certain guidelines for corporate governance. In Pakistan (as well as other South Asian countries), the banking sector restructuring took place only in the early 1990s and some steps towards good governance were initiated in late 1990s and early 2000. As such, not enough time has passed to conduct a meaningful assessment of the impact of these policies on bank efficiency. Therefore, this paper provides a review of corporate governance practices in Pakistan in comparison with some other regional countries. Our findings suggest that Pakistan has made significant progress towards good corporate governance standards for banks, followed by India. Bangladesh, on the other hand has just begun a discussion on some of the broad issues related to corporate governance.

The remainder of this study is organized as follows. Section 2 discusses the importance of corporate governance for banks in a theoretical perspective and looks at the main features of 'best practice' corporate governance. Section 3 details the banking sector's restructuring steps and corporate governance initiatives in Pakistan. Section 4 discusses the same for India and section 5 for Bangladesh. Some concluding remarks are made in section 6.

2. Corporate Governance for Banks

Banks are critical elements in any economy. They provide financing for commercial enterprises, basic financial services to a broad segment of the population and access to payment systems. Banks are also the major credit providers and, as such, must deal with the problem of information asymmetry. Although, banks are similar to other firms in terms of the composition of shareholders, debt holders, board of directors, competitors, etc. However, there is one important decision between banks and other firms. Rather than any firm, which is a profit-maximizer, the nature of transactions that banks are involved in makes them an expected utility (or expected profit-maximizer). The short-term liabilities (such as demand deposits) are invested in long-term risky assets (such as mortgage loans) and may take several years to mature (20 to 30 years). As a result, the risk factor increases substantially and risk management becomes important.

Another related issue is the role of the central bank in providing financial stability through efficient risk management, essential for sustainable growth. The central bank performs three important functions for the stability of the banking system. It acts as a lender of last resort, to help any short to medium-term liquidity problems of a bank and thus helps to avoid a bank run. Central banks also develop and implement a good regulatory

[1] Examples are United Kingdom, Sarbanes-Oxley legislation in the United States, Australia and the New Zealand (Bollard, 2003). Also see Macey and Miller (1995).

system and efficiently monitor it. Finally, it provides a code of 'best practice' corporate governance to establish self-discipline mechanisms for bank management and reduces the risk of bank failure. In recent years, corporate governance has become one of the key factors in determining the health of the financial system and this system's ability to survive through economic shocks. The health of the financial system depends on the underlying soundness of its individual components such as management's ability to identify, measure, monitor, and control their risks (Bollard, 2003).

Banks and the payment system are important ingredients of a financial system. The nature of transactions that banks are involved in expose them to a variety of risks. Good Corporate Governance will help banks to operate without excessive risk exposures and provide a healthy financial system. At the same time, the health of the financial system also depends on an efficient, reliable, and rapid payments system. The payment system involves many different components, such as, systems for settling large, inter-bank and inter-corporate payment transactions, and systems for handling myriads of smaller transactions. (cheques, credit cards, direct debits etc). Thus, the payment system could be subject to operational risks. The payments system or the payment operators need to ensure the systems for processing payments, the back-up arrangements, and the internal governance structures are robust. A major operational failure in the payment system may cause severe disruption to the financial system and may have a significant negative impact on the economy. In summary, it is important that bank management and the payment system operators are able to identify, monitor and control the risks. Again, good Corporate Governance helps to achieve these goals and, as such, becomes the foundation for effective risk management.

The need to implement 'best practice' corporate governance in an emerging economy, such as the sample countries in this study, becomes even more important due to the absence of deposit insurance and a relatively less experienced and less disciplined bank management. In order to provide a safety net to the depositors and the banking industry, organizations such as the Basel Committee and IMF have emphasized the need to establish some minimum regulatory norms and a code of corporate governance.

The recent banking crises in Europe (in 1980s) and in Latin America and Asia (in 1990s) have further exposed the riskiness of the banking sector. A similar crisis may lead to major bankruptcies, recession, and even economic and political instability in the sample countries. Given the high non-performing loans ratios faced by these emerging economies, it is even more important to establish a code of Corporate Governance for the banking system. Therefore, the issue of Corporate Governance of banks is fundamental in an emerging economy and a valid focus of research. A brief review of the existing literature is provided in the next sub-section.

2.1 Recent Literature on Corporate Governance for Banks

The first line of literature looks at the issue of corporate governance applicable to banks as opposed to other firms and emphasizes the importance of Corporate Governance for banks. Macey and Hara (2003), argue that commercial banks pose special corporate governance problems for managers, regulators, and claimants on banks' cash flows. They argue that bank managers and directors should be held to a broader, if not higher, set of standards than their counterparts at unregulated, non-financial firms. Moreover, they recommend that the scope of fiduciary duties and obligations of bank officers and directors can be broadened to address the interests of fixed and equity claimants. They suggest that top bank executives take solvency risk explicitly and systematically into account when making decisions.

Adams and Mehran (2003) argue that the governance of banks may be different from that of unregulated, non-financial firms for several reasons. They argue that investors, depositors and regulators have a direct interest in bank performance. Given the dependence of the whole economy on banking performance, regulators are more concerned about the safety of the financial system. Adams and Mehran (2003) think that a significant difference between banking firms and manufacturing firms relate to board size, board makeup, CEO ownership and compensation structure, and block ownership. These differences support the theory that corporate governance structures should be industry-specific.

Levine (2003) argues that banks have two related characteristics that inspire a separate analysis of corporate governance for banks. First, banks are generally more opaque than non-financial firms. Second, banks usually operate in a highly regulated environment. Due to the importance of banks in the economy, the opacity of bank assets and activities, and banks being a ready source of fiscal revenue, governments have imposed an elaborate array of regulations on banks.

Furfine (2001) claims that although information asymmetries affect all areas of the financial sector, the problem is more fundamental in the banking sector. He argues that loan quality, in a banking industry, is not readily observable. Moreover, banks can alter the risk composition of their assets more quickly than most non-financial firms. In a system of connected lending, banks can extend loans to clients who have a history of bad credit or were not able to service their previous debt obligations. Morgan (2002) finds severe difficulties in acquiring information about bank behavior and monitoring ongoing bank activities, hinders traditional corporate governance mechanisms. The opacity of banks can weaken competitive forces that, in other industries, help discipline managers through the threat of takeover as well as through competitive product markets. Product market competition is frequently less intense in banking. Takeovers are less likely to be effective when insiders have much better information than potential purchasers. Even in industrialized countries, hostile takeovers tend to be rare in banking (Prowse, 1997). Furthermore, the absence of an efficient securities market hinders takeovers because if potential corporate raiders cannot raise capital quickly, the effectiveness of the takeover threat will be reduced. Similarly, if bank shares do not trade actively in efficient equity markets, this will further hinder takeovers as an effective governance mechanism. All these factors make corporate governance more important for banks than any other industry.

