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REGULATORY STRATEGY OF THE STATE BANK OF PAKISTAN

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The two major determinants of functional efficiency of financial system are market structure and the regulatory framework and the challenge for any Central Bank is to strike a right balance between the two. Over regulation can stifle financial innovation while an imperfect market structure can impair the efficiency of the system and penalize the consumer interests.

Market structure consists of the degree of competition, and interlocking control between financial institutions and business enterprises as well as the degree of specialization within the financial sector. It is influenced by the internal organization and management of financial intermediation. These in turn, are affected by the degree of government ownership and control.

The regulatory framework includes regulations imposed both for monetary policy as well as prudential purposes. An adequate framework can help ensure financial stability by reducing the probability of bank failures and the costs of those that do occur. Regulation is about changing the behavior of regulated institutions because unconstrained market behavior tends to produce socially sub-optimum outcomes. The regulator therefore has the responsibility to move the system towards a socially optimum outcome.

The strategy followed by the State Bank of Pakistan aims at improving the market structure and competition on one hand and optimizing the overall regulatory regime on the other.

The steps taken to stimulate completion and improve the market structure consist of lowering entry barriers, abolishing interest rate ceilings, privatizating government owned banks, promoting mergers and consolidation of financial institutions, enlarging the economies of scope for banks, liberalizing bank branching policy, and removing directed credit regulations.

The so called dichotomy between regulation and market mechanism is in practice a false one. There needs to be appropriate internal incentives for management to behave in appropriate ways and the regulator has a role in ensuring that internal incentives are compatible with the regulatory objectives. Market imperfections and failures, information asymmetries, externalities and moral hazards associated with safety net arrangements make it difficult in developing countries for incentive structures within financial institutions to be aligned with regulatory objectives.

Let us first define as to what the regulatory objectives of the State Bank of Pakistan are. These can be summarized as:

a) Avoiding adverse selection in bank entry by ensuring that individuals likely to misuse banks do not get bank licenses. For this purpose, the owners are required to provide equity capital of some considerable magnitude, cross ownerships are discouraged and character stipulations for bank ownership are laid down.

b) Aligning the incentives of bank owners with those of depositors by making sure that the bank owners stand to make substantial losses in the event of insolvency. Capital adequacy requirements and loan loss provisions fulfill this role.

c) Preventing excessive risk taking more generally. This means limiting bank holdings of excessively risky assets, preventing lending to related parties, requiring diversification and making sure that banks have appropriate credit appraisal, evaluation and monitoring procedures in place.

Components of Regulatory regime

What are the various components of the regulatory regime which can help achieve these regulatory objectives and what is the State Bank doing in respect to each of these components. There are at least seven core components which form the basis of the regulatory regime in Pakistan.

First, prudential regulations have been established by the SBP, disseminated widely and act as the ground rules and guidelines for the financial industry. Mostly these regulations pertain to capital adequacy, quality of assets, classification and provisioning of loan losses, liquidity requirements, risk concentration and management etc. Basel I capital ratios are enforced strictly and action taken against those falling short. Although the stock of non-performing loans is being tackled through a variety of measures the flow of loans does not suffer from this problem. Since 1997, only 5 percent of loans disbursed have become non-performing indicating an overall improvement in the quality of banking assets in Pakistan.

Second, once the regulations have been put in place the SBP monitors and supervises the banks. This is done through an integrated approach of on-site inspection, off-site surveillance and market information. Supervision techniques have been aligned with the best practices of other Central banks in the world and the CAMELs rating system is used to assess the health of the banks. A banking desk responsible for monitoring a few banks continuously reviews the available data and flags early warning in cases where prompt corrective actions are required. The Enforcement Unit then moves in and gets the remedial action implemented.

Third, the incentive structures faced by regulatory agencies, consumers and banks have to be aligned to the maximum extent feasible. Mark-to-market valuation of assets, forced sale value of collaterals, greater and regular disclosure of financial information, mandatory credit ratings of the banks are some of the tools, which have been used for this purpose. Consultation between regulators and regulated institutions ensures consistency between external regulations and internal risk control procedures. The SBP has developed a regular consultative mechanism whereby the views and comments of Pakistan Banking Association are sought and incorporated in the draft policies, circulars and regulations.

Fourth, the role of market discipline and monitoring has to be enhanced. Privatization of nationalized commercial banks (NCBs) is largely motivated by this particular consideration because these banks have ill-defined incentive structure and are not subject to the normal disciplinary pressures of the market. Their owners - the Government - do not systematically monitor their behavior and the market cannot exercise the corporate controls which, through the threat of removing incumbent management, is a discipline on managers to be efficient and not endanger the solvency of their banks. It is quite well known that management of the NCBs have faced pressures to make loans on political considerations. Interference by the ministers and bureaucrats in the operations of such banks and the unwitting encouragement of bad banking practices can itself become a powerful ingredient in bank distress. After Habib Bank's impending privatization, 80 percent of the banking assets in Pakistan will be owned and managed by the private sector and thus become subject to market discipline and monitoring. It is for this reason that 20 percent of the shares of National Bank of Pakistan have been off-loaded for flotation at the Karachi Stock Exchange. The feedback from the market in terms of its share prices will act as a powerful disciplining tool to the management and the board.

