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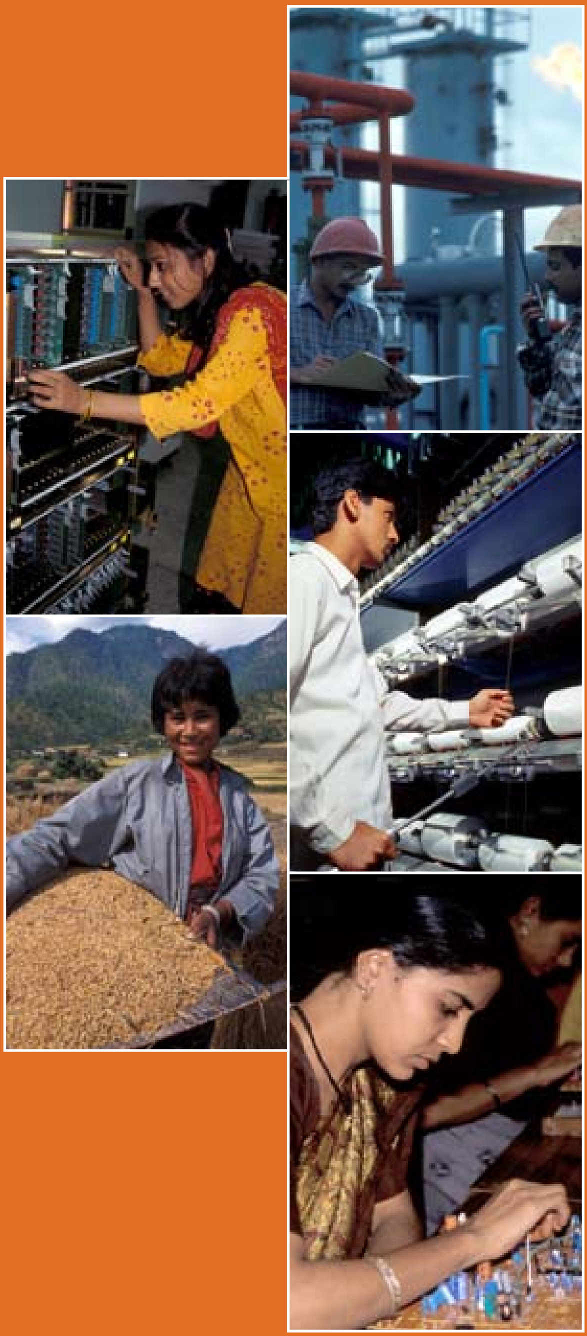

South Asia Economic Report

Financial Sector in South Asia: Recent Developments and Challenges

May 2009

Asian Development Bank

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FOREWORD

We are pleased to present the fourth issue of the *South Asia Economic Report* (SAER), a series of reports on economic and development issues in South Asia. Each SAER provides an update on South Asia's economy and examines an important development issue. The theme of the fourth SAER is "South Asia's Financial Sector: Recent Developments and Challenges."

SAERs present findings based on reviews and analyses of relevant development issues, with a particular focus on policy reforms across South Asia, targeting policy makers in the region. The theme of the first SAER, published in October 2006, was "Banking, Governance, and the Investment Climate." The second, issued in June 2007, featured "Social Sectors in Transition: Accelerating Inclusive Growth and Human Development" and covered education and health. The theme of the third SAER, issued in December 2007, was "Foreign Direct Investment in South Asia."

This SAER assesses the recent performance and development of South Asia's financial sector against the backdrop of a deteriorating outlook for the region. It presents an overview of current developments in South Asia's financial and capital markets and then surveys developments and identifies issues in each of the region's eight financial markets. For each country, issues that need to be addressed to advance market development are identified, and policy recommendations aimed at developing a robust financial system to support sustainable economic growth are provided.

South Asia's economic growth has been strong, driven by a buoyant services sector and solid investment demand. To sustain high growth, countries in the region must increase savings and investment through financial deepening or financial development. Enhancing saving rates through financial development is crucial, particularly considering the expected declines in remittances and foreign direct investments as well as possible liquidity squeezes from global financial turmoil. Financial development can also contribute to poverty reduction by expanding financial services and increasing the poor's access to and use of these services.

Recent years have seen South Asian countries embark on development of their financial markets through financial liberalization and banking sector and capital market reform. Although liberalization and reform have led to the deepening of domestic financial markets in the region, challenges remain, including the lack of legal foundations for financial services and commercial transactions, the failure to apply best practices in regulation and supervision of financial institutions and markets, and limited outreach of the formal finance sector.

Policy recommendations, which have particular poignancy given the effects of the global financial turmoil, are provided to address these challenges and to deepen and develop South Asia's financial markets further, thereby helping them accelerate economic growth and alleviate poverty. These recommendations include (i) prudent fiscal policies; (ii) strengthening the legal foundation and government infrastructure; (iii) lifting nonprudential restrictions; (iv) reforming and privatizing state-owned financial institutions; (v) removing remaining capital account restrictions; (vi) improving the quality and application of accounting standards; (vii) bringing the legal framework and prudential standards for the finance sector fully in line with international best practices; (viii) building policy development and supervisory capacity, particularly in nonbank sectors such as insurance and pensions; (ix) establishing an appropriate legal framework for microfinance; and (x) supporting credit bureau development.

We hope that this SAER will help all stakeholders—especially policy makers—appreciate important global and regional trends and take effective, proactive steps to capitalize on opportunities and to mitigate risks through the development of financial and capital markets. This SAER also aims to provide background information on these markets for further in-depth analyses.

We would like to thank South Asia Department staff and consultants of the Asian Development Bank for preparing this SAER. The work was conducted under the overall guidance of Bruno Carrasco. Production was completed by Michael Andrews, Shunsuke Bando, and Angelo Taningco. Sally Mabaquiao, Aileen Pangilinan, and Jane de Ocampo provided administrative support. The publication was made possible by the cooperation of the Department of External Relations and the printing unit.

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CONTENTS

ABBREVIATIONS

ADB	—	Asian Development Bank
CBSL	—	Central Bank of Sri Lanka
DAB	—	Da Afghanistan Bank
GDP	—	gross domestic product
IOSCO	—	International Organization of Securities Commissions
IMF	—	International Monetary Fund
NGO	—	nongovernment organization
NRB	—	Nepal Rastra Bank
M2	—	cash and demand deposits
MISFA	—	Microfinance Investment Support Facility for Afghanistan
MMA	—	Maldives Monetary Authority
RBI	—	Reserve Bank of India
RMA	—	Royal Monetary Authority of Bhutan
SAARCFINANCE	—	Network of Central Bank Governors and Finance Secretaries of the South Asian Association for Regional Cooperation
SAER	—	*South Asia Economic Report*
SEBI	—	Securities and Exchange Board of India
SBP	—	State Bank of Pakistan
SMEs	—	small and medium-sized enterprises

NOTE

In this report, "$" refers to US dollars.

EXPLANATORY NOTES

For this issue of the *South Asia Economic Report*, the following analytical and geographical groupings apply.

- Developing Asia refers to the 44 developing member countries of the Asian Development Bank.
- Central Asia comprises Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.
- East Asia comprises People's Republic of China; Hong Kong, China; Republic of Korea; Mongolia; and Taipei,China.
- South Asia comprises Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka.
- Southeast Asia comprises Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam.
- The Pacific comprises Cook Islands, Fiji Islands, Kiribati, Marshall Islands, Federated States of Micronesia, Nauru, Palau, Papua New Guinea, Samoa, Solomon Islands, Timor-Leste, Tonga, Tuvalu, and Vanuatu.

In the main text, tables and figures containing regional comparisons follow the regional classifications of the Asian Development Bank, World Bank, and others, as indicated.

1. INTRODUCTION

This issue of the *South Asia Economic Report* assesses the recent performance and outlook for South Asia's financial sector against the backdrop of a deteriorating outlook for the region. Countries in South Asia have diverse financial sector, from Afghanistan, which is still rebuilding basics after decades of conflict, to India, which has all the elements of a modern financial system.

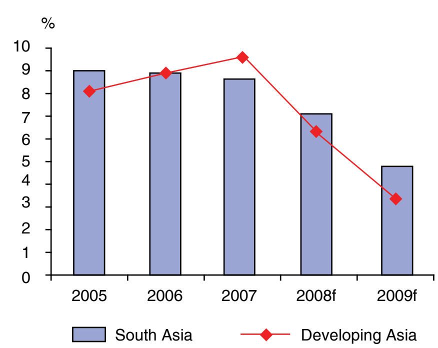
Common themes throughout the region are ongoing reforms to enhance legal foundations for financial services and commercial transactions, and evolution toward best practices in the regulation and supervision of financial institutions and markets. All countries have a legacy of significant state ownership and direct government intervention in their financial sector, which generally remains prevalent today. Progress to date in financial sector reform and the extent of the outstanding development agenda are major determinants of resiliency as South Asia's economies face decelerating growth.

Economic performance in developing Asia is slackening following an annual gross domestic product (GDP) expansion of 9.5% in 2007, the highest growth in the last two decades (Figure 1). South Asia's performance will follow the same trend, with GDP growth moderating to 4.8% in 2009. The anticipated deceleration is linked to the global economic slowdown brought about by the weakening of the world's major economies, particularly the European Union, Japan, and United States. Inflationary pressures experienced until mid-2008—caused by rising food and oil prices—also are expected to slow growth in developing Asia.

The outlook for South Asia is subject to considerable downside risks arising from rapidly deteriorating expectations for the world's major economies. As prospects dim in Europe, Japan, and the United States, South Asia's economies face potential declines in exports and remittances, which, in turn, will dampen domestic consumption. Foreign direct investment is likely to decrease, and banks and corporations in South Asia that have tapped international financial markets are being negatively affected by the global tightening of liquidity.

The still-unfolding global financial turmoil is highlighting underlying weaknesses in the world's financial sector. South Asia's banking systems were largely insulated from the immediate causes of turmoil in 2008, having no direct exposure to United States subprime assets, limited exposure to complex financial instruments, and generally liquid banks with a high proportion of funding by domestic deposits. Decelerating growth, however, is bringing into sharp focus the risks of homegrown credit bubbles in Bhutan, Maldives, Nepal, and Sri Lanka. Nonbank financial institutions throughout the region are emerging as key concerns for two reasons: (i) those dependent on wholesale funding are facing liquidity shortages, and (ii) those raising deposits from the public (which is common in South Asia) are generally subject

Figure 1: Gross Domestic Product Growth in Developing Asia and South Asia
(% annual change)



f = forecast.

Source: ADB. 2009. *Asian Development Outlook* 2009.

to a less stringent prudential regime than are banks. South Asia's capital market performance has largely tracked global stock market trends, illustrating that markets remain highly correlated despite earlier hypotheses of decoupling.

