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Khan, Muhammad Arshad

Pakistan Institute of Development Economics Islamabad

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MUHAMMAD ARSHAD KHAN
Ph.D Student,
Pakistan Institute of Development Economics
Islamabad.
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Economic growth and stability are related with mature and efficient financial markets. With that recognition, a large number of developing countries including Pakistan have implemented ambitious financial liberalization programme. Financial sector reforms have been pursued over the past two decades in many LDCs as a part of broader Structural Adjustment Programme (SAP) which includes fiscal consolidation, reforms of the trade and exchange rate systems, and wide-ranging measures to enhance the efficiency and supply responsiveness of the economy. These reforms were expected to bring about a significant economic benefits, particularly through a more effective mobilization of domestic savings and a more efficient allocation of resources. Policies for restructuring the domestic financial system aimed at strengthening the role of market forces and competition through liberalization of interest rates, adoption of indirect monetary instruments, strengthening of prudential supervision and related market information system in order to deal effectively with interest rate and exchange rate risks and other banking risks, particularly in the context of capital account liberalization by enhancing bank's soundness and by promoting equity markets (IMF 1995). Moreover, liberalization of current and capital accounts transactions aimed at better integrating the domestic financial system into world financial markets. It is now widely recognized that weak and inefficient financial systems are more vulnerable to contagion, less able to cope with volatile capital flows and exchange market pressures, and more likely to propagate and magnify the effects of financial crisis on other economies. This recognition has highlighted the need for global adoption of strengthened standards for banking supervision (IMF 1996). The appropriate sequencing of financial sector restructuring and supervision policies have also become pressing issues in many LDCs, where a large part of the banking system is undercapitalized (or insolvent), reflecting major macroeconomic shocks, large structural changes and weak banking supervision. The resulting distress in the banking system has, in turn, complicated monetary management and affected the effectiveness of stabilization policies [Sundararajan (1996)].

In this context, it has been suggested that the development of a sound banking system and well-functioning prudential supervision arrangements should precede the adoption of market-based monetary arrangements [Villanueva and Mirakhor (1990)]. The rationale for this argument is that, in insolvent banking system, adverse selection and moral hazards could distort the impact of market-based instruments such as the treasury bills auctions and credit auctions -- and exacerbate instability. The outcomes of such efforts have varied among countries and have been influenced by factors such as the speed of reforms, initial financial conditions and, most importantly, the design and sequencing of the reform package.

A well-functioning system of financial intermediation not only facilitates the development of investor-friendly institutions and competitive markets, but also improves the overall economic efficiency through efficient allocation of resources, which lead to increase economic growth. In contrast, regulated financial systems – as in Pakistan where extensive interest rates and credit controls still persist -- led to markets that typically are underdeveloped and uncompetitive, with a financial sector dominated by government-owned financial institutions that impose constraints on economic growth. Pakistan's economic performance during 1980s has been mixed. It achieved strong growth (averaged 6.5 percent) with low inflation (i.e. annual average of 7.3 percent) as compared to 1970s but low savings (averaged 9.0 percent) and large fiscal deficit (averaged 8.0 percent of the GDP). On the other hand, Pakistan's financial sector was unable to respond to the impressive and broad-based economic growth because the government had pursued an economic growth strategy based on excessive controls on interest rates, directed credit to priority sectors, obtained credit at cheap rate from the banking system for the budgetary support and to provide politically motivated credit at subsidized rates. During this period, the financial sector in Pakistan mainly accommodated the financing needs of the government, of public enterprises and of priority sectors. The private sector investment remained modest, and efforts to mobilize savings lacked dynamism of a competitive financial system. Financial intermediaries were insulated from competition in the domestic market through oligopolistic practices and barriers to entry in the sector, and from outside competition through tight restrictions on current and capital accounts transactions [Khan (1995)].

In such an environment, which was typical of many pre-reform situations, distortions were widespread, interest rates were generally negative in real terms, taxing savers and providing incentives to inefficient investment, credit was rationed based on government-determined priorities and excessive regulations hindered the activity of financial intermediation. Consequently, economic efficiency remained low and growth suffered from relatively low savings and investment rates in the private sector.