The second line of existing literature links corporate governance with a mechanism that reduces agency costs and agency problems. Modigliani and Miller (1958) view debt and equity as legal claims on cash flows of the firm. Jenson and Meckling (1976) stress that statutory laws and the degree to which regulators enforce those laws shape the types of contracts that are used to address agency problems. Beck and Levine (2003), assert that a country’s contract, company, bankruptcy and securities laws and the enforcement of these laws fundamentally determines the rights of securities holders and the operation of the financial system. At the firm level, Shleifer and Vishny (1997) note that inside managers and controlling shareholders are frequently in a position to expropriate the rights of minority shareholders and creditors. Laws and legal institutions play a crucial role in determining the degree of expropriation. Expropriation may include theft, as well as transfer pricing, asset stripping, the hiring of family members, and other 'perquisites' that benefit insiders at the expense of minority shareholders and creditors (La Porta et al., 2000).

Another area of growing research looks at the impact of financial sector development on economic growth. It is important to note that corporate governance is implicit to financial sector development Also implicit in this is the role of legal institutions and internationally accepted regulatory structures such as Basel I or II that govern depository institutions.[2] Levine (1997) presents a framework whereby a well-developed financial sector facilitates the allocation of resources and helps to mobilize savings, facilitate risk management, identify investment opportunities, monitor and discipline managers, and facilitate the exchange of goods and services. At the heart of these theories is the role of the financial sector in reducing information and transaction costs in an economy. In spite of the central role of information in these theories, until recently little attention has been given by empirical researchers to the information environment per se in explaining cross-country differences in economic growth and efficiency. Bushman and Smith (2003) discuss the role of a country's corporate disclosure regime in the efficient allocation of capital and found a positive relationship between the quality of financial accounting information and economic performance.

2.2 Corporate Governance Mechanism

From a banking industry perspective, corporate governance involves the manner in which, business and affairs of individual institutions are governed by their respective Boards. This mechanism looks at how banks: (i) set corporate objectives to generate sustainable economic returns to owners; (ii) run the day-to-day operations; (iii) consider the interests of recognized stakeholders, including depositors; and (iv) align corporate activities and behaviors with the expectation that banks will operate in a sound manner and in compliance with the laws and regulations of the land.

Therefore bank directors have specific responsibilities to manage the risks at their respective financial institutions and effectively oversee the systems of internal controls. Directors are not responsible for the day-to day operations of the banks, which are run by the management. However, they have responsibility to set certain guidelines for the risk management of the bank and ensure an efficient and transparent internal-control system. The Board is also responsible to hire individuals who have the required level of expertise.

The Board is responsible to periodically assess management's integrity and to ensure an effective audit process. The reporting lines of the internal audit function should be such that the information that directors receive is impartial and not influenced by management.

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[2]La Porta et al. (1997), La Porta et al. (1998), La Porta et al. (2000) and Beck and Levine (2004).

Internal audit is a key element of management's responsibility to validate the strength of a bank's internal controls (Bies, 2002). This discussion forms the basis of a code of 'best practice' initiated in some of the South Asian economies and is the focus of this study.

3. Corporate Governance of Banks in Pakistan

Pakistan implemented some bold policies in the 1990s to reform its financial sector. These reforms included deregulation of interest rates, denationalization and privatization of state-owned banks, provision for new private and foreign banks and development of money and capital markets and instruments. An interesting and equally important feature of this reform package was the reform and restructuring of the central bank, the State Bank of Pakistan (SBP). Although, initially the pace of reform was slow, the reforms have been consistent and continuous. As a result, the SBP has emerged as a relatively more independent and more efficient central bank. Having more independence and more autonomy to make decisions, the SBP also looked into measures to make the commercial banking industry more efficient and create a safe environment for resource transfer. To achieve these goals, SBP restructured the regulatory framework governing the commercial banking industry and issued some guidelines for corporate governance. It is premature to assess the impact of these measures and comment on any improved efficiency of the banking industry because not enough time has passed and some policies are yet to be implemented.[3] Nevertheless, the commercial banking industry in Pakistan has taken a new shape with more than 80 per cent of the banks operated by the private sector. Given the rapid pace of development that has taken place in the sector, it is imperative to provide a brief discussion of the banking sector restructuring and development before we embark on the issue of corporate governance. This is done in the next sub-section.

3.1 Banking Sector Restructuring in Pakistan [4]

Commercial banking in Pakistan has experienced significant changes over 50 years since the inception of the industry. At the time of independence, only 1 (Habib Bank) of the 99 commercial banks had its Head office located in Pakistan. The other 98 banks were based in India and were under the jurisdiction of the Reserve Bank of India. Pakistan did not have its own central bank until 1948, a year after independence. [5] From 1947 to 1974, the banking sector grew rapidly. The private sector invested in the establishment of commercial banks with a network of branches across the country. At the same time, the SBP granted licenses to certain foreign banks to operate in Pakistan. In 1974, the political regime decided to nationalize all 13 commercial banks. The 13 commercial banks were then merged to become five Nationalized Commercial Banks (NCBs).

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[3] See Hussain (2003) for details.

[4] For a more detailed discussion on banking sector development and reforms in Pakistan, see Ariff and Khalid (2005).

[5] Pakistan did not have any formal stock exchange, merchant or investment bank.

The deposits in the NCBs were fully insured and their activities were supervised by the Pakistan Banking Council (PBC), also established 30 years ago, but abolished later. [6] These NCBs experienced a rapid expansion in staff (by 55 per cent) and number of branches (by 82 per cent) in a few years. High and increasing inflation resulted in reduced deposits (-20 per cent) and in real terms deposits were reduced by about 23 per cent.

The military regime during the 1980s introduced certain reforms to denationalize commercial banks and to create an environment for the development of a competitive banking system by easing entry barriers for foreign banks. To achieve these goals, the following policies were introduced:

1. The partial deregulation of interest rates
2. The rate of expansion of the NCBs were deliberately reduced, and
3. Foreign Banks were allowed entry

Some important policies are summarized in Table 1.

Downsizing and privatization became the buzzwords of the 1990s to deal with the inefficiencies of the public sector including NCBs. The process of privatization was accelerated during 2000. The pace of privatization of nationalized banks is considered to be the fastest in the developing world. This is evident with the fact that the domination of nationalized commercial banks in the banking sector reduced from almost 100 per cent in 1991 to 20 percent by 2003. At the same time, the government encouraged the private sector to invest in banking. This added a large number of private commercial banks in the country, which is essential for a competitive market structure. At present, there are 17 private commercial banks, 4 privatized commercial banks, 2 nationalized commercial banks, 2 provisional banks, 3 specialized banks, 6 development financial institutions, 4 micro-finance banks and 11 foreign banks operating in Pakistan.[7]

Foreign banks add to the competitive environment facing the domestic commercial banks and have become an important part of the banking industry. Although, foreign banks are not allowed to open more than four branches, they have better managerial skills and more access to the international financial markets. As a result, foreign banks receive the bulk of foreign currency deposits.