Weak loan-loss provisioning standards—common in the region—may result in an overly optimistic view of banking systems' resiliency throughout South Asia. In many South Asian countries, the continued prevalence of state-owned institutions is a double-edged sword. Government ownership can help maintain confidence and ensure stability, but at the same time, state-owned institutions have tended to be inefficient and susceptible to political influence, often incurring large losses ultimately borne by taxpayers. Furthermore, they are not good at developing innovative products and effective leveraging of resources.

The balance of this report explores these issues for individual countries and the region as a whole. Section 2 begins with an overview of the region's financial sector, comparing and contrasting their structures, performance, and levels of development. The section continues with an assessment of financial stability, followed by commentary on the infrastructure for financial services and outreach of the formal financial sector. It concludes with a summary of key finance sector reform issues for the region. Section 3 supplements this crosscutting analysis with a brief overview of key issues, structure, outreach, and the reform agenda for each South Asian country.

2. SOUTH ASIA'S FINANCIAL SECTOR

In South Asia, regional trends and averages can be misleading because India accounts for three-fourths of the region's population and about 80% of its GDP, and has the most highly developed capital and financial markets (Table 1). The region does share a legacy of direct state involvement in banking and other financial services, and all countries have undertaken a range of finance sector reforms in recent years.

Liberalization of capital markets in South Asia began in the early 1990s. In India, the 1991 balance of payments crisis facilitated capital market reforms that mainly targeted the development of India's equity market and the establishment of the Securities and Exchange Board of India in 1992. Other capital market reforms during the 1990s focused on improving corporate governance, securities disclosure, and pricing systems, and making listing requirements stringent. These reforms continued in the early 2000s with the ownership ceiling raised for foreign institutional investors, restrictions relaxed on use of forward contracts by foreign institutional investors, and the foreign institutional investor ownership ceiling increased for corporate and government bonds. Trading of derivative products started in 2000 on the National Stock Exchange, which now ranks among the largest futures and contracts markets in the world.

Pakistan's capital market reforms began in the early 1990s with the lifting of restrictions on purchases of shares of listed firms by foreigners and nonresidents. More recently, reforms have included the automation of the stock exchange trading system and efforts aimed at enhancing the government securities market in order to stimulate the development of the corporate bond market. Sri Lanka also initiated capital market reforms in the early 1990s by allowing foreign firms to buy listed securities on the Colombo Stock Exchange, subject to certain restrictions. Further improvements in the government securities market were instituted with the introduction of a real-time gross settlement system, a scripless security settlement system, and a central depository system for government securities. Additionally, foreign investors are now allowed to purchase treasury bonds up to a maximum of 5% of the total outstanding value of treasury bonds. Finally, since 1991, nonresidents of Bangladesh and foreigners have been permitted to buy listed securities and stocks.

Maldives is distinct from the rest of the region due to its small size, high dependence on tourism, relatively high per capita GDP, and small financial sector. Afghanistan stands apart because its recent reform have focused on rebuilding a financial sector devastated by decades of conflict. Bhutan is far smaller and relatively more prosperous than Nepal, and Nepal has a larger and much more diverse financial sector, but both countries display worrying signs of a credit bubble against a backdrop of still incomplete finance sector reforms.

Table 1: Selected Economic Indicators for South Asian Countries
(2007, percent of gross domestic product unless otherwise noted)

	South Asia	Afghanistan	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka
Population (million)	1,506.1	24.5	140.6	0.7	1,134.0	0.3	26.4	159.6	20.0
GDP ($ billion)	1,437.4	9.6	68.4	1.1	1,170.7	1.1	10.3	143.9	32.3
Per Capita GDP ($)	986.8	350.1	486.8	1,664.8	1,028.7	3,470.5	390.8	910.0	1,616.1
GDP Growth (percent, annual)	8.6	11.5	6.4	17.0	9.0	7.6	2.6	6.8	6.8
Inflation (percent, annual)	5.5	13.0	7.2	5.2	4.7	7.4	6.4	7.8	15.8
Fiscal Balance	(5.2)	(1.8)	(3.2)	(3.4)	(5.4)	(7.8)	(2.0)	(4.3)	(7.7)
Current Account Balance	(1.7)	0.9	1.4	10.5	(1.5)	(40.1)	(0.1)	(4.8)	(4.2)
Gross International Reserves (months of imports)	12.3	3.6	3.3	12.9	15.0	3.1	8.9	4.5	2.9
External Debt[a]	18.5	21.6	29.1	69.6	16.3	62.9	31.6	26.9	45.4
Debt Service[b] (percent of exports)	7.0	1.5	3.6	4.2	10.2	5.7	10.7	12.9	12.7
M2 (base money, currency in circulation, bank deposits)	–	21.6	45.3	59.5	85.2	73.8	54.4	50.6	39.2
Bank Deposits[c]	–	10.9	39.5	46.0	68.0	64.9	29.9	79.4	65.3
Credit to the Private Sector	–	–	37.7	21.2	47.4	100.0	37.7	29.4	34.0

– = data not available, ( ) = negative, GDP = gross domestic product, M2 = cash and demand deposits.

[a] Maldives, Sri Lanka, 2006.
[b] India 2005, Sri Lanka 2006.
[c] ADB Key Indicators for Asia and the Pacific 2008, most recent year available.

Sources: Statistical appendix (except notes a and b, previous *South Asia Economic Report* edition statistical appendix); and note c, ADB Key Indicators for Asia and the Pacific 2008, most recent year available.

Fifteen years ago, the bank-dominated financial sector in Bangladesh, India, Pakistan, and Sri Lanka displayed broad similarities. Capital and exchange controls limited financial market development, and the predominant state-owned banks were constrained by interest rate controls and noncommercial mandates including directed lending and support for inefficient state-owned enterprises. Direct government interventions resulted in a proliferation of special-purpose financial institutions, many of which were authorized to raise deposits. Significant losses in many state-owned banks meant that the financial sector was constrained in their ability to intermediate to support growth, instead consuming deposits to cover ongoing credit and operating losses. High reserve requirements for banks essentially co-opted deposits to finance government deficits. All four countries have pursued financial sector reforms, with the nature and extent of progress varying.

Despite an early start with privatization of one of five state-owned banks in the 1980s and a program of financial reform since the 1990s, Bangladesh remains burdened with undercapitalized and poorly performing state-owned commercial and specialized banks. State bank reform and further privatization efforts have proceeded slowly. Private and foreign banks have grown in number and market share, now accounting for almost 60% of banking assets, but the inefficient state banks are a drag on the entire system. Some interest rate controls remain, and banks are still required to meet directed lending requirements to targeted sectors. Prudential standards have been strengthened, although loan-loss provisioning requirements remain weak—a common feature of the region (Box 1). Many banks, particularly state-owned banks, do not comply with key prudential requirements.

India's financial sector reform since the 1990s has focused on gradual liberalization and use of an activist supervisory authority, the Reserve Bank of India (RBI), to drive the restructuring of state-owned banks. Following recommendations from the 1991 Narasimham Committee report on the financial sector, several key steps were taken, including interest rate deregulation, reduction in cash reserve and statutory liquidity requirements, reduction in barriers to entry in banking, and gradual strengthening of prudential norms. The combination of exposure to increasing competition and strengthened prudential regulation was intended to improve the performance of state-owned banks while retaining majority government ownership and the banks' social role.

New banks quickly took advantage of the liberalized entry rules in India. Between January 1993 and March 1998, 24 new private banks—including 15 with foreign ownership—began operations. The impact of new prudential standards was immediately evident, with the state-owned banks recording large losses and impaired capital, leading to recapitalization of 19 state-owned banks in 1993 and 1994, with many banks receiving further government support in subsequent years. The capital injections were at least notionally dependent on time-bound remedial plans, but there were few consequences for not meeting the objectives established in memoranda of understanding with RBI. In the face of a state-owned bank's failure to meet prudential standards or reluctance on the part of government as a shareholder to recapitalize or support reforms, RBI had few options but to provide forbearance while continuing to push for needed restructuring. Over time, the performance and governance of state-owned banks have been

Box 1: Loan Classification and Provisioning Requirements

Despite recent improvements, the standards for loan classification and provisioning in South Asia have several weaknesses including:

- interest accrual when more than 90 days in arrears (Bangladesh);
- no minimum provision required for loans 90 days in arrears (Bangladesh, India, and Sri Lanka); and
- lengthy arrears required before classified as doubtful or a loss (Bhutan, India, Maldives, and Sri Lanka).

Country	Classification	Days in Arrears	Minimum Provision
Bangladesh	Substandard	180	20% of the balance, net of liquid security, and 50% of mortgages
	Doubtful	270	50% of the balance, net of liquid security, and 50% of mortgages
	Bad debt	360	100% of the balance, net of liquid security, and 50% of mortgages
Bhutan	Substandard	91	20%; 30% for the housing sector
	Doubtful	361	50%; 60% for the housing sector
	Loss	720	100%
India	Substandard	90	Nonaccrual status only, no minimum provision
	Doubtful	365	100% of unsecured portion plus 20% of secured portion if up to 2 years in arrears, 30% if up to 4 years, and 100% if more than 4 years in arrears
	Loss	Not specified	100%
Maldives	Especially mentioned	90	5%
	Substandard	180	10%–20%
	Doubtful	365	35%–50%
	Loss	730	100%
Pakistan	Substandard	90	25% of balance, net of liquid security, and 30% of forced sale value of mortgages
	Doubtful	180	50% of balance, net of liquid security, and 30% of forced sale value of mortgages
	Loss	365	100% of balance, net of liquid security, and 30% of forced sale value of mortgages (no value for mortgages more than 3 years in arrears)
Sri Lanka	Special mention	90	Nonaccrual status only, no minimum provision
	Substandard	180	25% of unsecured portion for credit cards; 20% of unsecured portion for other facilities
	Doubtful	360	50% of unsecured portion
	Loss	540	100% of unsecured portion

Sources: Country prudential standards.

improved, but the most recent committee reviewing India's financial sector has reiterated the need for further progress and privatization (Government of India, Planning Commission 2009).

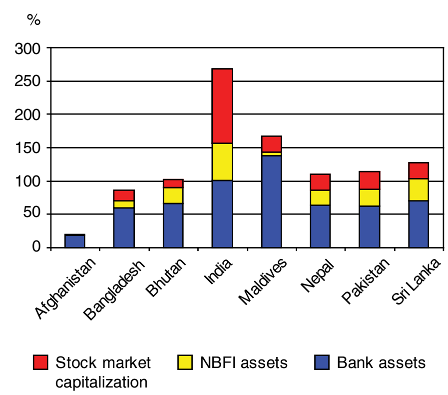
The list of changes to India's legal framework for banking supervision as well as improvements to its practical implementation is impressively long. Prudential standards have been continually reviewed and updated. In particular, more stringent accounting and loan-loss provisioning requirements have been phased in, with nonperforming loans being recognized when 90 days in arrears, effective March 2004—a significant change from the previous standard of 180 days. A prompt corrective action framework has been introduced in an effort to ensure that capital deficiencies are addressed in a timely manner.