Like many other developing countries Pakistan also undertook the process of financial restructuring through reforms in early 1990s to establish a more market-based system of financial intermediation and government financing, conduct the monetary policy more efficiently through greater reliance on indirect instruments and increase the contribution to the rapid development of the stock markets. These reforms were primarily designed to correct the distortions implicit in the administered structure of rates of returns on various financial instruments, to abolish the directed and subsidized credit schemes, to allow free entry of private banks in the financial sector in order to enhance the competition and efficiency in the financial sector and to strengthen the State Bank of Pakistan (SBP) supervision.

The study is structured as follows: Section II discusses the financial restructuring strategy and the stages it has passed over time. Section III describes the history of financial reforms carried out so far in Pakistan, while section IV assesses the impact of restructuring programme in Pakistan. Section V presents some concluding remarks.

II. Financial Restructuring Strategy and its Stages

Financial restructuring policies have been defined as those that seek to influence and strengthen the balance sheet structure of banks and non-bank financial intermediaries (NBFIs). Practically financial restructuring is a complex endeavor. The insolvency and poor profitability of banks must be reversed, the regulatory environment must be modernized and supervisory institutions must be restructured [Hoelscher (1998)]. These steps are designed to ensure that banking failure does not jeopardize the stability of the financial institutions. The successful restructuring programmes needed detailed diagnosis of the causes of the crisis and the development of a comprehensive restructuring strategy which includes steps to address individual bank insolvency and shortcomings in the accounting, legal and regulatory framework. Factors impeding bank operations, such as interest rate controls, high reserve requirements and distortions in the tax system should also be identified and their elimination planned. The implementation of a comprehensive restructuring strategy requires co-ordination among a variety of government institutions including the tax authorities, ministry of finance and central bank.

It is argued that bank insolvency is a "stock" problem reflecting negative net worth which is dealt with by financial restructuring. While poor profitability is a "flow" problem caused by some combination of non-performing loans and high operating costs. These problems arise when the bank management is weak and when risk and credit assessments are inadequate. Flow problems are dealt with through the operational restructuring of the banking system.

Financial Restructuring

Financial restructuring improves the bank's balance sheet and increases bank's net worth. The instruments for financial restructuring include: (i) improving the management of non-performing loans, (ii) transferring non-performing loans to a special agency, (iii) injecting new capital, and (iv) shrinking bank liabilities. Improving management of non-performing loans requires working with debtors to develop a loan repayment schedule. In this context, a specialized unit may be established in the bank to manage these loans. This unit has the advantage of bringing together specialized personnel who understand the financial conditions and prospects of the debtors. Such unit may divert scarce human resources and capital from the main business of the bank. The second instrument is the transfer of non-performing loans from the bank to an asset management company (AMC). Either the bank's non-performing loans could be replaced by interest bearing securities of the AMC or the entire balance sheet could be shrunk. The AMC should be responsible to manage and collect the non-performing loans and also to rehabilitate and liquidate the enterprise. The third instrument is the injection of new capital for the financial restructuring purpose. This capital may be provided by the existing owners, new investors and the government. The owners of the banks should bear the costs by writing down non-performing loans and then recapitalizing the bank with their own resources. If recapitalization is not possible then new owners, domestic (or foreign) may be sought. The fourth instrument of financial restructuring is the writing down of liabilities or the conversion of debt into equity. Both activities will increase the bank's net worth and reduce the interest costs. The liabilities may reduce through negotiation with creditors or government, which in turn, may reduce the bank's cost.