Fifth, intervention arrangements in the event of compliance failures ought to be credible and biting as they provide a deterrent against errant behavior by the bank managers, owners and directors. In the last three years, the SBP has cancelled the licence of one of the commercial banks – the first of its kind, has changed the ownership of two banks, allowed mergers and amalgamation of half a dozen banks, forced change in boards of directors and debarred a few directors and managers from banking profession. These punitive measures and weeding out process have helped strengthen the overall health and soundness of financial system in Pakistan.

Sixth, the role of internal corporate governance arrangements within financial institutions has been defined, reinforced and closely monitored. In addition to the code of corporate governance prescribed by the SECP the banks have been provided explicitly defined criteria for the selection of Chief Executives and Directors. Family representation on the Boards has been limited to 25 percent and the remaining directors have to be drawn from non-family members. External audit firms have been screened, categorized and rated for purpose of auditing the financial institutions. Two top firms were blacklisted and this sent a strong message to the audit community for upgrading the quality of their audit. Conflict of interest rules have been explicitly laid down barring those having any potential conflict from becoming involved in the management and oversight of banks.

Seventh, the accountability arrangements applied to the State Bank of Pakistan have been strengthened to minimize the potential dangers arising from its monopolist regulator position. An independent Board of Directors consisting of seven eminent persons of repute and integrity provide the overall oversight on the affairs of the SBP and its management. Greater disclosure and transparency have been introduced and International accounting standards with a new Audit Charter have been put in place. The financial reports and accounts of the SBP are audited both by the Auditor General of Pakistan and firms of established external auditors. A Monetary and Fiscal Coordination Board headed by the Minister of Finance reviews the monetary and exchange rate policies of the SBP. Quarterly and Annual Reports on the state of economy and the affairs of SBP are regularly submitted to the Parliament which, at times, holds hearings and asks questions on important issues. The IMF has made an assessment of the SBP's corporate governance and Internal Controls under its safeguards clause and found them in consonance with international practices. We also observe various International Codes and standards on Corporate governance, Auditing and Accounting.

Capacity building within the SBP

Most importantly, the State Bank has to have a strong capacity and core competencies to implement the above strategy. To this end, a major restructuring and reform program is under implementation for the last several years. The largest automation project in Pakistan today is the Technology upgradation program at the S.B.P. It will cost more than $ 24 million at its completion but equip the SBP with automated banking solutions, enterprise resource planning tools, data warehouse and connectivity and net working among its field offices and the headquarters. SBP will be able to access real on-time information on the banking institutions and not wait for three months to receive the reports. The ability of the SBP to take timely corrective and remedial actions will thus be enhanced.

The most critical asset of a regulating institution is its human resource base. The SBP is undertaking massive retraining of its professional staff in technical skills and recruiting talented young men and women directly from the market through a rigorous merit based competitive process at all levels. For example, 11000 applications were received for entry level Banking Officers' positions. About 2600 qualified at the written exam and 50 were finally selected after interview. Those selected receive a 9 months extensive training at NIBAF and 6 months on-the-job training in commercial banks and various departments of the SBP. Middle level managers have also been recruited through the same competitive process. We have hired more than 20 Chartered and Management Accountants, more than 100 high level IT Professionals including three from Wall Street to fill in our skill gap. Higher educational opportunities are available to staff to improve their academic qualifications or upgrade their professional skills. Foreign training and attachment with Central Banks in England, Australia, Malaysia, Singapore and Federal Reserve keep the staff abreast with the recent developments and techniques of central banking. The SBP provides full scholarships to young Pakistanis who can obtain admission to Ph.D. program in Economics and Finance at any of the top 20 universities of the world. The Bank has also set up endowed chairs at Economics Departments of five Pakistani universities to upgrade the quality of Economics Education.

Another element of SBP reform program is business process re-engineering under which the existing procedures, processes and reporting requirement are being streamlined, simplified and redundancies eliminated. With the commissioning of the data warehouse project the banks will no longer need to earmark dozens of their employees to fill in the various forms and reports required by the SBP. Delegation of authority has empowered officials at the various rungs of hierarchy to take decisions and dispose of the cases.

As part of its organizational restructuring the SBP has set up an independent subsidiary - the Banking Services Corporation

(BSC) to handle all retail banking functions. All the 16 field offices have been transferred to the control of the BSC which is run by a Managing Director. This arrangement has allowed the Governor and Senior Management to concentrate their attention and energies on the core central banking functions.

Despite the above achievements we are fully aware that there is no room for complacency. The world around us is changing rapidly and we have to keep up with these changes and adapt ourselves constantly to the new requirements. A dynamic organization cannot afford to stand still we will be faced with unforeseen events. But if the SBP is transformed into a flexible, agile and competent organization the chances of meeting the new challenges successfully will be high. We have still a long and arduous path to travel.