Banking reforms in Pakistan started in the 1990s with deregulation, consolidation, restructuring, and privatization of state-owned banks, as well as permitting the entry of new banks. Government-owned commercial banks lost their dominance to private commercial banks, as the former's share of total banking system assets declined sharply. Today, they amount to about 20%, the lowest level in the region.

Improvements in corporate governance, information disclosure, and transparency of Pakistan's banks are a direct result of enhancements in prudential frameworks and the practice of bank supervision. The State Bank of Pakistan (SBP) underwent institutional reform, building the capacity of its personnel and introducing prudential regulations that, in most respects, conform to best practices and international standards. SBP has increased minimum capital requirements and imposed a moratorium on new bank licenses to promote consolidation, and these reforms have improved financial intermediation and supported growth in credit to the private sector. Despite the progress to date, SBP has identified a range of further reforms, including the need for a new banking act and new or revised prudential standards.

Sri Lanka's reforms since the 1990s have included interest rate deregulation, strengthening prudential requirements, and building the supervisory capacity of the Central Bank of Sri Lanka (CBSL). Efforts to reform underperforming state-owned banks have focused on operational restructuring rather than on privatization. While state-owned development banks were privatized in the early stages of finance sector reform in the 1990s, the government has taken steps to reverse this trend with the establishment of three new state-owned development banks between 2005 and 2007.

Figure 2: South Asia's Financial Systems (percent of GDP)



GDP = gross domestic product, NBFI = nonbank financial institution.

Notes: End 2007 data, except Bhutan stock market capitalization, 2005; India data end-March 2008; Nepal data July 2007.

Sources: Country section tables.

Structure, Performance, and Development

Banks currently dominate the financial system of most South Asian countries (Figure 2). All countries in the region except Afghanistan have established capital markets, with India's stock market capitalization ranking among the world's top 10. Development of nonbank institutions lags behind that of the banking sector, with most countries in the region lacking legal frameworks and supervisory structures to support growth of contractual savings vehicles such as life insurance and pensions.

Banks

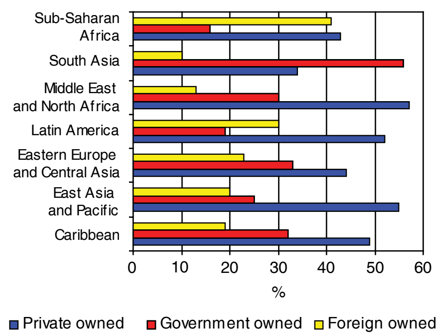
South Asian countries have a much higher proportion of government-owned banks than the rest of the world, ranging from 20% of total banking assets in Pakistan to 70% in India (Figure 3). Although state-owned bank dominance has been gradually decreasing across South Asia, progress over the last few years has been slow, resulting from more rapid growth of private sector banks than from significant privatizations.

State-owned banks throughout the region have tended to be less profitable and efficient than private and foreign-owned banks (Table 2). This is largely attributable to higher operating expenses—often from overstaffing—and higher loan-loss expenses, reflecting the generally poorer asset quality arising from directed or priority sector lending and politically influenced credit decisions. These contributions to poor asset quality, together with the delivery of subsidized credit programs, help explain the lower interest margins of state-owned banks. While there has been recent improvement in the performance of India's state-owned banks, they continue to demonstrate underperformance relative to its private sector banks.

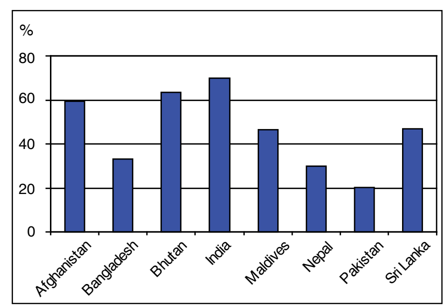
Continuing weaknesses in South Asia's state-owned banks have negative consequences for finance sector development and, more generally, private sector development. Inefficient state-owned banks require high margins to cover their operating expenses and loan losses. Thus, rates charged for loans, aside from subsidized and directed lending, need to be higher than would be required by better-performing banks. This phenomenon effectively shields private and foreign banks from the full effects of competition, as they only have to be slightly more efficient to gain the market share from state-owned banks and do not have to pass on to customers the full benefits of their superior efficiency. As a result, bank customers bear the burden of higher margins, and private and foreign banks are able to earn extraordinary profits because of the continued underperformance of the large state-owned banks.

Figure 3: State Ownership of Banks in South Asia

Bank Ownership Around the World, by Region (percent of total bank assets, median values 1995–2002)



State-Owned Bank Market Share (percent of total bank assets)



Sources: First panel, Micco, Panizza, and Yanez (2007); and second panel, country section tables.

Table 2: Bank Profitability, Efficiency, and Margins

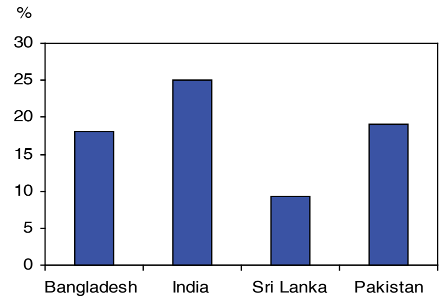
	Return on Assets	Overhead Costs/ Total Assets	Interest Margin/ Total Assets
South Asia			
Government owned	0.54	2.64	2.69
Foreign owned	1.68	2.07	3.43
Private owned	1.04	2.44	3.08

Note: Data are median values covering the period 1995–2002.

Source: Micco, Panizza, and Yanez (2007).

The high reserve requirements prevalent across South Asia (Figure 4) limit the ability of the banking sector to intermediate to support private sector growth. Deposits are effectively co-opted to meet government financing requirements, as banks must invest significant funds in government securities to meet the reserve ratios. This can have the effect of crowding out lending to the private sector. High taxes are another concern, with effective rates in excess of 40% of pretax profit evident in banks' financial statements across the region. Retained earnings are essential for banks to build capital to support growth, so governments may need to reassess the taxation of financial institutions to achieve a better balance between fiscal requirements on and the importance of bank profits to support private sector growth.

Figure 4: Statutory Reserve Ratios (%)



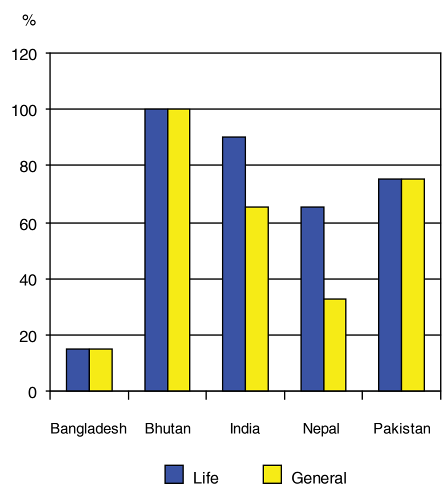
Sources: Bangladesh Bank, Central Bank of Sri Lanka, Reserve Bank of India, and State Bank of Pakistan.

Nonbanks

Governments have a large presence in South Asia's nonbank financial sector. In addition to the state-owned insurance companies with significant market shares in most countries (Figure 5), government-run pension and provident funds are typically the only large institutional investor. All countries in South Asia also have state-owned specialized banks or financial institutions focusing on specific regions, sectors such as housing finance, or functions such as longer-term development finance.

South Asia's insurance industry is relatively less developed than its banking sectors. This reflects many factors, including dominance by state-owned companies that often lack technology, actuarial skills, and sound underwriting and investing practices. Growth in the insurance industry is linked to the growth of the middle class, so at early stages of development, the insurance sector is a lower priority than banking. However, as South Asia's economies continue to grow, authorities should place higher priority on reforming and privatizing state-owned insurance companies and establishing the required legal and supervisory frameworks. Most countries in the region have yet to adopt a modern insurance law and an approach to regulation embracing International Association of Insurance Supervisors principles. In most cases, insurance supervision is the responsibility of a government department rather than being housed in a fully resourced independent agency.

Figure 5: State-Owned Insurance Companies' Market Share (%)



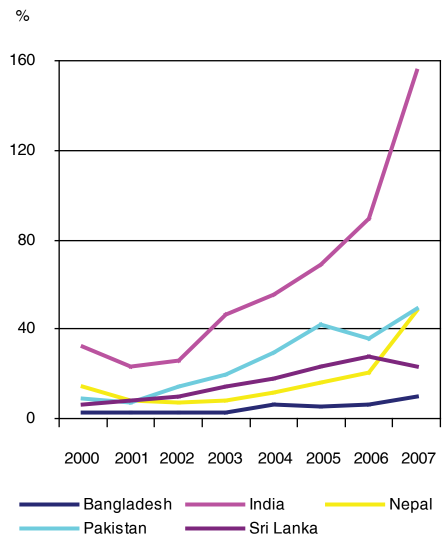
Sources: Bangladesh Bank, Insurance Regulatory and Development Authority, Nepal Rastra Bank, Royal Monetary Authority of Bhutan, and State Bank of Pakistan.

Many of South Asia's nonbank financial institutions rely on deposits for at least part of their funding. For example, finance institutions in Bangladesh and finance companies in India, Nepal, Pakistan, and Sri Lanka are restricted from accepting demand deposits and have lower minimum capital requirements than banks, but otherwise engage in the bank-like business of raising deposits and providing loans and leases. The policy intent of providing a bank-like charter is to encourage a range of competitors, with business restrictions intended to reduce risk to offset lower capital requirements. In practice, finance companies have proved a significant source of risk. Those truly relying on term deposits have been subject to liquidity pressures as wholesale markets have dried up. Others are engaging in regulatory arbitrage, operating as banks in all but name while complying with lower capital requirements and typically less stringent internal control and governance requirements than those that apply to banks.

Capital Markets

Stock markets in South Asia have developed rapidly in recent years, as indicated by the increase since 2000 in the ratio of stock market capitalization to GDP (Figure 6). Equity listing and trading are the most advanced aspects of South Asian capital markets, but with the exception of India, still only provide access for a small number of companies, predominantly financial firms (Table 3).

Figure 6: Stock Market Capitalization
(percent of gross domestic product)



Source: World Bank (2008c).

Table 3: Number of Listed Companies

Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka
237	15	4,900	5	130	652	235

Note: Data for Bangladesh, India, and Sri Lanka, end-2007; Bhutan end-2005; Maldives end-2008; Nepal July 2008; Pakistan end-2008.