Operational Restructuring

An adequate framework for strong governance, internal controls, and risk management must be established for banks to remain solvent and profitable. Strengthening of such a framework will require changes in the bank management, improvement in the internal evaluation procedures, changes in loan recovery procedures and cost reducing measures [Hoelscher (1998)]. Operational restructuring begins with re-evaluation of bank's business plan. Problem banks are required to avoid unprofitable activities and focus on the core business. The improved focus needs to be combined with cost-reducing measures, including branch closures and staff reductions. Internal procedures for risk pricing and credit assessments must also be modernized. If the management is unable to absorb these adjustments, the supervisory authorities must be in a position to replace the management. It is important to note that financial restructuring in the absence of operational restructuring is usually unsuccessful and incomplete.

If the overall financial system is remaining sound, the environment in which banks operate must be improved. Rules must be established governing the exit and entry of banks. Both competition and market discipline must be strengthened. Entry requirements are often lax leading to a proliferation of inadequately capitalized financial institutions. The adoption and enforcement of regulations require fit and proper management and sufficient capitalization of new banks. Market discipline requires that banks be able to exit the market in an orderly fashion. Bankruptcy procedures must be clear and enforceable; their implementation must be relatively efficient. Legal procedures must be established for the orderly distribution of remaining assets of liquidated bank among creditors [Hoelscher (1998)].

An appropriate legal framework is also required including adequate and enforceable corporate contract and accounting laws. A modern and enforceable system of bank regulation and supervision is also necessary. Prudential rules must be taken into account for the evolution of capital markets, inter-bank relationships and development of modern banking services. The supervisory authorities must be in a position to obtain required information regarding the enforcement of prudential regulations.

Experiences of economies in transition illustrate that sequencing of bank restructuring and supervision policies have had a great impact on macroeconomic performance and financial market development. In Eastern and Central Europe, bank restructuring policies – recapitalization with government funds (Hungary, Czechoslovakia, Poland), carving out bad loans (Poland, Czech Republic), conversion of enterprise debt to equity (Bulgaria and Croatia) – were implemented in varying degrees since 1991 [Sundararajan (1996)]. The effectiveness of financial liberalization requires sustained efforts towards stabilization, while both liberalization and stabilization have required proper design and enforcement of bank restructuring and prudential supervision policies in order to avoid major disruption to growth and stability.

The sequencing financial restructuring and prudential supervision policies during the transition process may be divided into three stages [Sundararajan 1994 and Alexander et al (1995)]. These three stages (Table 1) can provide guidelines for every economy, pursuing restructuring and financial liberalization policies.

In order to ensure successful transition towards full interest rate flexibility (i.e. from stage 1 to stage 3), specific groups of reforms of prudential regulations and supervision system should be implemented early (in stages 1 and 2 of table 1) and should be coordinated with monetary management and market development policies. Specific configuration of measures in various stages, particularly at the initial stage, would depend upon variety of factors such as extent of disintermediation, extent of state-ownership of banking, degree of openness, adequacy of laws on collateral, bankruptcy and court system.

Table 1
Financial Restructuring During the Various Stages of Financial Sector Reform
Stage 1 (Preparatory)

(Preparatory stage for interest rate liberalization, direct controls on credit and interest rates dominate, limited liberalization of interest rates, – e.g. interbank rates – is initiated and impediments to broader interest rate flexibility begin to be dealt with)

* A minimal programme of financial restructuring policies is introduced to deal with fixed rate loans, selected non-performing loans, capital adequacy and subsidized selective credit.
* Legal and organizational arrangements for banking supervision are reviewed and adjusted.
* Licensing and entry regulations are strengthened. A framework for orderly intervention and liquidation of banks is put in place or streamlined.

Stage 2 (Initiating Market Development)

(Direct control on credit begins to be phased out, simple market based instruments of monetary and exchange policy i.e. open market-type operations based on treasury bills and credit auctions begin to be used. Discount window and Lombard Credit provide liquidity to money markets; policy interest rates insufficiency flexibility.)

* Reform of commercial bank accounting and bank reporting systems are phased in to help enforce prudential norms and facilitate monetary analysis.

* Prudential regulations, particularly loans classification and provisioning, credit concentration limits, credit appraisal guidelines and foreign exchange exposure rules begin to be phased in based on new accounting standards.