A major reason for poor banking performance in Pakistan is the history of extremely high levels of Non-performing loans (NPLs) and loan defaults (as of 1997, outstanding balance from these defaulted loans stands at Rs. 126.15 billion).[8]

[6] In January 1997, PBC was merged with the SBP.

[7] Hanif (2003).

[8] This is equivalent to US$ 2.66 billion; good enough to meet Pakistan's immediate need to service and pay back some of the foreign loans.

This is an area where Pakistan has made significant progress. With the help of a more independent and accountable central bank, the Accountability Bureau has managed to recover a large portion of defaulted loans. The regulatory restructure also removed provisions for connected loans and extension of credit to financially unstable state-enterprises. With inflation in control, which leads to more stable interest rates, banks were able to attract deposits. However, a lack of expertise in credit risk screening, such a rapid development is expected to increase the informational asymmetry and agency cost problems. To avoid any banking crisis, there is a need to have more skilled and efficient management, create an environment of self-disciplined mechanisms for risk management and have more responsible and accountable boards and management. To achieve this, SBP, in early 2002, introduced guidelines for corporate governance for banks. This is the main focus of our discussion in the next sub-section.

3.2 Recent Developments in Corporate Governance

As discussed earlier, Pakistan implemented some bold measures to reform the financial sector first in the 1990s and then in 2000. To further strengthen the stability of the financial sector, the SBP issued Corporate Governance guidelines for the banking sector. A major step towards this was a joint project by the Securities and Exchange Commission of Pakistan and the UNDP (SECP-UNDP) in collaboration with the Economic Affairs Division (EAD) of the Ministry of Finance.[9] The project was launched in August 2002, with the objective to design, develop and implement a Code of Corporate Governance. Although the project had some discussion on corporate governance for banks, its main focus was, in general the corporate sector. The project issued measures to create stakeholder awareness, capacity building and networking with other emerging economies. To address the problems of the banking sector, the State Bank of Pakistan (SBP) issued a 'Handbook of Corporate Governance' in 2003 (SBP, 2003c). The objective of this handbook was to provide guidelines for Board of Directors, managers and shareholders. Most of the recommendations and guidelines stated in the handbook are directly drawn from the recommendations made by the Basel Committee on corporate governance and the OECD. These guidelines cover four important areas, namely, Board of Directors, Management, Financial Disclosure, and Auditors. In January 2005, Ford Rhodes Sidat Hyder, a member of Ernst & Young published a comprehensive handbook on key regulations for commercial banks in Pakistan. This handbook serves as a basis for an overview of corporate governance for banks in Pakistan. The recommendations made in this handbook are summarized below.

[9] See Securities and Exchange Commission of Pakistan (2004).

3.3 The Board of Directors

The Basel committee places major responsibility on the board of directors and senior bank management to fully understand the Bank's risk exposure. As such, it is recommended that the composition of the board of directors and senior management in a bank should include individuals who are highly skilled and experienced in determining and managing risk. Regulators and supervisors have an important responsibility to determine the adequacy of internal control measures. This includes the responsibilities of the board of directors in dealing with organizational structure, accounting principles, checks and balances, the security of investments and compliance with the law and required disclosures.[10] Another important part of the recommendations, issued by different committees such as Basel and OECD, deals with business ethics. This recommendation is designed to make sure that the rights of shareholders and stakeholders are protected. Accordingly, these shareholders and stakeholders have a right to adequate and timely information and appropriate forms of participation in the decision making process of the bank.

3.4 Appointment of a Director

Prior clearance of the SBP is needed for the appointment of a Director to the Board of a Banking firm. The potential nominee/appointee for the post of a Director should have a substantial interest (no less than 20 per cent shares) and should be working in a management capacity for the bank. Anyone holding at least 10 per cent shares can become Director subject to SBP's approval. SBP requires that the incumbent should also satisfy the standard 'fit and proper test' for appointment. A minimum of 5 years of senior business/management level experience is required for the posts of Director while a potential candidate for President or Chief Executive officer (CEO) of a bank needs to have spent 15 years in banking with a minimum of 3 years of a senior level. These individuals should also have an impeccable record in their professional capacities, should not have been involved in any bank insolvency, should not be a defaulter of any kind and should not be a director in any other financial institution. In addition, Directors cannot hold office for more than six consecutive years.

The SBP may also ask any bank to call a general meeting of shareholders to elect a new director.[11] The total number of directors should not be less than seven and the tenure of a director is restricted to no more than six consecutive years. Effective January 1, 2004, banks are no longer required to seek prior approval from the SBP to appoint the Chairman, President, Managing Director or CEO. Banks are, however required to provide a brief outline to the SBP of individuals in these appointments.

[10] See SBP (2003c), pages: 16-19 for details.

[11] Procedures for the election of a director are detailed in Banking Companies Ordinance (BCO), 1962 and Companies Ordinance (CO), 1984.

The SBP also requires that a member of the Board of Directors (BOD) of a bank should not hold any more than 5 per cent of the paid-up capital of the banking company in the Director's individual capacity or in the name of a family member. The Director should not be appointed in any other capacity, shall not be paid other than traveling and daily allowances to attend meetings and no more than 25% of the total directors can be paid executives of the bank.

In order to reduce the control of one family within a bank, SBP, in November 2001 issued a circular to restrict the number of directors on a board from the same family to no more than 25% (as compared to the 50% limit allowed previously). The Banking Companies Ordinance (BCO), 1962 also restricts an individual acting as a director to two directorships at any one time. To reduce political influence, Federal Ministers, Provincial Ministers, civil servants and the Minister of State cannot be appointed as a director of a bank.

3.5 Responsibilities of the Board of Directors

The main responsibilities of the BOD are as follows:[12]

- The Board shall approve and monitor the objectives, strategies and overall business plans of the institution and will ensure that all activities are carried out prudently within the framework of existing laws and regulations.

- The Board shall clearly define the authorities and key responsibilities of both the Directors and the senior management without delegating its policymaking power to the management.

- The Board shall approve and ensure the implementation of all policies related to audit and internal management of risk and resources and will be responsible for the review and update of existing policies. The Board will ensure an effective 'Management information system' to cater to the needs of changing market conditions.

- The Board should meet frequently (preferably on a monthly basis but at least quarterly), and the individual directors should attend at least half of the meetings held in a financial year. The SBP requires that all Pakistani scheduled banks should hold these meetings in Pakistan (not overseas).

- The Board is required to prepare a formal summary of the proceedings of the general meetings, meetings of directors and meetings of any committee of directors. These summaries are to be duly signed by the chairman and should be available, for inspection by members of the bank. All banks incorporated in Pakistan are required to furnish copies of the minutes of the meetings of their respective BODs within seven days of the meeting.[13]

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[12]SBP (2003).

[13]This was made effective January 2000 through an amendment to the BCO, 1962.