Source: Country stock exchanges.

The expansion of stock markets in South Asia implies buoyant trading activities. However, secondary markets are not yet active and remain very thin, due primarily to inadequate information available to investors. Bank financing, consequently, remains the main source of funds for productive investment in South Asia. Foreign access to local stock markets is limited due to several factors, such as macroeconomic weaknesses, inadequate transparency and accounting standards, foreign ownership limitations in listed companies, and cumbersome and opaque regulatory environments. Bond markets barely exist in South Asia except in India, where public bond market capitalization is around 30% of GDP (Table 4). Private bond markets do not exist or are small in South Asia compared to other developing Asian countries due to the preference for private placements by borrowers.

Despite ongoing development efforts in most countries across the region, the necessary infrastructure for broad, deep, and efficient capital markets is not yet fully in place. With the exception of Afghanistan where capital market development is very much a second-order issue, all countries in the region have ongoing reform programs to improve company and securities laws and the efficiency and effectiveness of capital market oversight. Except in India and Sri Lanka, South Asia still lacks robust clearing and settlement systems, in particular, real-time gross settlement and electronic fund transfer and settlement systems. Some countries, like Nepal, still issue debt instruments in paper form, while Bangladesh still uses a manual payment system for securities transactions.

There are both supply and demand constraints to capital market development in the region, including the lack of benchmark debt

Table 4: Bond Markets in Selected Asian Countries
(percent of gross domestic product)

	Corporate Bond Market Capitalization	Government Bonds Outstanding
Bangladesh	–	17.1
India	0.9	29.6
Nepal	–	14.1
Pakistan	–	27.5
Sri Lanka	–	31.6
Indonesia	2.4	18.0
People's Republic of China	10.6	23.5
Philippines	0.7	38.2
Thailand	13.5	27.8

– = data not available.

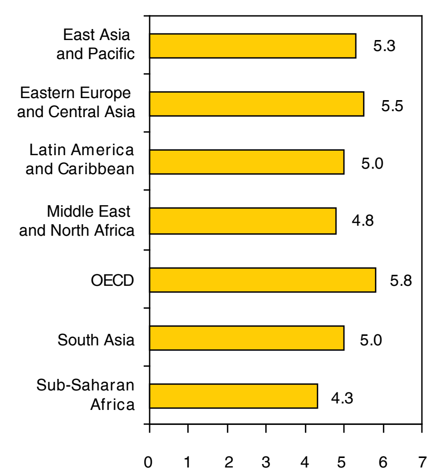
Note: Corporate bond market data is as of 2005. For East and Southeast Asian countries, government bond outstanding data is as of 2005.

Sources: Beck, Demirgüç-Kunt, and Levine (2000); and Sophastienphong and Kulathunga (2008).

securities, small institutional and retail investor bases, lack of an active and efficient secondary market, and poorly-designed tax policies. A supply side constraint in India is the preference by borrowers for private placements, which have less stringent regulatory requirements and low transaction costs. In Bangladesh, the supply of corporate debt is very limited as domestic borrowers prefer bank borrowings to avoid complying with disclosure and other governance-related requirements. Nepal's corporate bond market is also very small due in part to low investor confidence, high costs of bond issuance, weak corporate governance rules, lack of a credit rating system, little transparency in financial statements, and political instability. The main issue hampering the further development of Sri Lanka's stock market—aside from the impact of the civil war on investor confidence—is the lack of liquidity and a limited market size. In 2008, investor confidence in Pakistan's capital markets was shaken by the imposition of a price floor on listed securities in an ill-considered measure to check the sharp slide in prices. These country-specific issues are reflected in the regional ranking of investor protection, which falls short of the average for East Asia and the Pacific (Figure 7).

Greater participation by institutional investors in South Asia's capital markets is crucial to provide more long-term investment opportunities and to meet the region's investment needs. Liberalization of remaining capital account restrictions will facilitate participation by foreign institutional investors. Development of domestic institutional investors in the region is especially important considering the

Figure 7: Investor Protection Index by Region, 2008



OECD = Organisation for Economic Co-operation and Development.

Note: The investor protection index ranges from 0 to 10, with higher values denoting better investor protection.

Source: World Bank (2008a).

expected demographic changes and economic development in South Asian countries. Pension funds and insurance companies should play important roles, so the necessary privatization and reform are crucial complementary activities to the development of more efficient capital markets in the region.

Financial Deepening

Financial sector development is an important contributor to economic growth and poverty reduction. Measures of financial deepening indicate the extent to which financial intermediaries channel savings into productive investments. A low level of financial deepening indicates that individuals are more reliant on barter and informal savings, and hold real assets or livestock as stores of wealth. Deeper financial systems are better able to meet the demand for investment, easing constraints in external financing.

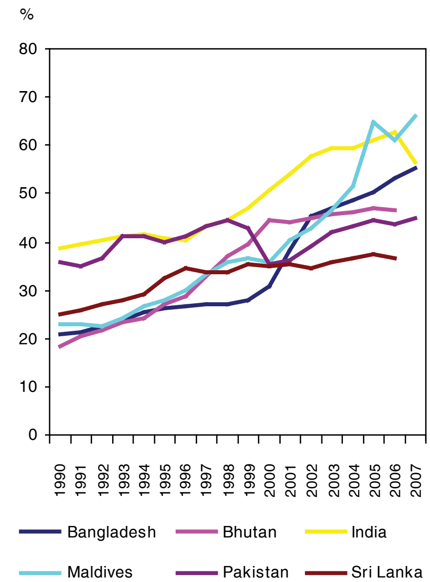
The ratio of cash and demand deposits (M2) to GDP is indicative of the level of monetization of savings and transactions. In countries where significant portions of the population do not have access to formal financial services or are reliant on barter, the M2–GDP ratio will be low. As more transactions become cash-based—and at a higher level of development are completed by check or electronic transfer—the level of the M2–GDP ratio increases. The upward trend throughout South Asia is indicative of the growing importance of the formal finance sector for transactions and savings, and reflects the varying degrees of progress in finance sector reform across the region (Figure 8).

Credit growth is another indication of deepening financial systems. Credit to the private sector is particularly important as it indicates the extent to which savings are channeled by the financial system into productive private sector investments rather than simply being used to meet government financing needs. Despite the steady upward trend in South Asia (Figure 9), credit to the private sector as a percent of GDP remains low by international standards. This reflects several factors, in addition to the still developing state of most banking sectors in the region, including the continuing role of directed lending and support for other state-owned institutions, co-opting of bank deposits for government financing through high reserve requirements, and the more general crowding-out effect of high government deficits.

Financial Stability

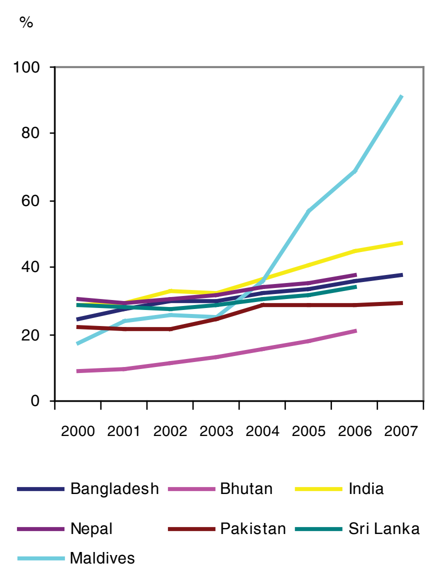
Assessing financial stability requires a review of macroprudential links, considering both the implications of the macroeconomic context and the prudential soundness of the financial sector. The degree of progress in financial sector reform is a key determinate of the resiliency of South Asia's financial systems, as the regional economy is affected by adverse economic developments in the world's major economies.

Figure 8: Selected South Asian Countries Ratio of Cash and Demand Deposits to Gross Domestic Product
(percent)



Sources: Bangladesh Bank, Central Bank of Sri Lanka, Reserve Bank of India, Royal Monetary Authority of Bhutan, and State Bank of Pakistan.

Figure 9: Selected South Asian Countries Credit to the Private Sector
(percent of gross domestic product)



Source: World Bank (2008c).

The central banks of Pakistan and Sri Lanka have begun to produce regular financial stability reports. RBI includes a chapter on financial stability in its annual *Report of Trends and Progress in Banking*, and the Bangladesh Bank publishes a half-yearly financial sector review. These efforts provide a range of data and analysis about the bank and nonbank finance sector, and endeavor to assess macroprudential links and risks to the finance sector. SBP's *Financial Stability Review* is particularly commendable for the scope of its coverage, depth of analysis, and acknowledgement of identified weaknesses.

Macroeconomic Context

South Asia's economies were not directly exposed to the proximate causes of the current global financial turmoil, but will be affected by the decline in demand for exports. The impact of global liquidity tightening is less significant because of the relatively low levels of external finance in South Asia (Table 5). However, even at these moderate levels, the difficulties in obtaining international financing has caused corporations to turn to domestic sources, increasing loan demand in the domestic banking system. This, in turn, has led to some liquidity squeezes and difficulties, particularly for nonbanks in India and Pakistan, in rolling over existing domestic short-term financing.

Table 5: External Financing: Total Bonds, Equities, and Loans in Selected Countries
($ million and as percent of GDP)

	2002	2003	2004	2005	2006	2007
Bangladesh	–	10.0	176.8	16.7	106.5	57.5
(% of GDP)	–	0.0	0.3	0.0	0.2	0.1
India	1,427.4	3,277.2	13,301.1	23,189.6	33,037.3	61,059.7
(% of GDP)	0.3	0.5	1.9	2.9	3.6	5.2
Pakistan	388.8	983.8	970	739.2	3,298.90	2,149.3
(% of GDP)	0.5	1.2	1.0	0.7	2.6	1.5
Sri Lanka	33.7	186.0	135.0	383.0	129.8	755.0
(% of GDP)	–	1.0	0.7	1.6	0.5	2.3
Indonesia	1,122.5	5,207.2	4,115.3	5,195.5	8,364.3	8,340.7
(% of GDP)	0.6	2.2	1.6	1.8	2.3	1.9
PRC	10,205.3	15,772.8	25,661.6	41,331.2	63,393.5	87,615.0
(% of GDP)	0.7	1.0	1.3	1.8	2.4	2.7
Philippines	6,345.5	6,405.4	6,358.3	6,194.8	7,172.5	6,648.4
(% of GDP)	8.3	8.1	7.3	6.3	6.1	4.6
Thailand	2,672.5	3,860.0	4,141.3	6,310.9	5,232.8	2,617.4
(% of GDP)	2.1	2.7	2.6	3.6	2.5	1.1
Viet Nam	392.5	397.0	114.0	968.8	457.4	2,641.6
(% of GDP)	1.1	1.0	0.3	1.8	0.8	3.7

– = data not available, GDP = gross domestic product, PRC = People's Republic of China.
Source: International Monetary Fund (2008b).