* Capital adequacy norms are strengthened and phased in, in line with bank restructuring strategy.

* A strategy to combine off-site, on-site, and external audits is introduced, the balance among the components initially dictated by the availability of resources and technical assistance.

* Institutional development of banks is pursued actively.

* A comprehensive programme of bank restructuring, bank liquidations, loan recovery and loan workout arrangements is formulated. As part of this programme, simple financial restructuring policies for banks – supported by enterprise financial restructuring – are implemented (e.g. policies to reduce debt-equity ratio of non-financial firms and recapitalize banks through portfolio restructuring).

Stage 3 (Strengthening Financial Markets)

(Money markets and secondary markets in government securities are strengthened through supporting programmes of institutional arrangements and payment systems; open market operations become more active; foreign exchange markets are fostered. Central bank manages money market liquidity at its own initiative and interest rates are fully flexible).

* Comprehensive reforms to foster bank and enterprise restructuring are continued systematically in lines with the programme designed in stage 2.

* Promote well-capitalized and well-supervised dealers in government securities (and money market instruments) as part of strengthening security market regulations and supervision.

* Reforms of bank accounting and prudential standards are completed.

* Strengthen financial risk management in payment systems.

* Strengthen supervision of asset-liability management (interest rate risks, liquidity management), internal controls, and management systems of banks.

* Appropriate balance between off-site supervision, on-site inspection and external audit is achieved through technical assistance and training.

* Risk implications of financial innovations and internationalization are monitored closely.

III. History of Financial Restructuring in Pakistan

The financial system in Pakistan remains largely undiversified and inefficient, while the status of financial institutions is precarious due to, *inter alia,* high intermediation costs resulting from overstaffing, large number of loss-incurring branches, poor governance with low quality banking services, accumulation of non-performing loans and inadequate capitalization. In order to remove these inefficiencies, the government of Pakistan undertook financial reforms as part of a wider process of Structural Adjustment Programmes (SAP) in the early 1990s to strengthen its financial system and to provide an adequate macroeconomic environment. The Adjustment Programmes describe a series of liberalization and deregulation policies encompassing most of the economic activities including reforms in the financial sector. The main goals of these reforms are: (i) to liberalize the interest rates by switching from an administrated interest rate setting to a market based interest rate determination; (ii) to reduce controls on credit by gradually eliminating directed and subsidized credit schemes, (iii) to create and encourage the development of secondary market for government securities, (iv) to strengthen the health and competition of the banking system by recapitalizing and restructuring the nationalized commercial banks (NCBs) increasing their autonomy and accountability, (v) to improve the prudential regulations and supervision of all financial institutions, and (vi) to allow free entry of private banks in the financial market.

The key reforms that have already been implemented as a part of financial restructuring policies include: (i) liberalizing of interest rate by initiating a regular auction programme of government debt, (ii) gaining efficiency and enhancing competition within the financial sector. The government has partially privatized two nationalized banks i.e. Muslim Commercial Bank and Allied Bank of Pakistan. The privatization of other banks like H.B.L. and U.B.L. is underway. A number of new banks, leasing companies and modarabas have been established. At present the financial structure of Pakistan comprises the State Bank of Pakistan, 4 nationalized commercial banks, 2 partially privatized banks, 3 specialized banks, 21 foreign commercial banks, 12 private domestic banks, 3 provincial commercial banks, 12 Development Finance Institutions (DFIs), 15 investment banks, 33 leasing companies, 51 modarabas, 42 mutual funds, 3 stock exchanges and 68 insurance companies. Public sector enterprises have been allowed to borrow from any scheduled bank in competition with nationalized commercial banks (NCBs). (iii) credit ceiling as an instrument of credit control abolished with effect from 1st August, 1992, (iv) credit-deposit ratio (CDR) abolished with effect from 30th September, 1995 and OMO (open market operation) is now instrument of monetary policy and SBP at regular intervals conducts auction of government securities, (v) non-banks have been allowed to trade in government securities, (vi) scheduled banks and DFIs have been allowed to determine their lending-deposit rates from July 16, 1997, (vii) SLR reduced to 16.5% on June 22, 1998, (viii) non-residents have been permitted to invest in government securities including NIT units and are empowered to repatriate, (ix) repo rate reduced to 13%, (x) auctioning of government securities (TBs/FIBs and PIBs) are introduced and closure of non-earning branches of nationalized commercial banks (NCBs) undertaken in order to reduce fixed cost and increase the profitability.