- The activities of the Board should be transparent to external auditors and supervisors to form a judgment on its working and decision-making performance. The Board will ensure that appropriate actions are taken, in consultation with the audit committee of the Board, to rectify any weaknesses or lack of controls. A copy of the letter summarizing these actions should be submitted to the SBP for monitoring purposes.

- Directors are empowered to make important decisions on investment and human resource management as well as capital expenditure.[14]

Under prudential regulation guidelines of the SBP, a bank is not allowed to make loans or advances to any of its directors, chief executive, individuals, or their family members or firms or companies which the bank or any of its directors has an interest in as a partner holding more than 5 per cent of the share capital or guarantee loans and advances to the above individuals. The banking company is also not allowed to make loans and advances against the security of its own shares. The prudential regulation circular issued in 1992 also forbids banks to enter, without prior approval from the SBP, into a lease, rent or sale/purchase agreement with the banks' directors, officers, employees or any individual (or their family member) with ownership of 10 per cent or more of the equity of the bank. Whenever deemed necessary, the SBP has the authority to override the BOD and may continue to do so for a period determined by the SBP. The SBP guidelines also detail the procedure for the removal, retirement or prosecution of director(s) or chief executive officers.

3.6 Management

The appointment criterion of the Chief Executive Officer (CEO) is the same as for a Director of the BOD. No prior approval of the SBP is required for such appointments. However, banks are required to adhere to the SBP's guidelines containing the "Fit and Proper Test" for the appointment of key executives. Especially for very senior level officials noncompliance will result in punitive actions against the banking company. The key criterions of the 'Fit and Proper test' include:

- The individual should have a track record of honesty, integrity, have a good reputation and should have never been convicted of any criminal offence including fraud or financial crime.

- The individual should be competent and capable of fulfilling his/her duties and have adequate qualifications and experience.

- The individual should not have been removed or dismissed from service in the capacity of an employee, director or chairman on account of financial crime or moral conduct.

- The individual should not have defaulted on any payment owing to any financial institutions or the tax office.

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[14] Companies Ordinance, 1984.

- The individual should not supervise more than one functional area that gives rise to conflicts of interest within the bank and should not hold a directorship of a company that is a client of the bank.

3.7 Financial Disclosure

- Under the BCO, 1962, all banks incorporated in Pakistan or foreign banks with branches in Pakistan are required to furnish a balance sheet and profit and loss account to the SBP at the end of the calendar year.

- The CO, 1984 requires that directors shall attach a report with the balance sheet to report the state of the company's affairs, the details of dividend distribution, and the details of any reserve accounts.

- The bank must disclose any material changes affecting the financial position of the company.

- The bank must disclose any observation or negative remark made in the auditor's report.

- The bank must disclose the details of share-holding, earnings per share, state the reasons for loss incurred or any default during the reporting period.

- Noncompliance to the above will result in punitive actions by the relevant authorities.

3.8 Auditors

Another principal of effective bank supervision is effective internal audit. Internal audit helps to identify problem areas and to avoid a major collapse. However, to have an effective internal audit, it is important that the bank has sufficient resources, qualified staff and an appropriate methodology to undertake this task. Again, supervisors have to make sure that banks have an appropriate audit function and satisfy the above criterion. Reporting of all internal audit reports in an accurate and timely manner is essential for evaluation of the bank's status and needs for any change in strategy. Supervisors have the authority to hold management responsible for the release of this information and the accuracy and timeliness of the information. Some of the recommendations from the SBP's handbook are as follows:

- Under Company's Ordinance, 1984, the banking company is required to appoint an auditor at its annual general meeting for a period of one year. The first auditor of a newly incorporated company should be appointed within 60 days of the incorporation of the company.

- All banks are required to appoint auditors from the panel of auditors maintained by the SBP. This panel consists of auditors who satisfy certain minimum criteria based on their qualifications and experience.

- Any individual who is a director of the company or has any kind of employment with the company or any of his/her family members employed by the company cannot be appointed as the auditor of the same company. Any individual or his/her family member who is appointed the external auditor is not allowed to hold, purchase, or sell shares in the banking company.

- The BCO, 1962 states that the balance sheet and profit and loss account prepared by the company shall be audited by the banking company's auditor.

- The auditor is required to furnish an audit report stating the authenticity of the information and extent of cooperation provided by the banking company while conducting the audit. This will include verification of the sources of funds generated and investments made by the bank during the audit period.

- The auditor shall adhere to the guidelines or any amendments to the guidelines issued by the SBP for the audit of the banking company. The auditors will furnish a special report to the Director, Banking Supervision Department (BSD) of the SBP and a copy to the relevant bank.

3.9 Minimum Capital and Reserve Requirements[15]

- The minimum paid-up capital of commercial banks shall be Rs. 2 billion (US$33.33 million). Any banking company that fails to meet this requirement by December 31, 2005 will be converted into a non-scheduled bank as of January 1, 2006.

- All scheduled commercial banks are required to maintain a minimum capital adequacy ratio of 8 per cent of risk-weighted assets.

- Every banking company is required to create a reserve fund of an amount, not less than 10 per cent of its profit before tax. Every DFI shall credit to its reserve fund an amount not less than 5 per cent of its after tax profit.

- Banks are not allowed to pay any dividend to shareholders unless and until the bank meets the minimum capital requirement as set by the SBP.

- Banks shall not hold any immovable property other than for their own use.

- Banks shall pay or deliver any unclaimed deposits or articles to the SBP after 10 years.

- Banks are required to make arrangements to be credit rated by a credit rating agency on the panel list of the SBP.

- Banks shall hold a meeting of the BOD, senior management and external auditors, at least once a year when a satisfactory rating is obtained and more often when an unsatisfactory rating is provided.

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[15]Ernst and Young (2005) and SBP (2003a, 2003b) provide a detailed description of the code of corporate governance for commercial banks in Pakistan.

- Foreign currency deposits shall not exceed 25 per cent of local currency deposits of the bank.

- Banks are required to maintain statutory liquidity requirements in cash, gold or unencumbered approved securities.

- Banks are required to maintain reserves with the SBP against their foreign currency deposits.

- There is to be a special cash reserve (remunerative) of 15 per cent of foreign currency deposits and a cash reserve (non-remunerative) of 5 per cent of foreign currency deposits.

3.10 Internal Controls[16]

In addition to the above, the SBP has also recently issued 'Guidelines on Internal Controls'. It is well documented elsewhere in this study, that effective risk management is strongly influenced by an effective internal control mechanism and helps to reduce the risk and probability of a banking crisis. Hence, the SBP has put special emphasis on these guidelines for internal control as part of an approach to effective risk management. The system of internal controls includes financial, operational and compliance controls. In addition risk measurement and management is required. These guidelines are to ensure efficiency and effectiveness of operations, reliability, completeness and timeliness of financial and management information and compliance with policies, procedures, regulations and laws. An important aspect of risk management is risk-recognition and assessment as well as processes to correct any deficiencies. Self-assessment requires certain levels of expertise and experience. It is, therefore important that senior management and internal auditors of a bank are qualified to perform these tasks.