Despite the relatively low levels of external financing across the region, the current account deficits of some countries prior to the onset of the global financial turmoil—Maldives, Pakistan, and Sri Lanka in particular—highlight the potentially uneven impact of global developments (Table 6). The impact is already evident in Pakistan in sharply increased bank credit to the government, crowding out financing to the private sector, as well as the decision in 2008 to seek an International Monetary Fund (IMF) stand-by facility.

Table 6: Current Account Balances in Selected Countries
(percent of gross domestic product)

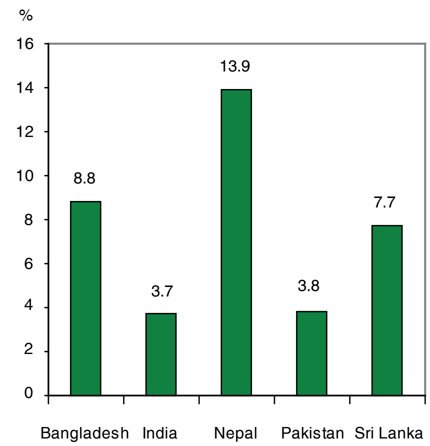
Country	2006	2007	2008
Afghanistan	(4.9)	0.9	(1.3)
Bangladesh	1.3	1.4	0.9
Bhutan	(4.4)	11.0	3.9
India	(1.1)	(1.5)	(3.0)
Maldives	(33.0)	(39.1)	(50.6)
Nepal	2.2	(0.1)	2.6
Pakistan	(4.0)	(4.8)	(8.4)
Sri Lanka	(5.3)	(4.5)	(7.1)
PRC	9.5	11.0	10.1
Indonesia	2.9	2.4	0.1
Philippines	4.5	4.9	2.5
Thailand	1.1	5.7	(0.1)
Viet Nam	(0.3)	(9.9)	(9.3)

( ) = negative, PRC = People's Republic of China.
Source: ADB (2009).

A specific concern for most South Asian countries is the impact of a global slowdown on the flow of workers' remittances. These are a large contribution to economies across the region (Figure 10), and any negative trends would have implications for domestic demand and the balance of payments. Although anecdotal evidence suggests general cutbacks in the number of migrant and guest workers employed around the globe, this has not yet had a major impact, partially because returning workers will repatriate any savings still held abroad. However, as the economic downturn progresses, a slowdown in remittance growth is likely, if not an outright decline.

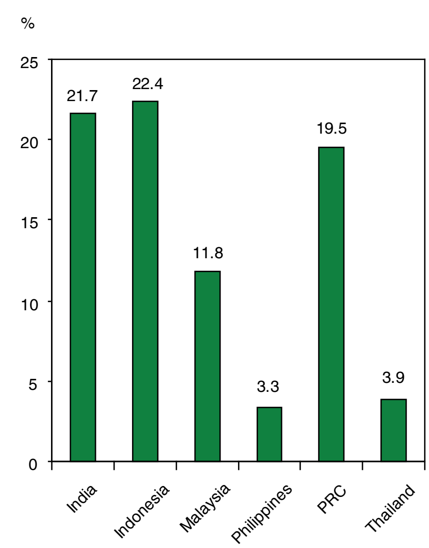
Homegrown credit bubbles in several South Asian countries appear to be the greatest risk to financial stability. In 2007, private credit growth in India was 21.7%, one of the highest levels in developing Asia (Figure 11). While partially attributable to robust economic expansion, declining inflation, financial deepening, more competition among banks, improvements in the quality of banks' assets, and financial innovation, much credit growth in 2007 and continuing into 2008 was from increased demand from corporations no longer able to

Figure 10: Workers' Remittances, 2007
(percent of gross domestic product)



Sources: Asian Development Bank (2008a) and Reserve Bank of India.

Figure 11: Private Sector Credit Growth in Selected Asian Countries, 2007
(percent annual change)



PRC = People's Republic of China.

Source: International Monetary Fund (2008a).

access international financing. This most recent development is not a classic credit bubble, characterized by rapid increases in credit, as it is essentially replacing foreign borrowing with domestic bank financing. However, to the extent that these corporations may not be able to service current debt levels, the banking system has assumed additional risk. More classic credit bubbles may be evident in Bhutan, Nepal, and Maldives, where rapid credit growth appears linked to rapid—and possibly unsustainable—increases in real estate prices.

Prudential Soundness

Across South Asia, the legal framework and practice of bank supervision are closer to international best practices than the regimes for insurance and capital markets. Most countries have taken or have in progress measures to increase their compliance with the Basel Committee on Banking Supervision's Core Principles for Effective Banking Supervision. Four countries have adopted elements of Basel II (Box 2). South Asia's banking sectors are generally more developed and, in most cases, are the primary sources of systemic risk. Thus, a greater focus on bank supervision has been warranted, although further progress in the nonbank sectors is clearly needed to support growth and development.

Box 2: Basel II in South Asia

Several South Asian countries are adopting the revised framework for *International Convergence of Capital Measurement and Capital Standards* (Basel II). Banks in the region are expected to follow the standardized approach for credit risk, which is similar to the Basel I risk-weighted approach, with the additional option of using external ratings to determine risk weightings. Key, but often overlooked, elements of Basel II include pillar 2 (the supervisory review process) and pillar 3 (disclosure and market discipline). An important aspect of pillar 2 is the ability to impose higher capital requirements on individual institutions based on their risk profile, a power not generally provided under the current legal framework in most South Asian countries. South Asian countries adopting Basel II have made commendable progress with disclosure and transparency, with a wide range of industry- and institution-specific data made public by the central banks in India, Nepal, and Pakistan. Sri Lanka's disclosure is not yet of the same standard; however, this weakness is somewhat mitigated by the requirement for all of Sri Lanka's banks to obtain coverage from a ratings agency.

India. From March 2008, India's larger banks with an international presence (including the entire State Bank of India group) adopted the standardized approach for credit risk and the basic indicator approach for operational risk. The net effect has been an 80 basis point decline in reported capital adequacy as the effect of lower risk weightings for some assets was more than offset by the operational risk capital charge.

Nepal. Effective July 2008, all commercial banks and larger financial institutions were required to adopt a framework based on the simplified Basel II standardized approach, together with the basic indicator approach to capital charges for operational risks and the standardized measurement approach to market risks.

Pakistan. Beginning in 2008, all commercial banks were required to adopt the standardized approach to credit risk and the basic indicator approach to operational risk. The net effect has been capital-neutral, with the charge for operational risk offsetting the lower risk-weights for some assets.

Sri Lanka. The standardized approach for credit risk and basic indicator approach for operational risk came into effect for Sri Lanka's banks in 2008. Capital requirements for market risk, based on the standardized measurement approach, had been introduced previously.

Table 7: Macroprudential Indicators for Selected Countries

	Bank Regulatory Capital to Risk-Weighted Assets	Bank Nonperforming Loans to Total Loans	Bank Return on Assets	Bank Return on Equity
Bangladesh	10.0	13.2	0.9	13.8
India	12.6	2.8	1.0	12.7
Pakistan	13.6	8.4	3.0	30.1
Sri Lanka	13.3	5.7	1.8	15.4
Indonesia	20.5	8.5	2.7	19.2
Philippines	15.9	5.8	1.4	11.8
PRC	7.7	6.7	1.0	19.9
Thailand	14.8	7.9	0.1	7.3

PRC = People's Republic of China.

Note: Data for Bangladesh (except for Bank Nonperforming Loans to Total Loans), Pakistan, the Philippines, the PRC, and Thailand as of 2007; Sri Lanka as of 30 June 2007; and India's Bank Return on Equity as of 2006.

Sources: Central Bank of Sri Lanka and International Monetary Fund (2008b).

Reported capital adequacy varies across the region (Table 7). Capital adequacy for the system overall obscures the fact that in Bangladesh, Pakistan, and Sri Lanka, the capital adequacy of state-owned banks is much lower than for private banks. Since weaknesses were not addressed during the recent boom, the state-owned banks and banking systems as a whole are not well positioned to face an economic downturn. Private sector banks throughout the region and state-owned banks in India have increased capital adequacy over recent years in response to strengthened prudential requirements and enhanced supervision, building capacity to absorb the inevitable loan losses as economic growth decelerates.

Reported asset quality has improved overall in the region in recent years, with Bangladesh as a notable outlier (Table 7). As with capital adequacy, the banking system asset quality data obscure weaknesses in state-owned banks in most South Asian countries. A further concern is that weak loan classification and provisioning requirements prevalent in the region tend to overstate asset quality, profitability, and capital; and thus provide an exaggerated view of system resiliency. Profitability of South Asia's banking sectors has tended to lag behind other Asian countries, reflecting the impact of inefficient state-owned banks that have a larger market share in South Asia.

One strength of South Asia's banking systems is that—with the exception of Maldives and some specific banks in other countries—the banks tend to be liquid with loan–deposit ratios comfortably under 85% (Table 8) and well-developed retail deposit bases. While the high reserve ratios prevalent in the region have had a dampening effect on growth and profitability of the banking sector, ensuring that banks hold high volumes of government securities has one benefit.

Table 8: South Asia's Banking System Loan–Deposit Ratios
(percent)

	2001	2002	2003	2004	2005	2006	2007
Bangladesh	–	–	–	–	82.8	82.3	82.2
India	49.4	53.2	54.1	54.4	62.3	69.6	73.0
Maldives	62.4	58.3	54.1	63.6	87.7	107.3	124.4
Nepal	60.1	61.1	60.2	59.8	64.9	60.7	68.7
Pakistan	–	65.3	65.2	73.6	76.8	80.3	71.9
Sri Lanka	72.9	67.0	66.4	66.7	71.1	78.6	78.9

– = data not available.

Note: Bangladesh data covers all banks while Pakistan data covers all scheduled banks.

Sources: Bangladesh Bank, Central Bank of Sri Lanka, Maldives Monetary Authority, Nepal Rastra Bank, Reserve Bank of India, and State Bank of Pakistan.

In the event of a crisis, these securities can be used for repurchase transactions with the central bank, providing banks with additional liquidity.

Response to the Global Financial Turmoil

To date, the most notable impact of the global financial turmoil on South Asia's financial systems is the bringing to light of underlying weaknesses. Credit booms in Bhutan, Maldives, and Nepal developed locally without any influence from structured finance products or credit default swaps. Weaknesses in state-owned banks in Bangladesh, Pakistan, and Sri Lanka are the result of long-term underperformance of basic banking—i.e., gathering deposits and making loans—rather than ventures into exotic new markets. Continued operation of insolvent and money-losing banks in Bangladesh and Nepal is attributable to domestic inability to take decisive supervisory action. The liquidity pressures on finance companies are a reflection of the fundamental riskiness of a business model using short-term wholesale funds to finance longer-term assets. The higher risk of loss from bank-like deposit taking by nonbank entities that are subject to less stringent capital and other prudential requirements existed long before mid-2007.