Despite efforts for financial liberalization in early 1990s financial markets segmentation continued owing to continuing controls on interest rates on government debts and to specialized credit programmes. These financial sector reforms were undertaken mainly to promote financial savings, improve the process of financial intermediation, enhance competition and assure efficient allocation of financial resources. Efforts to achieve these objectives have, however, been hampered by the political interference, besides the lack of financial support to carry out banking reforms.

As a result of fresh financial sector reforms introduced in 1997-98, Pakistan was able to reduce the number of bad loans and restructure the nationalized commercial banks (NCBs) in preparation for privatization. These reforms addressed the fundamental causes of banking crisis and corruption by strengthening banking supervision and regulation via independence of the central bank, improving banking courts, and introducing private sector boards to improve governance in state-owned banks. However, the reform process is far from complete, and fragile gains can easily be reversed. During 2001-2003, World Bank agreed to assist Pakistan's efforts in making further reforms including (i) complete governance reform in the nationalized commercial banks by restructuring them further and selling them to "fit and proper" private investors; (ii) pursue further legal and judicial reforms to facilitate loan recovery through the banking court system, (iii) continue to strengthen the State Bank of Pakistan's supervisory role, (iv) integrate National Saving Schemes (NSS) with the financial sector, (v) reduce effective tax rate on financial intermediation in line with the rest of the economy to promote expansion; and (vi) phase out the direct and concessional credit programmes to promote market integration.

IV. Impact of Restructuring Programme

The objective of financial restructuring programme is to forestall a generalized banking system collapse and to establish a viable banking system. The financial and operational restructuring policies strengthened the microeconomic foundations of the banking system. However, commercial banks have been slow to mobilize deposits or play a significant role in financial intermediation. Although the financial restructuring process in Pakistan was initiated in early 1990s, it remains only partially effective. The impact of the financial sector reforms can be discussed under the following headings :

1. *Interest Rate Policy*

Interest rates directly affect the business conditions and economic activities and thus represent a powerful policy instrument. In Pakistan, before financial reforms, interest rates were administratively set and were often negative in real terms. For example, deposits were either not remunerative at all or paid real negative returns, thus discouraging savings in the country. Ceilings on interest rates were imposed with the desire to provide low-cost financing to encourage investment, particularly in priority sectors. However, restrictions on interest rates led to financial disintermediation, as savers and investors sought alternative outlets outside the formal financial system. Consequently, financial deepening was hindered, and financial resources were not directed into productive activities.

After liberalization, the price and remuneration for most financial services were intended to be determined by the banks on competitive basis, with little intervention from the SBP. In order to provide succour to the banking sector, the interest rates on NSS were reduced from 16% to 11% during 1999-2001. The weighted average of rates on advances from banks dropped from 14.36% in mid-1996 to 13.5% in mid-2000. In the same period the interest rate on deposits fell from 5.15% to 4.0% per annum. The reduction in lending rate indicates little improvement in the profitability of the banks but purely ad hoc and not in the lines of financial liberalization. Consequently, a reduction in the deposit rate will reduce the saving rate even further.

The interest rate spread (average lending rate minus average deposit rate) is an important indicator for the financial sector's competitiveness and profitability. Spreads typically decline when competition increases – competition both by new banks for access to the market and among alternative savings and investment instruments such as equity, bonds and commercial paper. But in Pakistan, the spread between deposit and lending rates has not reduced and continues to be very high—nearing 8.16% in December 2000. The increased cost of the banks as a result of inefficiency was passed on partly to the borrowers by charging high lending rate and partly to the depositors by offering lower deposit rate. As a result, in the face of high inflation rate the real rate of return on deposits is often negative. The high lending rates increase the cost of borrowing and hence discourage investment, while low deposit rates discourage both consumption and savings, resulting in high debt/GDP ratio, lower economic growth, deterioration of banks balance sheet and increase in poverty. Furthermore, the large spread also reflects perceived sovereign risk.