4. Corporate Governance of Banks in India

Similar to Pakistan, India also reformed their financial sector in early to mid-1990s. In early 2000, the Indian central bank, Reserve Bank of India (RBI) provided some guidelines for 'best practice' Corporate Governance in the banking sector. For consistency, we first look at developments in the banking sector in India and then review the issue of corporate governance for banks in India.

4.1 Banking Sector Restructuring in India

At the time of independence, India's financial system at the time of independence was basically providing limited services to cater to the demands of international commerce credit needs of large trading and manufacturing houses. India started to nationalize the largely private-sector banks into a few large government banks in the early years of post-independence. The main central bank, the Reserve Bank of India (RBI), was established and made responsible for the co-ordination of nationalization and control plans. There were three bouts of nationalization, one immediately after independence in 1949 with the nationalization of the Imperial Bank of India, a second bout in 1969 and a third one in 1980.

[16]See SBP (2004) for details.

The State Bank of India (SBI) was granted a license in 1955, with the objective to promote and expand SBI-affiliated banking facilities in the country and to provide access to deposit and credit facilities to a large population base including both rural and urban sectors. This resulted into a fast growth of the banking sector with a large number of bank branches available across the country. Some of the policies to reform the banking sector are summarized in Table 1.

Fourteen banks were nationalized during the second round with eight more in March 1980. The structural result was that Indian banks moved from the private to the government sector. Under government control the banks basically provided the payment function but failed to develop the ability to assess and price investment risks. Later, the private sector was allowed to participate and some licenses were granted to domestic firms as well as foreign banks. This resulted in a mixed structure for the banking sector in India with 22 large nationalized banks owned and operated by the government, 29 domestic origin banks owned as joint-stock private companies and 24 foreign-origin banks. The nationalized banks accounted for about 55 per cent of all retail banking activities in the late 1980s. These banks also had the largest network of branches, (61 per cent of the 61,000 branches in the country). It is surprising to see how the much less powerful 29 privately-owned commercial banks and the 24 foreign-origin banks managed to retain a 40 per cent share of the market in the 1990s! The Indian financial sector was heavily regulatory which reduced the efficiency of the industry. There were very high reserve requirements (at one time as high as 45 per cent of deposits), which channeled deposits into the central bank. There were 20 different schedules of interest rates. By controlling the minimum and maximum rates, the regulators were able to subsidize some activities more than others. As a result, a pervasive program of directing credits to certain economic activities developed.

The main banking sector reforms were implemented during 1992-94. The aims of these reforms were to introduce greater transparency, to improve investor protection, to enhance efficiency, to improve competition and to upgrade the standards of customer service. The liberalization that started in India about thirteen years ago has led to far-reaching changes in the financial structure. At present, India has 53 private-sector banks, which represent about one third of all banking activities. The Indian Overseas Bank and certain others have approximately 120 branch operations in foreign countries to facilitate international transactions. The number of branches increased from 8,321 in 1969 to approximately 61,000 branches by the year 2000. The number of branches increased at an annual rate of 10.4 per cent.

The Reserve Bank of India (RBI) supervises all of the above-mentioned institutions and markets. It has direct responsibility for the licensing and supervision of financial institutions and more generally the responsibility for the smooth functioning of the entire financial system. In the pre-reform years of 1949-88, the RBI played a critical role in implementing policies to support the diversion of financial resources to the central government in order to carry out targeted credit programmes to expand industrial capacity and agricultural outputs. Nowadays, the RBI is more concerned with the deregulation of the financial sector, although retaining responsibility for overall macroeconomic stability. All banks are now required to extend credit to priority sectors, namely agriculture, small-scale industries and small businesses, at concessionary interest rates. Up until 1990, this directive applied to only the public sector banks but with deregulation this rule has been extended to the private-sector banks as an 'advisory' guideline. In addition, 1 per cent of credits are required to be made to certain sections (the scheduled caste persons) of the community at a concessionary interest rate.

The government-owned banks, which still dominate the banking sector, are now under pressure to improve operational efficiency to compete with new entrants and now face increased scrutiny in relation to prudential norms. More private banks are now being licensed to increase competition in order to improve customer service. Some of the major reform measures undertaken are included in Table 1. For example, branching regulation has been removed; the Capital Adequacy requirement has been increased to 8 per cent in 1996; and the reserve ratio has been reduced to 10 per cent. In summary, India has been able to significantly reform its banking sector, which is essential to sustainable growth. However, with more active public and private banking sectors in place, there is a need to implement some "self- discipline" measures, or corporate governance guidelines. This is the focus of the next sub-section.[17]

4.2 Recent Developments in Corporate Governance

The code of ethics of best practice for the corporate sector in India was first introduced through the recommendations of the Cadbury report in December 1992. The report clearly identified the responsibilities of the Board of Directors and the issues related to their accountability and the company's compliance to reporting requirements.

The Cadbury report identified three areas for best practice:

(a) Transparency
(b) Off-site surveillance and
(c) Prompt corrective action

Although the report dealt with 'best practice' in a corporate sector, its recommendations served as the basis for a similar code of ethics to be developed for the banking industry.[18] One important factor of the Indian banking sector is that a large segment of the industry is government-owned and run as cooperatives. Thus, the banking sector is not completely corporate. As such, government has the responsibility to act as a regulator, develop a code of practice for private banks and makes sure that banks comply with not only the regulatory requirements but also with the practices of corporate governance for banks.

The prudential regulations focus on market risk management, capital adequacy and asset-liability management. Accordingly, the capital adequacy requirement was set at 9 percent, higher than the common international levels of 8 percent. Exposure limits were set at 15 percent for individuals and 40 percent for groups. Limits were also imposed on foreign currency borrowing, the hedging of foreign currency loans, and capital market exposure.

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[17] For more details on banking sector reforms in India, see Ariff and Khalid (2005).

[18] Carter (2004) identifies the area of corporate governance in general.

Banks are also required to maintain a minimum of 5 percent for an Investment Fluctuation Reserve by March 2006. In 2002, regulators moved to a system of risk-based supervision and a scheme of prompt correction action.[19] These prudential approaches were implemented and are consistent with the Basel committee principles. The measure helped to create a system of active supervision, essential for a stable financial system.

In July 2004, the RBI issued draft guidelines on ownership and governance for the private sector banks. These guidelines are now being finalized in view of the feedback received from the public, business and academics.[20]

The key features of these guidelines are:

1. The guidelines require that any shareholding of 5 per cent and above must meet a 'fit and proper' test for competence, reputation, track record, integrity, satisfactory outcome of financial vetting, sources of funds, etc.

2. No single entity or a group of related entities is to hold shares or ownership of a bank in excess of 10 per cent of the paid-up capital. Any higher level requires an approval from the RBI. In the case of a request the RBI will use certain guidelines to make a decision, which include consideration of the sources and stability of funds and the business record and experience of the applicant.