In common with their counterparts around the world, the central banks in India, Pakistan, and Sri Lanka have injected liquidity into the financial system, including making extraordinary refinancing available to nonbank finance companies. RBI has provided some countercyclical capital relief to banks through relaxation of provisioning requirements on restructured loans. This is broadly consistent with the concept of through-the-cycle or countercyclical approaches to capital adequacy, which involve building buffers of excess capital (or provisions) during good times, which are then drawn down when conditions deteriorate. The RBI approach has the disadvantage of not being transparent, as the banks will report better-than-actual asset quality.

Banks in South Asia are likely to be exposed to increasing loan losses as the global financial turmoil continues to unfold. The primary reason will be deterioration of the ability of domestic borrowers to repay—largely due to moderating domestic demand arising in part from declines (or at least slackening growth) in remittances, reduced exports, and to a lesser extent the generally limited reliance of South Asia on foreign funding and the global tightening of liquidity. The magnitude of losses will be most severe in countries recently experiencing credit booms and/or property price bubbles. Stress testing and scenario analyses can provide indications of likely losses, but are not themselves mitigating measures. Building strong capital buffers during good economic times is the best protection for the stability of the finance sector. Unfortunately, it is too late now to wish that different policies had been previously adopted. As the condition of poorly capitalized banks, particularly state-owned institutions, worsens, governments will be challenged in their policy response.

Financial support—without addressing banks' preexisting weaknesses—merely defers the recognition of losses and risks, creating an open-ended liability for governments. The fiscal position of countries with already weak state-owned banks—Bangladesh, Pakistan, and Sri Lanka—will make it difficult for governments to give the kind of capital support and guarantees provided to the financial sector in Europe and the United States. Considering these factors against the backdrop of long-standing difficulties in reforming state-owned banks and addressing identified weaknesses throughout the region, the most likely policy response is continued forbearance and deferring loss recognition. The downside is that the drag of the already weak banks on the finance sector and economy as a whole will increase. The clear lesson for policy makers is the urgency of addressing financial sector weaknesses as the global financial turmoil begins to abate, to position South Asia's finance sector better in anticipation of the inevitable next downturn.

Infrastructure for Financial Services

The absence of some basic government infrastructure for financial services and commercial transactions has hampered the development and performance of South Asia's financial sector. The lack of macroeconomic stability; costs of doing business; and issues concerning rule of law, transparency, and governance are all factors that negatively affect private sector development overall and the financial sector specifically.

Time, expense, and uncertainty in land registration are major obstacles to private sector and financial sector development because of the implications for taking and enforcing mortgage security. Of all regions in the world, South Asia has the second-highest number of procedures legally needed to acquire property, which on average takes more than 3 months and costs almost 6% of property value (Table 9).

A lack of good bankruptcy and collateral laws that adequately protect borrowers and lenders is common throughout the region. With an average score of 4.8, South Asia ranks below East Asia and the Pacific and only slightly above Sub-Saharan Africa in the legal rights index—a measure of how well-designed are bankruptcy and collateral laws. Legal rights vary across the region, with Bangladesh and India scoring well at 8 (out of 10), while other countries face a more extensive reform agenda to introduce modern collateral and bankruptcy laws (Table 10).

Table 9: Registering Property by Region

	Procedures (number)	**Duration** (days)	**Registration Cost** (% of property value)
East Asia and the Pacific	5.0	99.0	4.1
Eastern Europe and Central Asia	6.0	72.1	1.9
Latin America and the Caribbean	6.8	71.4	6.0
Middle East and North Africa	6.4	37.4	5.9
OECD	4.7	30.3	4.5
South Asia	6.4	106.0	5.9
Sub-Saharan Africa	6.8	95.6	10.5

OECD = Organisation for Economic Co-operation and Development.

Source: World Bank (2008a).

Table 10: Legal Rights and Credit Information in Selected Countries

	Legal Rights Index	**Credit Information Index**	**Public Credit Registry** (% of adults)	**Private Credit Bureau** (% of adults)
Afghanistan	1.0	0.0	0.0	0.0
Bangladesh	8.0	2.0	0.9	0.0
Bhutan	2.0	0.0	0.0	0.0
India	8.0	4.0	0.0	10.5
Maldives	4.0	0.0	0.0	0.0
Nepal	5.0	2.0	0.0	0.2
Pakistan	6.0	4.0	4.9	1.5
Sri Lanka	4.0	5.0	0.0	8.7
Indonesia	3.0	4.0	26.1	0.0
PRC	6.0	4.0	58.8	0.0
Philippines	3.0	3.0	0.0	5.4
Thailand	4.0	5.0	0.0	31.8
Viet Nam	7.0	4.0	13.4	0.0

PRC = People's Republic of China.

Note: The legal rights index ranges from 0 to 10, with higher scores indicating better-designed bankruptcy and collateral laws. The credit information index ranges from 0 to 6, with higher scores depicting more credit information available from either a public registry or a private bureau. Public credit registry coverage shows the number of individuals and firms listed in the registry with 5-year information on repayment history, credit outstanding, or unpaid debts. Private credit bureau coverage indicates the number of individuals and firms listed by the bureau with 5-year information on repayment history, credit information, and unpaid debts.

Source: World Bank (2008a).

Another common obstacle to financial sector development is the lack of information about borrowers' credit history. South Asia has the lowest penetration of public and private credit bureaus of any region in the world, with an average of less than 1.0% of the population registered with a public credit bureau and 2.6% with a private credit bureau. Only one half of South Asian countries have a credit bureau, and penetration in these countries is much lower than in some other Asian jurisdictions (Table 10).

Perceptions of weak governance and institutions continue to beleaguer South Asian countries, which on average receive poor rankings in terms of political stability, voice and accountability, control of corruption, government effectiveness, and regulatory quality. There is significant variation among the region's countries (Table 11). These findings emphasize the importance of broader-based reforms to provide the underpinnings for finance sector development.

Table 11: Indicators of Governance, South Asia, 2007

	Voice and Accountability	Political Stability	Government Effectiveness	Regulatory Quality	Rule of Law	Control of Corruption
Afghanistan	−1.17	−2.37	−1.33	−1.75	−2.00	−1.53
Bangladesh	−0.63	−1.44	−0.81	−0.86	−0.81	−1.05
Bhutan	−0.88	+0.67	+0.01	−0.68	+0.49	+0.92
India	+0.38	−1.01	+0.03	−0.22	+0.10	−0.39
Maldives	−0.91	+0.11	−0.19	−0.04	+0.02	−0.78
Nepal	−0.89	−2.13	−0.81	−0.65	−0.64	−0.66
Pakistan	−1.05	−2.44	−0.62	−0.56	−0.93	−0.83
Sri Lanka	−0.39	−1.96	−0.29	−0.11	+0.06	−0.13

Note: Governance scores range from −2.5 to +2.5, with higher (lower) values denoting better (poor) governance.

Source: Kaufmann, Kraay, and Mastruzzi (2008).

Outreach

The outreach of the formal financial sector varies across South Asia (Table 12). The number of bank branches per capita is much higher in Bangladesh, India, Pakistan, and Sri Lanka than might be expected given per capita incomes, in part because of state-owned banks' mandates to serve all areas of the country. This outreach comes at a cost in terms of state-owned bank inefficiency, and the cross-subsidization of unprofitable state-owned bank branches discourages entry on commercial terms by private sector financial firms. The banking sectors in Bangladesh, India, Pakistan, and Sri Lanka all appear to encourage financial inclusion with low minimum deposit and loan amounts, and low fees for consumer loans, mortgages, and small or medium-sized enterprise (SME) loans. The major barriers to access are the time needed to process applications and the number of documents required (Box 3).

Despite these positive signs, South Asian countries remain among the lower ranked in financial inclusion (Table 13) due to interest rate ceilings or controls and government-subsidized credit. For example, interest rate controls in India can make priority sector lending unprofitable because permissible interest rates do not cover the high credit risk and fixed costs of the loan (Government of India, Planning Commission 2008a). Furthermore, these ceilings force banks to charge additional fees or even be susceptible to bribes, making bank lending to the poor an arduous task. Similarly, well-intentioned subsidized credit programs have the adverse effect of crowding out lending on market terms and conditions. Clearly, market-determined interest rates are crucial if outreach programs are to be sustainable.

Another main reason for the low level of financial inclusion in South Asia is the generally low penetration of microfinance, aside from Bangladesh (Figure 12). One challenge has been the lack of a suitable regulatory framework for microfinance in most countries, although Bangladesh introduced legislation and established the Microfinance Regulatory Authority in 2006. Initiatives are underway to expand microfinance in India and Pakistan, but striking a balance between consumer protection and self-sustaining microfinance providers is difficult. Particularly in India, there has been reluctance to permit deposit mobilization, reflecting concerns about the weaknesses and unsatisfactory supervision of many existing small financial institutions—urban, rural, and regional banks. Sri Lanka has experienced a unique set of challenges, with donor financial support provided following the 2004 tsunami, overwhelming the microfinance sector's capacity to disburse prudently and to administer properly.

Table 12: Indicators of Financial Sector Outreach

	Number of Bank Branches (per 1,000 people)	**Number of ATMs** (per 1,000 people)	**Number of Loans** (per 1,000 people)	**Number of Deposit Accounts** (per 1,000 people)
Bangladesh	4.7	0.3	61.1	255.2
India	6.4	1.9	78.0	442.9
Nepal	1.7	0.3	10.8	110.4
Pakistan	5.0	1.3	31.8	171.1
Sri Lanka	7.7	5.7	364.2	1,117.8
PRC	1.3	3.8	–	–
Indonesia	8.4	4.8	–	–
Philippines	7.8	5.3	–	302.1
Thailand	7.2	17.0	247.9	1,423.1

– = data not available, ATMs = automated teller machines, PRC = People's Republic of China.

Note: PRC, Indonesia, Philippines, and Thailand data are based on 2003/2004 survey data.

Sources: Beck, Demirgüç-Kunt, and Martinez Peria (2007); and Sophastienphong and Kulathunga (2008).