2. *Bank Performance*

Bank performance involves two aspects – solvency and sustainable profitability. Solvency improving measures affect bank's balance sheet while profitability measures affect the bank's income. The improvement in the banking performance emanates from financial restructuring operations. The indicator for the bank's performance used in this study is the volume of non-performing loans. In Pakistan the NCBs and the DFIs have been facing the problem of non-performing loans (NPLs), which increased from Rs. 25 billion in 1989 to Rs. 128 billion in June 1998, or 4% of the GDP. Moreover, the non-performing loans increased from Rs. 230 billion in December 1999 to Rs. 237 billion in December 2000. Although these have come down from 25.9% to 23.30% of the total advances of the banks and DFIs, but are still very high. As of end-December the banks and DFIs were holding provisions of Rs. 133 billion, which covered only 47% of their classified portfolios. Thus the net NPLs (net loan ratio), which is a more appropriate measure, was about 16%. Since 1992, when private banks were allowed to enter the financial market, some banks have disappeared alongwith the deposits of the people. This does not inspire much confidence in the governance. The first bank was Mehran Bank followed by Schon and Indus and the collapse of the much larger and older Bankers Equity, and the latest in the series are the Prudential Bank and the NDFC. Despite the new entry of private banks, competition in the financial markets is still limited because NCBs continue to dominate the market. Further financial liberalization was constrained by a marked deterioration in the financial position of NCBs, which continue to dominate the banking sector. This sector as a whole experienced declining profitability, increasing inefficiencies, weakening of capital base and a built up of non-performing loans. Under such circumstances, operational restructuring is required in order to improve the banks and non-bank financial institutions.

3. *Money and Credit Policies*

In the late 1980s and early 1990s, Pakistan conducted monetary policy through direct control on credit and interest rates. Banking system was not generally competitive and major banks were owned by the state. In addition, banks and other financial institutions were required to hold part of their portfolios in government debt at below market rates. The government directed bank loans to state owned-enterprises. The range of financial instruments available to banks and the public intended to be narrow with maturity structure and yields unrelated to risk and liquidity.

In recent years, Pakistan has started to reform the monetary policy by using indirect or market-based instruments to achieve the macroeconomic stability. In 1995, the SBP shifted the emphasis from direct to indirect instruments i.e. open market operations including rediscount window, liquidity auctions, repurchase agreements and overdraft facility. The monetary authorities have sought to reduce direct government interventions and strengthen the role of market forces in allocating financial resources in order to improve the capacity of institutions to mobilize domestic savings, improve the effectiveness of the monetary policy, enhance competition among the banks and strengthen bank's financial soundness.

To measure the improvement in the financial intermediation capacity of the banking system following the financial restructuring process, the standard indicators used in this study include the ratios of currency to broad money (M_2), ratio of M_2 to GDP, ratio of M_3 to GDP, ratio of M_1 to M_2 , the ratio of private sector credit to total credit and market capitalization. Credit to the private sector would be expected to expand when banks are successfully restructured. In addition, this ratio also reflects whether private sector receives sufficient resources to carry out its economic activities. Table 2 represents the entire situation after the introduction of financial sector reforms.