3. A minimum of Rs. 300 crore (about US$ 640 million) of net worth is deemed desirable for optimal operations and systematic stability.

4. In the case of new licenses, a promoter's shareholding is expected to be brought down to 10 per cent within three years.

5. Large industrial firms will be permitted to invest in a bank to an ownership limit of 10 per cent.

6. Any domestic bank or financial institution's cross share holding is restricted to 5 per cent.

7. Foreign banks operating in India are restricted to a shareholding of 5 per cent.

8. The maximum limits for portfolio investment through stock exchanges by individual NRI and FII are set at 5 per cent and 10 per cent respectively, while aggregate limits are set at 10 per cent and 24 per cent respectively.

9. Provisions will be introduced in the guidelines (at a later stage) not to allow more than one family member or a close relative or associate on the Board.

10. Continuing compliance of 'fit and proper' criteria for shareholders and directors will have to be ensured by the bank subject to independent verification by RBI.

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[19] See Udeshi (2005) for details.

[20] Some details of corporate governance for banks in India are discussed in Chakrabarti (2005), Mohan (2004) and RBI (2005).

The specific details of the guidelines are discussed below.

4.3 The Board of Directors

Guidelines for the appointment of directors, role and responsibilities of directors and the Board, signing of the declaration and undertaking by directors and other related issues were issued first on June 20, 2002 and later on June 25, 2004. These guidelines were based on the recommendations of the Ganguly Committee. The guidelines are:

- The Board of Directors is required to ensure that the responsibilities of the directors are well defined and that banks arrange for any training that may be required.

- Private sector banks are required to ensure that all directors satisfy the criteria listed under the corporate governance norms.

- They should also fulfill the criteria in accordance with the 'fit and proper' status of important shareholders. Banks should obtain a declaration and undertaking from the proposed or existing directors to ensure that these requirements are met.

- The guidelines require that no more than one member of a family or a close relative or an associate should be on the Board of a bank. RBI may apply additional requirements for the Chairman and CEO.

- The banks will be required to furnish all relevant information and seek approval from the RBI for the appointment of Chairman or CEO.

4.4 Shareholding

The RBI issued the following guidelines for the acquisition or transfer of shares.

- The guidelines are applicable to any acquisition of shares of 5 per cent or more of the paid up capital of the private banks.

- To encourage diversified ownership of banks, no single entity or group of related entities has control over a shareholding, directly or indirectly, in any bank in excess of 10 per cent of the paid up capital of the private bank. Any level higher than 10 per cent will be subject to prior approval of RBI.

- For a corporate entity, no single individual or entity should have ownership and control in excess of 10 per cent of that entity.

- In the case of a financial entity, it is required that the entity is a well established regulated entity, widely held, publicly listed and has good standing in the financial community.

- Domestic banks and foreign banks (with branches in India) and financial institutions should not acquire any fresh stake in a bank's equity, if by doing so, the investing bank or financial institution's holding of shares exceeds 5 percent.

- Large investment houses will be allowed to acquire shares not exceeding 10 per cent of the paid up capital of the bank subject to prior approval of RBI.

- The RBI may permit a higher level of shareholding in the case of restructuring of a weak bank or in the interests of consolidation in the banking sector.

4.5 Disclosures

The commercial banks are required to disclose accounting ratios relating to operating profits, return on assets, business per employee, NPAs, etc. They also need to submit reports on the maturity profile of loans, advances, investments, borrowings and deposits.[21]

4.6 Auditors

The RBI requires that all banks and cooperative banks should prepare and submit their profit/loss accounts and balance sheet statements in a transparent manner. The auditors are required to make sure these statements meet the necessary criteria suggested in the guidelines. The guidelines emphasize the importance of the internal audit system.

4.7 Minimum Capital

On January 3, 2001, the RBI issued some guidelines for minimum capital requirement for private sector banks. They are as follows:

- The minimum capital requirement for existing private sector banks will be at par with the requirement for new private sector banks.

- This requirement is set at Rs. 20 billion (200 crore) but with a commitment to increase it to Rs. 30 billion (300 crore).

- Further, private sector banks are required to have a net worth of Rs. 30 billion at all times. This will help to comply with the minimum capital requirement.

- Any banks with a net worth below this level will be required to submit a time frame to achieve the minimum requirement for RBI's approval.

4.8 Foreign Investment in Private Sector Banks

Guidelines for foreign investment in private sector banks were issued on March 5, 2004 through a press note from the Government of India. The guidelines through this press note and earlier guidelines issued on February 3, 2004 suggest that:

- Foreign investment in private banks is restricted to 74 per cent.

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[21]See Kamesam (2002) and Leeladhar (2004) for some specific details on disclosure and audit.

- Further, the law requires that at least 26 per cent of the paid up capital of the private sector banks have to be held by resident Indians.

- There is a limit of 10 per cent for individual foreign institutional investors investment with an aggregate limit of 24 per cent (can be raised to 49 per cent subject to Board's approval).

- The individual non-resident Indian portfolio investment is limited to 10 per cent (can be raised to 24 per cent with Board's approval).

- 'Fit and proper' status of shareholding of 5 per cent (as stated above) and other guidelines will also be applicable to all individual/institutional foreign direct/portfolio investment in private sector banking.

RBI requires all private sector banks to submit a timeframe for full compliance with all the above stated requirements for ownership and governance. The RBI may undertake independent verification of the 'fit and proper' test conducted by the private sector banks.

5. Corporate Governance of Banks in Bangladesh

In comparison to Pakistan and India, the pace of financial sector restructuring in Bangladesh has been slow and very recent. Nevertheless, the country's Central Bank, the Bangladesh Bank (BB) has initiated some necessary steps to reform the banking sector along with the introduction of a code of best practice. Given the early stage of these developments, we may not provide a complete overview of the banking sector developments in Bangladesh. Some important facts and features are discussed here.

5.1 Banking Sector Developments in Bangladesh

Following its neighbours, Bangladesh also introduced much needed reforms in the financial sector. Specific reforms to the central bank were introduced and were very different from the previous system that operated in the 1990's. The central bank has now built the capacity to macro-manage the economy. Of particular interest were the prudential regulation reforms that the central bank adopted to supervise financial institutions. Some salient features of these reforms are now discussed.

The Bangladesh Bank is the central bank of the country with a paid up capital of Tk. 30 million. The BB has a Board of Directors comprising 9 members. The Governor and Deputy Governor are appointed by the Bangladesh government. The Bank has 9 branch offices and 28 departments. The Bank has corresponding relations with one international bank and 8 foreign central banks. It has invested its foreign exchange reserves with 14 banks at different international financial centers. The security Printing Corporation (Bangladesh) Limited was established in October 1992 and is responsible for printing the local currency on advice from the BB.[22]

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[22]See Bangladesh Bank (2005).