Box 3: Accessing Formal Financial Services in South Asia

	Physical access			Affordability				Eligibility	
	Number of Sample Banks	**Loan Market Share in 2004** (bank % share out of total system)	**Locations to Submit Loan Application** (out of 5)	**Minimum Amount of Business Loan** (% of GDPPC)	**Fees of Business Loan** (% of minimum loan amount)	**Minimum Amount of SME Loan** (% of GDPPC)	**Fees of SME Loan** (% of minimum loan amount)	**Days to Process Business Loan Application**	**Days to Process SME Loan Application**
Bangladesh	5	56.51	2.12	55.28	6.46	174.40	2.62	34.55	43.26
India	4	37.75	2.44	57.77	0.93	145.17	0.84	19.98	10.75
Nepal	5	42.40	2.00	19,407.57	18.57	2,970.18	16.86	9.53	10.94
Pakistan	3	44.02	3.09	1,526.04	0.12	234.25	0.19	31.98	33.63
Sri Lanka	3	51.10	2.90	20.56	2.29	20.56	2.09	15.57	10.04
				Minimum Amount of Consumer Loan (% of GDPPC)	**Fees of Consumer Loan** (% of minimum loan amount)	**Minimum Amount of Mortgage Loan** (% of GDPPC)	**Fees of Mortgage Loan** (% of minimum loan amount)	**Days to Process Consumer Loan Application**	**Days to Process Mortgage Loan Application**
Bangladesh				25.70	0.23	1,412.52	0.18	9.44	33.48
India				28.79	1.19	145.17	0.74	4.17	9.45
Nepal				1,153.17	0.94	2,147.93	1.00	3.71	9.50
Pakistan				146.71	0.14	954.59	0.08	20.71	28.44
Sri Lanka				36.10	0.34	51.64	1.83	7.34	20.61
				Minimum Amount to Open Checking Account (% of GDPPC)	**Minimum Amount to Open Saving Account** (% of GDPPC)	**Annual Fees of Checking Account** (% of GDPPC)	**Annual Fees of Saving Account** (% of GDPPC)	**Number of Documents to Open Checking Account** (out of 5)	**Number of Documents to Open Saving Account** (out of 5)
Bangladesh				2.28	0.89	0.00	0.00	4.57	4.57
India				8.85	5.02	0.00	0.17	2.69	2.55
Nepal				90.66	63.39	8.28	4.97	4.11	3.92
Pakistan				1.59	1.59	0.00	0.00	2.64	2.43
Sri Lanka				15.76	3.54	0.73	0.00	2.62	1.00

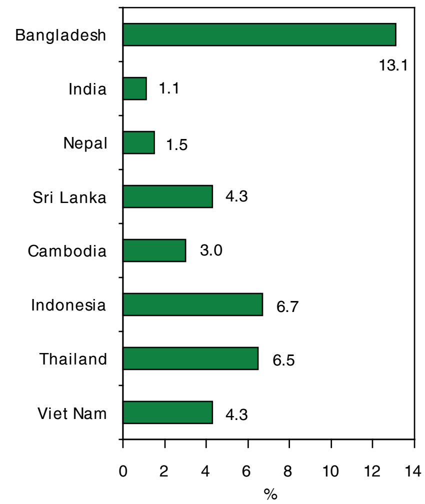
GDPPC = gross domestic product per capita, SME = small or medium-sized enterprise.

Note: Indicators are weighted country-specific averages based from a 2003/2004 survey of banks. Locations to open deposit account take the value 1 if an account can be opened at headquarters only; 2 if at headquarters or a branch; and 3 if at headquarters, branches, or nonbranch outlets.

Source: Beck, Demirgüç-Kunt, and Martinez Peria (2007).

Many reasons for the limited outreach of the formal finance sector relate to broadly applicable barriers to private sector development. For example, bank credit growth to India's SME sector was found to be weak because of (i) high levels of nonperforming SME loans in state-owned banks, (ii) a large number of SMEs yet to be registered, and (iii) the high costs of registering property as collateral and enforcing contracts (ADB 2004). In Sri Lanka, high real interest rates and weak enforcement of collateral laws are the main causes of banks' reluctance to provide credit to SMEs (ADB 2005), and SME financing is considered by Bangladesh's financial institutions to entail high administrative costs (Ahmed 2006). In Pakistan, a lack of good financial records by SMEs, brought about by their paucity in skills and resources, partially explains banks' reluctance to provide SME financing (State Bank of Pakistan 2008b).

Figure 12: Microfinance Penetration
(clients/population, percent)



Source: Honohan (2004).

Table 13: Index of Financial Inclusion

	IFI	IFI Rank
Bangladesh	0.118	69
India	0.170	50
Nepal	0.089	76
Pakistan	0.120	67
Sri Lanka	0.134	63
People's Republic of China	0.297	32
Indonesia	0.141	60
Philippines	0.163	53
Thailand	0.303	30

IFI = Index of Financial Inclusion.

Source: Sarma (2008).

There are also structural issues within the financial sector that inhibit outreach. The lack of computerization, particularly in state-owned banks, hinders communication between branches and regional and head offices, exacerbating long processing times. For example, in India, out of more than 6,000 bank branches managing government-related activities, only 16 have been computerized (RBI 2007). Adoption of new technologies is limited among nationalized and privatized commercial banks in Bangladesh (Rahman 2007), and in Pakistan, only a few banks provide mobile banking services (State Bank of Pakistan 2008a). One effort being made to improve efficiency in India is to convert all government payments and receipts into electronic form (RBI 2005). Mobile and internet banking, together with automated teller machines, are also seen as tools that can potentially lower the cost of financial intermediation.

Reform Agenda

South Asian countries need to continue—and in many cases to enhance—already identified reforms to increase the resilience and capacity of the financial sector to support economic growth and private sector development. Most issues and needed reforms have already been identified, and the key will be to make progress in some of the more difficult issues that remain outstanding, in some instances after many years of reform efforts. The most important issues across the region include

- creating prudent fiscal policies to avoid crowding out private sector credit growth by the need to finance government deficits;
- strengthening the legal foundation and government infrastructure for commercial transactions, including company and bankruptcy law, land title registration, and registration and enforcement of security interests in real and personal property (chattels);
- lifting nonprudential restrictions on financial institutions, such as directed and priority lending requirements;
- reforming and privatizing state-owned financial institutions;
- removing remaining capital account restrictions;
- improving the quality and application of accounting standards;
- bringing the legal framework and prudential standards for the financial sector fully in line with international best practices;
- building policy development and supervisory capacity, particularly in nonbank sectors such as insurance and pensions;
- establishing an appropriate legal framework for microfinance; and
- supporting credit bureau development.

Countries across South Asia have improved banking regulation and supervision in recent years, although a significant reform agenda remains. Key legal reforms are outstanding in several countries, but in many cases, the biggest challenges relate to the enforcement of prudential requirements and taking decisive actions to resolve identified problems in institutions. The passage of laws and regulations can be the easiest part of moving toward international standards. Enforcement, however, can be challenging, especially in the case of state-owned banks as illustrated by the long difficulties in addressing insolvent or undercapitalized banks in Bangladesh, Pakistan, and Sri Lanka. A related issue is the lack of supervisory capacity, particularly in rapidly growing banking systems such as Nepal's, or in supervising large numbers of previously unregulated or undersupervised institutions such as Bangladesh's microfinance sector or India's small banks and bank-like institutions that are not wholly under the remit of RBI.

To date, South Asian countries have made less progress with reforms to the nonbank sector and capital markets development. The two are linked, as institutional investors such as life insurance companies and pension funds play prominent roles in capital market development. In addition to legal reforms, there is a pressing need in most countries for policy development and supervisory expertise in the insurance and pension fields. Reform and privatization of the state-owned insurance companies that dominate the market will be an integral part of developing nonbank institutions. Improving investor protection through strengthening legal frameworks, transparency and disclosure, and corporate governance will be important to further capital market development in South Asia.

A specific challenge is to rationalize the approach to regulation of deposit-taking institutions. The pressures from the ongoing global financial turmoil are highlighting the flaws in the philosophy of allowing small and thinly capitalized institutions to engage in bank-like activities, albeit with some business restrictions, in an effort to promote competition and to serve specific sectors or regions. These institutions are facing liquidity pressures and are often seen as systemically important because of their role as providers of business credit, leading to official support action that is out of proportion to their size and importance relative to banks. Countries should be moving to a harmonized regulatory regime with uniformly high capital requirements for bank-like activities, complemented by an appropriate regime for microfinance.

Several countries across the region have yet to establish appropriate legal frameworks for sustainable microfinance. Laws should provide for a graduated approach to regulation and supervision, ranging from a light regime of registration and periodic reporting for institutions wholly reliant on their own capital and grants, to a more bank-like regime for institutions that mobilize deposits. This approach matches the level of oversight to the risks, balancing the need for oversight to provide confidence to depositors and potential investors with the dampening effect of regulatory burden on sector development. Putting this enabling framework in place will be important in moving microfinance penetration in South Asia to the levels existing in Bangladesh.

The commonality of issues across South Asia, despite the disparities in size and levels of finance sector development, highlights the potential benefits from regional cooperation. The Network of Central Bank Governors and Finance Secretaries of the South Asian Association for Regional Cooperation (SAARCFINANCE), established in 2002, provides a platform that could support multicountry efforts such as moving to a common and more stringent loan-loss provisioning standard, and more broader-based projects (regional training and technical assistance) to build capacity in policy development and supervision of the nonbank sector. The South Asian Federation of Exchanges may be a useful forum to pursue enhancements in transparency, disclosure, and governance.

Experience with global developments since 2007 has highlighted the need for regional coordination in dealing with financial sector turmoil. Although South Asian financial sector is not yet highly integrated, some financial institutions in the region have significant cross-border activities. Supervisory authorities in India, Maldives, Nepal, Pakistan, or Sri Lanka may have to deal with home-host issues in the resolution of a weak bank or insurance company with operations in more than one South Asian country. One early lesson from the experience with intervention in Europe's banks is the need to improve international cooperation and coordination, particularly with respect to resolution of troubled institutions. SAARCFINANCE provides a forum that could be used to build the necessary supervisory relationships for coordination of ongoing supervision and crisis management.

3. COUNTRY FINANCE SECTOR OVERVIEWS

Afghanistan

Considerable progress has been made in reestablishing a functioning financial system in Afghanistan despite the ongoing security challenges and lack of basic government services. The financial sector remains small—equivalent to about $1.5 billion at end-2007—but the banking sector has been growing steadily. Da Afghanistan Bank (DAB) has benefitted from extensive technical assistance to build bank supervision capacity. It has taken several actions to address identified weaknesses; however, banking sector financial soundness indicators suggest that some problems remain.