Table 2
Key Indicators of Pakistan's Financial Intermediation

Year	Ratio of currency to M_2 (in percent)	Ratio of M_2 to GDP (in percent)	Ratio of M_3 to GDP (in percent)	Ratio of M_1 to M_2 (in percent)	Ratio of private sector credit to total credit (as %)	Market capitalization (in billion of dollars)
1990	38	-	-	-	-	-
1991	36	39	-	66	54	-
1992	32	42	-	60	50	-
1993	29	43	57	55	48	11.60
1994	27	44	62	51	49	12.26
1995	29	45	61	51	51	9.29
1996	26	44	62	48	51	10.64
1997	23	43	62	42	50	10.97
1998	24	44	65	40	51	5.42
1999	26	42	66	50	56	6.96

Source: IMF staff estimates.
Note: Fiscal year is different from calendar.
M_1 = Currency in circulation plus demand deposits.
M_2 = M_1 plus saving, time and foreign currency account deposits.
M_3 = M_2 and other type of deposits as well as short term money market instruments (e.g. certificates of deposits).

The ratio of currency to broad money tends to fall in the financial environment where market forces dominate, where there are alternative saving investment instruments (stocks, bonds, mutual funds etc.) that raise real rate of return, where there is a confidence in the banking system and where access to the banking system has expanded. The ratio of currency to M_2 fell from 38% in 1990 to 26% in 1999 and this implies the domination of market forces and retains the confidence in the banking system.

During the financial reforms the ratio of M_2 to GDP tends to decline as other financial instruments outisde the M_2 become available. The low ratio (i.e. 42% in 1999), reflects mainly the lack of access to the banking system, the use of cash as a means of payments and occasional periods of financial repression. As financial liberalization began and other financial instruments were developed, the ratio declined further. However, the ratio of M_3 to GDP increased steadily indicating that depositors are holding longer-term fnancial assets to take advantage of the interest rate differential across maturities. This ratio tends to increase from 57% in 1993 to 66% in 1999, showing that banking system diversifies its instruments and offers longer-term financial assets.

The ratio of M1 to M2 provides a proxy for the extent to which the country's financial system succeeds in mobilizing savings. This ratio decreased from 66% in 1991 to 50% in 1999 implying that the banking system is relatively developed. There are significant foreign currency deposits in the banking system and substantial real rate of interest on saving accounts in domestic currency. The ratio of private-sector credit to total credit increased from 54% in 1991 to 56% in 1999 as a result of financial reforms. In addition, fiscal adjustment efforts, privatization of some public enterprises and liberalization of interest rates all had clearly enhanced the private sector's access to the banking system.

The market capitalization, which was 11.6 million dollar in 1993, is now 6.96 billion dollar. This relatively low market capitalization implies that the trading activities remained low and secondary market is not yet operating efficiently and remains very thin. Bank financing remains the main source of funds for productive investment. The foreign access to the stock market is limited because of a number of factors including macroeconomic weaknesses, inadequate transparency and accounting standards and a cumbersome and opaque regulation environment. In addition, there are some restrictions on the capital movements for non-residents and are also ceilings on non-resident's shares in company's equity.

The total paid up capital quoted on stock exchange even today is $ 180 million only. The private banks were undercapitalized at Rs. 300 million. This ceiling was increased to Rs. 500 million and is now Rs. 750 million which is expected to be increased to Rs.1000 million by the end of 2002. Additional equity and revaluation of fixed assets helped to improve the capital risk weighted average (CRWA) ratio, but deteriorated since calendar year 1998. The CRWA ratio for all banks at 9.7% is marginally the desired 8.0% level. However, five banks continue to be below the 8% CRWA ratio. The minimum capital requirement for investment banks and housing finance companies (discount houses) was raised to Rs. 500 million and Rs. 300 million respectively by the end of 2002.

Profitability and the earnings of the banks are also poor. Banks earnings fell from 42.4% of the GDP in 1997 to 38.5% of the GDP in 2000 and overall growth of deposits went down from 10.1% in 1997 to 6.7% in 2000. The high income tax rate on banks also reduced from 58% to 50%.