The banking sector in Bangladesh consists of 4 nationalized commercial banks, 28 domestic private banks, 5 development financial institutions and 12 foreign banks.[23] The sector is relatively large in comparison to the banking sectors in other developing countries and constitutes about 27 per cent of GDP. The non-banking financial sector, including capital market institutions, is only 3.22 per cent of the GDP. This reflects the importance of the banking sector as the main source of resource mobilization in this country. The banking sector accounts for 96 per cent of the total finance sector. The ratio of bank deposits to GDP increased from 19.53 per cent in 1990 to 32.35 per cent in 2001.

The main problem this industry has faced is the significant amount of non-performing loans. These loans account for 32 per cent of all loans and often result in huge losses.[24]

The NPL ratio increased to approximately 45 per cent in the state-owned commercial banks in 2001 while the same ratio for the private banks was estimated to be 25.76 per cent.

The NPL ratio for foreign banks was only 3.74 per cent. In 2001, approximately 86.6 per cent (Tk. 204.35 billion of the total classified loans of Tk. 235.99 billion) of loans were identified as bad or irrecoverable.[25] As a result, most of the banks were running a shortfall for loan provisions and for the risk-weighted capital adequacy requirement. The main factors that have driven these poor ratios are the weak corporate governance system, the large state-owned commercial banks, deficient managerial skills, deficient policy and political or directed lending, etc.[26]

5.2 Regulatory Restructuring

The Bangladesh Bank has been involved in regulatory restructuring of the banking sector since its establishment as a central bank in 1972. The key features of this regulatory structure are outlined below (see also Table 1):

- The Bangladesh Bank (BB) is the lender of last resort for the government and the country's scheduled banks. The bank acts as the main regulator and supervisor of the country's banking system. The BB is also responsible for managing Bangladesh's international reserves, including gold, foreign exchange, SDR and reserve position in the IMF.

- All scheduled banks are required to maintain a minimum reserve requirement with the central bank (BB). The minimum reserve requirement for demand and time deposit liabilities is set at 20 percent, 4 percent of which is maintained as cash reserve ratio and the remaining 16 percent in securities.

- The statutory reserve requirement for Islamic banks is 4 percent in cash and 6 percent in securities with a total of 10 percent.

[23] Asia Trade Hub (2005).

[24] Pakistan had a similar story but managed to control it during the last 4 years.

[25] Bangladesh Research (2002).

[26] For more details on banking sector developments in Bangladesh, see Ariff and Khalid (2000).

5.3 Deposit Insurance

Besides being a lender of last resort function, which helps to restore market confidence, the BB introduced a Deposit Insurance scheme in 1984 under the Deposit Insurance Ordinance. Bangladesh is the only country in the South Asian region or amongst the developing countries group (except the Philippines), which has a deposit insurance scheme. The scheme provides a safeguard to depositors, especially small depositors. Any deposit up to Tk.100,000 is insured. All scheduled banks are required to purchase this insurance at a premium, based on their deposits and a rate determined by the BB. These funds are then, accumulated in the Deposit Insurance Fund.

5.4 Recent Developments in Corporate Governance

The BB issued guidelines on best practices for private banks and banking companies through the BRPD Circular no. 12 on April 26, 2003.[27] The circular provides some guidelines for all banks working in Bangladesh. New banks, specialized banks and banks incorporated outside Bangladesh are an exception to these guidelines.

5.5 Key Features of the Guidelines: The Board of Directors

- The Board should constitute a maximum of 13 directors.
- In the case of a bank that exceeds the limit on the number of directors, the directors are allowed to complete their tenure of office.
- No more than one member of a family will become director of a bank. This includes spouse, parents, children, and any sibling or person dependent on the appointee.
- The appointee should have at least 10 years of management and professional experience.
- The appointee should not have been convicted of any criminal offence including fraud/forgery, financial crime or other illegal activities.
- The appointee must not have been involved in a company/firm whose license has been revoked or cancelled or which has been liquidated.
- The appointee must never have been in default on a loan or loans extended to him /her or any allied concern.
- The appointee must never have been adjudicated or involved in a bankruptcy.

[27]See Bangladesh Bank (2003) for details.

6. Conclusion

Banking system around the globe (such as Europe, Latin America, and Asia) has been subject to major crises during the 1980s and 1990s. Since banking crises may lead to a collapse of the banking system, it is important to develop a mechanism to prevent such a crisis. Academic literature has developed theoretical models and empirical methodologies to predict and prevent a forthcoming crisis.[28] However, until recently, not much attention was focused on corporate governance as a mechanism to avoid a banking collapse through effective risk management, transparency, and internal controls. Many emerging economies focused on restructuring the regulatory framework and establishing an effective supervision. However, good banking supervision cannot function without good corporate governance. The recent trends of internationalization and globalization, changing market conditions, deregulation and the debacle of the Asian banking crisis underline the need for proper self-discipline, efficient internal control systems and effective supervision. Hence, good corporate governance is fundamental to a stable financial system. In this context in the late 1990s and early 2000, international organizations such as IMF, OECD, Basel Committee, etc. embarked on the establishment of some guidelines for good corporate governance practices in the banking sector and made some formal recommendations.

The banking sector in emerging economies in the South Asian region has experienced significant changes in recent years, moving from nationalized commercial banks to private banks, allowing entry to foreign banks and measures of deregulation. Given that the banking sector is the most important channel of resource allocation and mobilization in an emerging economy, such as Pakistan, India and Bangladesh, a bank failure or banking sector collapse may have devastating effects. Therefore it is important for supervisors to take necessary steps to provide a safe banking sector and ensure its stability. This study provides an overview of the recent developments in the banking sector and measures of corporate governance in Pakistan with some comparisons of similar developments in India and Bangladesh.

We observe three main developments. First, the central bank, itself has gone through some organizational changes making its role as a regulator and supervisor more effective and to make the central bank relatively more independent. The second, the legal and regulatory structure governing the role and functions of commercial banks has been restructured. This restructuring was in line with the recommendations of some organizations such as the Basel Committee and the IMF. The third and final was the issuance of some guidelines to establish the code of corporate governance for banks. These guidelines, in general, were also drawn from the recommendations of the Basel Committee and the IMF but modified according to the domestic economic environment and the regulatory structure This last development was the main focus of this study. However, as the process of corporate governance of banks in Pakistan (as well as in India and Bangladesh) is very recent, not enough information is available to make an assessment of the impact of these policies such as an evaluation of the improvement in bank efficiency or reduction in bank defaults. This

[28] See Demirguc-Kunt and Detragiache (1997), Garcia (1997), Goldstein et al. (1996), Khalid and Irawati (2004) and Sachs et al. (1996), for further details on this issue.

study, however, serves the purpose of presenting a profile (or a 'state-of-the-art' report) on what has been done so far. Given the increased autonomy and independence that the SBP now enjoys, major improvements in information technology and a very competitive market, it is hoped that banks will use the guidelines for self-discipline and risk management. These trends are expected to establish a sound banking system in the region, which is essential to underpin sustainable economic growth.