4. *Privatization Policy*

The privatization of nationalized commercial banks and DFIs poses a serious challenge to the government. Although central bank has provided Rs. 21 billion to United Bank Limited (UBL) and Rs.9.7 billion to Habib Bank Limited (HBL) as equity support, the banks have not yet been privatized. The Government of Pakistan has given contradictory signals on privatization. The Allied Bank, which was privatized early 1990, reportedly is a victim of Rs. 1520 billion scam. The government yet sells out 49% of the shares of Allied Bank, 30% shares of the Bank Al-Falah (Habib Credit & Exchange Bank) and 15% of the shares of Muslim Commercial Bank (MCB). The central pillar of the present reforms is the privatization of the nationalized banks, which would help to stimulate competitiveness within the banking system. Ten years ago Pakistan allowed the privatization of banks, but the impact was limited, because five large nationalized commercial banks (NCBs) dominated the market place. Under the latest restructuring project, the government would privatize NCBs to make the sector more competitive.

On the basis of above analysis, it is suggested that there is still need for a further comprehensive package of reforms in order to restructure the financial sector of Pakistan's economy. The proposed reforms include:-

* Policies to strengthen prudential supervision-phase in prudential regulations, bringing about a balanced application of off-site analysis, on-site inspections, external audit and enforcement of entry and exit policies should be combined with policies to restructure financial sector and establish institutional arrangements for loan recovery and enterprise restructuring. Such a comprehensive package, encompassing both supervision system and restructuring options, is necessary to avoid adverse incentives towards excessive risk-taking by banks and debtors.

* Phasing in of reforms related to NCBs accounting system with proper implementation of prudential standards for capital adequacy, foreign exchange exposures, loan concentrations, loan classification and provisioning and early warning systems can support stabilization objectives, and facilitate financial restructuring as well. In addition, effective banking supervision should be introduced as a part of financial reforms.

* An initial package of financial restructuring policy to strengthen bank asset portfolio and profitability, to reduce debt-equity ratio of non-financial institutions and to eliminate interest subsidies (and related directed credit) should also be implemented early as a part of reforms. The financial restructuring programme should be based on the action plan for comprehensive restructuring of both banks and non-bank financial institutions that would be phased in over the medium term. The action plan should include steps to develop supporting institutional arrangements that would ensure operational restructuring including privatization, carried out as a counterpart of financial restructuring.

* The financial restructuring package should include the

development of long-term bond markets, the improvement of corporate governance, reinforcement of regulatory and supervisory arrangements, expansion of investor's base, improvement of equity market infrastructure, revaluation of market volatility-controlling mechanisms and sequencing the reforms.

V. Conclusions

Although Pakistan has made considerable progress during the past decade in reforming its financial sector, but the process is still at its initial stages because the financial sector is still dominated by the state-owned commercial banks which are playing a leading role. The secondary market is relatively thin and as such the supply of corporate securities remains small. The development of capital market is related to a range of economic, financial, institutional and legal factors that they need to be addressed properly. Non-performing loans, mostly extended to public enterprises, need to be addressed; moral hazard that surrounds the relationship between the government and nationalized commercial banks (NCBs) and public enterprises also needs to be addressed.

There is still need to reduce government-directed policy loans, privatize government-owned banks, improve governance, promote competition and sequence the restructuring policies. For rapid restructuring, correct appraisal is required for non-performing loans, and there is need of consolidation of fragmented banking sector via mergers and acquisitions. Financial restructuring needs massive infusion of capital, a fair cost sharing among the shareholders, creditors, depositors and taxpayers must be found. Furthermore, the legal infrastructure must be developed for financial supervision, bankruptcy and foreclosure. Bank secrecy laws should be improved to enhance transparency and deposit insurance scheme is needed to maintain confidence on the financial system. Early warning system and prompt corrective actions are needed. Reporting system must be upgraded to international standard, especially on-site and off-site supervision, capital adequacy ratio, loan-loss provisioning and definition of non-performing loans. The study further concludes that without the improvement of the corporate governance and expansion of investor's base, capital markets cannot be developed. Moreover, until the equity markets are strengthened, the capital market cannot function well to complement the banking sector.

The study further suggests a disclosure and market-based philosophy of market regulations. More openness, together with more transparency and disclosure of information, should contribute significantly to financial restructuring of the economy and integrating into the global economy.

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