Cross-country comparison in this study suggests that Pakistan has a made a significant effort in all three areas of banking sector developments. The State Bank of Pakistan has emerged as very responsible and relatively more independent central bank. At the same time, the pace of banking sector development has been very fast. The pace of privatization of nationalized banks has been observed as the fastest in any emerging economy in the recent past. Pakistan was also the first one to initiate the code of 'best practices' for private banks. The Reserve Bank of India also made significant efforts in regulatory restructuring and establishing the code of corporate governance for the banking sector. Their pace of privatization, however, is observed to be slow. One possible reason for this slow pace could be the large size of the Indian economy and its banking sector. Bangladesh has just taken some steps to restructure the banking sector. This study did not find any meaningful progress made in Bangladesh toward corporate governance for banks. We believe that Bangladesh Bank will also follow the other regional central banks and will expedite the process of restructuring its financial sector and establish the code of 'best practices' for banks.

We believe that important lessons can be learnt from the policies and new financial architecture implemented by the Southeast and East Asian economies in the aftermath of the 1997 Asian financial crisis. Organizing workshops and courses for senior bank management and sharing information dealing with a bank-specific problem are two important aspects of this new financial architecture. SAARC countries may follow a similar approach. In the regional emerging and rapidly developing financial system, central banks can coordinate by organizing training workshops for senior to middle-level bank management. This will help them to understand the mechanisms and systems required to properly assess the different categories of risk that the bank is likely to face in varying market conditions. We hope that the regional banking system will emerge as an important source of resource mobilization within a country and will also help to attract foreign investment if the set of polices initiated currently are effectively implemented.

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TABLE 1
Banking and financial sector reforms in the region, 1990-2002

Date of reforms	Liberalization policies implemented
PAKISTAN	
1991:	Full-fledged auctioning system of treasury bills introduced in 1991.
1992:	3-day repo facility introduced; credit ceiling as an instrument of credit control abolished and replaced by credit-deposit ratio (CDR)
1994:	State Bank of Pakistan Act, 1956 amended providing more autonomy to the SBP. Central Depository Company instituted in the same year to facilitate electronic book entry system in stock market trading.
1997:	Further amendments to the SBP Act, 1956, Banking Companies Ordinance, 1962, Banks Nationalization Act, 1974 and Pakistan Banking Council providing more autonomy to the SBP for the design and implementation of credit policy and authorizing SBP as the sole entity to regulate financial institutions. Capital adequacy ratio requirement under Basel Accord enforced in December 1997.
1998:	SBP allowed banks and other financial institutions to determine their deposit rates.
1999:	Security and Exchange Commission of Pakistan established in 1999 and later in 2000, SECP authorized to regulate and supervise insurance industry.
2000:	Micro-Finance Bank Ordinance, 2000 announced by the SBP stating rules and regulations related to MBF; Cash Reserve Requirement for banks increased; banks are required to maintain a minimum average balance of 7 per cent of time and demand liabilities on a weekly basis and no less than 6 per cent of total liabilities on a daily basis; Minimum capital requirements for banks revised; accordingly, no banking company shall be permitted to undertake full range of financial services unless and until it has a minimum paid-up capital, net of losses, of one billion rupees on or after 1 January 2003. All scheduled banks required to maintain with the State Bank special deposits equivalent of 2 per cent of their time and demand liabilities. In order to remunerate these deposits, banks were allowed to purchase Market Treasury Bills (MTBs) from SBP on one-month repo basis at the rate of 10 per cent per annum.
2001:	Financial Institutions Ordinance promulgated for the recovery of defaulted and nonperforming loans. Corporate and Industrial Restructuring Corporation established as an Asset Management Agency with the objective of liquidation and disposition of NPLs.
2002:	SBP bifurcated into two entities. State Bank of Pakistan: Responsible for formulation and implementation of monetary policy, supervision and regulation of financial sector, foreign exchange management, and payment systems SBP Banking Services Corporation: Responsible for retail banking and treasury functions.

TABLE 1
Banking and financial sector reforms in the region, 1990-2002

Date of reforms	Liberalization policies implemented
INDIA	
1989-90:	Prudential norms improved by supervision standards for bad debt provisioning and for risk-weighting the exposure to risky loans
1993:	Capital adequacy of minimum of 4% by March 1993 and 8 per cent by March 1996 introduced and implemented.
1998:	Statutory liquidity ratio reduced from high of 25% to 2.5% while the total reserve reduced to 10% by 1998; stricter reporting requirements on non-performing assets from 1998; restrictions on branching lifted as well for entry into the sector; repatriation of profits needs no approval from mid 1998.
1999:	More private sector banks are licensed to operate in the country since 1999; two foreign banks permitted were Morgan Guarantee and JP Morgan
2000:	To create liquidity and market indicators, new rules put in place to encourage short term money instruments, including forward contracts, repos and swaps in mid-2000.
2002:	More reforms to interest rate and bank deposits, reserve ratios made; more reforms on several aspects of financial sector introduced; as of 2002, the CRR ratio was 5.0%; maximum support for state-owned banks in recapitalization stipulated when the state owned banks undertook to improve efficiency; private sector could buy up to 10% voting rights in state banks to inject slow privatization into them.
BANGLADESH	
	Multiple exchange rates unified 1994. Daily fixing of rate on real effective exchange rate suggested by 15 country trading partners' exchange rates. Volatility reduced, but not depreciation. No controls on holding or trading in foreign currencies.
	Interest rates have been suppressed right up to 1992. Multiple interest rates with minimum and maximum limits. Minimum deposit rate as suggested by inflation expectation is still on. Interest subsidies pervasive for targeting. These were abolished and replaced with market rates and a 3% subsidy for agriculture, exports and cottage industries.
	Entry barriers to banking, non-banking, stock trading, etc. relaxed. Prudential regulations introduced. Reserve requirements reduced to 8 and 20% to create credits.
	Entry barriers in stock trading relaxed. Ownership restrictions on foreigners in the share market liberalized. Listing requirements and investor protection improved.
	Activities in capital market (bond and shares) enhanced.

Sources: Ariff and Khalid (2005), Ariff and Khalid (2000).

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Abstract

The emerging economies in the South Asian region have embarked on a bold reform process to develop the banking sector. This development has improved the transparency and accountability of the banking sector because these countries focused on 'best practice' corporate governance for banks. In view of a rapidly developing market with a slow pace of information dissemination, adverse selection and moral hazard problems are likely to be on the rise and may need a mechanism to train and discipline bank management. It was, therefore timely for the central banks in the region to introduce a 'best practice' for the banking system as a whole. This study provides a survey of recent developments in corporate governance of the banking sector in Pakistan and a comparison of similar developments in two other regional economies, namely, India and Bangladesh. In addition to a theoretical discussion on this issue, we also provide an overview of the banking sector restructuring and highlighting important features of the codes of corporate governance established by central banks in the sample countries. In conclusion, we present a comparison of the major differences in these measures across countries and comment on the pace of these developments.

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