The Microfinance Investment Support Facility for Afghanistan (MISFA)—a multidonor project providing financing and technical support—reports remarkable success, with a tenfold increase in outstanding loans since 2005. As with the rest of Afghanistan's economy, much finance sector activity is unreported in the informal sector. There are about 100 money service providers and about 300 foreign exchange dealers licensed by DAB, but there may be as many as 2,000 *hawaladars* (traditional money service providers) countrywide.[1]

Financial Sector Structure

Afghanistan's formal financial sector is dominated by commercial banks (Table 14), whose numbers have tripled since end-2005, albeit from a small base. The banking sector remains highly liquid, with loans accounting for about 47% of total assets. The proportion of loans to total assets has been increasing, indicating some success in dealing with the challenging environment for lending. However, the binding constraint for banking system growth continues to be a lack of bankable propositions rather than funding.

Afghanistan has one largely dormant state-owned insurance company. Although included in the list of state-owned companies to be restructured under the conditions of the IMF's Poverty Reduction and Growth Facility, little progress has yet been reported. Leasing is still embryonic. The only lessor, the Afghanistan Finance Company, was established with donor support in 2004, and to date has completed about 70 transactions.

Credit unions have been established with technical assistance from the World Council of Credit Unions. While their number has increased from

[1] Estimates vary from 500 to 2,000 (World Bank 2003).

7 to 15 since 2005, total credit union assets have declined by more than two thirds. This may be an unintended consequence of the success of microfinance, as borrowers rationally prefer to borrow at lower rates from donor-funded microlenders than at the rates required for a self-sustaining cooperative funded by member savings. A new United States Agency for International Development program will provide extensive financing support for credit unions, but experience elsewhere suggests that external finance undermines the cooperative foundations of credit unions that then often fail to achieve self-sufficiency (Andrews 2006).

The MISFA was established in 2002 to provide an umbrella organization to support microfinance development. There are over 25 nongovernment organizations (NGOs), donors, and other international organizations active through the MISFA, which provides technical assistance and wholesale funding for microfinance. The number of microfinance institutions has grown rapidly, from 5 in 2005 to 14 at end-2008, with total loan portfolio increasing during the same period more than 10 times to more than $100 million, equivalent to about one seventh of total bank credit outstanding.

Table 14: Afghanistan's Financial Sector Overview, End-2007

Institution	Number	Assets (AF million)	Assets (percent of GDP)
Commercial Banks	16	74,000	18.0
State-Owned	3	44,225	10.7
Private	8	12,900	3.1
Foreign	5	16,875	4.1
Credit Unions	15	5,100	1.2
Microfinance Institutions[a]	11	135	0.0
Insurance Companies[b]	1	385	0.1
Leasing Companies	1	NA	NA

AF = afghani, GDP = gross domestic product, NA = not applicable.

[a] Data for end-January 2008.

[b] Afghan National Insurance Company (state-owned) had estimated assets of AF385 million ($8 billion) in 2005—more recent data are not available.

Note: The estimated GDP was AF412 billion ($8 billion) at end-2007.

Sources: Da Afghanistan Bank, International Monetary Fund, Microfinance Investment Support Facility for Afghanistan, and World Council of Credit Unions.

Regulation, Supervision, and Prudential Standards

DAB is the banking supervisor, working within an appropriate legal framework established by new central bank and banking legislation prepared with extensive international technical assistance. The more general legal foundation for commercial activity is less satisfactory. There have been difficulties enacting and implementing key legislation such as an updated commercial code and mortgage law. Serious deficiencies in government services mean there are no reliable ways to register and enforce security interests.

DAB has used a self-assessment of compliance with Basel II to develop an agenda for further reform. This includes the need for several new or amended regulations to address various aspects of risk management. These framework issues are more easily addressed than ensuring effective implementation by the banking industry and appropriate supervisory verification by DAB.

Reported nonperforming loans to gross loans in the banking sector declined from 2.4% in 2005 to 1.0% in 2007. This is largely due to the rapid growth in the loan portfolio and the widespread practice of rolling over maturing loans ("evergreening"). The banking system remains well capitalized overall, but failure to establish appropriate loan-loss provisions means that earnings and capital are overstated.

Outreach

Formal financial sector outreach has increased dramatically, although there are still provinces without any formal financial service providers aside from DAB branches. At end-2007, commercial banks had 171 branches in 20 provinces. Microfinance organizations and credit unions now serve 24 of the 34 provinces. The security situation is limiting further outreach, with thefts of cash in transit and robberies of microfinance offices becoming more prevalent in 2007 (World Bank 2007a). With microcredit supplied to about 2% of the population, there remains an enormous unmet demand.

Table 15: Microfinance Outreach in Afghanistan

			Loan Portfolio	
Institution	**Depositors/Members**	**Borrowers**	**Total** (AF million)	**Average Loan** ($)
First Microfinance Bank	9,426	23,616	1,285,828	1,094
Credit Unions	10,735	3,009	75,660	484
Microfinance	–	443,295	5,338,058	242
Total	20,161	469,920	6,699,546	274

– = data not available, AF = afghani.

Sources: First Microfinance Bank Annual Report 2007; Microfinance Investment Support Facility for Afghanistan Update December 2008; and Mix-Market Data, World Council of Credit Unions at end-March 2008.

Issues and the Reform Agenda

The most pressing issues facing financial sector development in Afghanistan are fundamental concerns about personal safety and security, and protection of property. If these basic requirements can be met, there will be greater scope to address outstanding priority areas including implementation of an appropriate legal framework to support commercial transactions. Further work is required to build on DAB's progress to date in putting in place an effective supervisory regime. Only in the much longer term will policy attention be required for the development of other sound financial system elements that are able to support growth, including contractual savings vehicles, insurance, and capital markets.

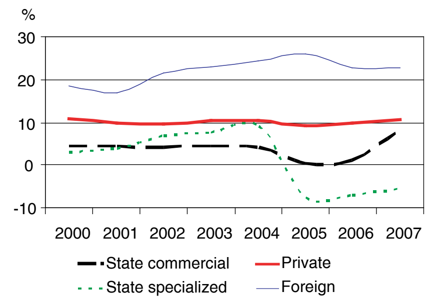
Bangladesh

Bangladesh's bank-dominated financial sector is significantly constrained in its ability to intermediate and support growth by the undercapitalization and ongoing losses of state-owned commercial and specialized banks. The increase in the reported capital adequacy of state-owned commercial banks to 7.9% in 2007 (Figure 13) resulted from accounting slight-of-hand, with goodwill created on the corporatization of three of these banks to eliminate Tk90 billion ($1 billion) in accumulated losses. However, no new equity was actually injected. The banks have to amortize this goodwill over 10 years and will continue to be burdened with significant volumes of nonperforming assets that will be an ongoing drag on their financial performance. Both the state-owned commercial and specialized banks are under provision for loan losses (Figure 13); therefore, adjusting for goodwill and underprovisioning, these banks are insolvent.

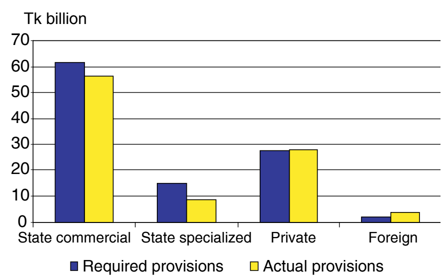
The state-owned banks require large spreads to cover their costs and are constrained in their ability to lend, thus distorting the market and contributing to high profits for private domestic and foreign banks. Continued losses by the state-owned commercial and specialized banks (reported 5-year average returns on equity of –1.8% and –10.1%, respectively) mean that they are consuming deposits to cover expenses rather than intermediating. Thus, the private and foreign banks can gain the market share without having to pass on all of their efficiency gains in the form of higher deposit rates or lower loan rates. This situation will continue as long as the state-owned banks provide an umbrella to shelter the more efficient banks from real competition.

Figure 13: Bangladesh's Undercapitalized State-Owned Banks

Reported Capital Adequacy Ratios (%)



Required and Actual Loan-Loss Provisions (Tk billion)



TK = taka.

Source: Bangladesh Bank.

Financial Sector Structure

Bangladesh's 48 banks dominate the financial sector with total assets equivalent to almost 60% of GDP (Table 16). State-owned banks' share of banking assets has declined to 40% due to higher growth rates by domestic private banks. Financial institutions are authorized to raise deposits from the public and institutional investors, and provide a range of specialized financial services including leasing, corporate finance, housing finance, and—subject to the licensing requirements of the Securities and Exchange Commission—stock broking, dealing, and underwriting.

Two state-owned insurance companies, Jiban Bima Corporation and Sadharan Biba Corporation, each have about 15% of the market, respectively, for life insurance and general insurance. There are five private life insurers and 20 private general insurers. Private insurers are required to place half their reinsurance with the state-owned Sadharan Biba Corporation.

Table 16: Bangladesh's Financial Sector Overview, 2007

Institution	Number	Assets (Tk billion)	Assets (percent of GDP)
Banks	48	2,773.9	59.3
State-Owned Commercial Banks[a]	4	917.9	19.6
State-Owned Specialized Banks[b]	5	201.7	4.3
Domestic Private Banks	30	1,426.6	30.5
Foreign Banks	9	227.7	4.9
Finance Institutions[c]	29	99.1	2.1
Grameen Bank	1	68.9	1.5
Microcredit Institutions[d]	335	91.1	1.9
Credit Unions	413	2.2	0.0
Insurance Companies[e]	27	NA	–
State-Owned	2	NA	–
Stock Exchanges	2	–	–
Investment Corporation of Bangladesh	1	23.3	5.0
Broker-Dealers	202	–	–
Merchant Banks	29	–	–
Mutual Funds	17	–	–
Credit Rating Agencies	2	–	–

– = data not available, GDP = gross domestic product, NA = not applicable, Tk = taka.

[a] Agrani, Janata, Rupali, and Sonali.

[b] Krishi, Shilpa, Shilpa Rin Sangstha, Bangladesh Small Industries and Commerce Bank, and Rajshahi Krishi Unnayan.

[c] One state-owned, Infrastructure Development Company, 15 local privately owned, and 13 joint ventures with foreign participation.

[d] Licensed to date by the Microcredit Regulatory Authority, which has received an additional 3,900 applications for a microfinance license.

[e] Six life and 21 general insurance companies.

Note: The GDP was Tk4,675 billion ($68 billion) at end-2007.

Sources: Bangladesh Bank, Grameen Bank Annual Report, Microfinance Regulatory Authority, Securities and Exchange Commission, and World Council of Credit Unions.

Two stock exchanges (Dhaka and Chittagong) had a combined market capitalization equivalent to about 16% of GDP at end-2007. There are about 230 licensed brokers, dealers, and merchant banks, with a significant number of these licenses held by other financial institutions. The state-owned Investment Corporation of Bangladesh is the biggest player in the capital markets, involved in underwriting, bridge financing, investment accounts, managing open- and closed-end mutual funds, and dealing on both stock exchanges. There were 273 listed companies at end-2007, with the bulk of market capitalization accounted for by banks and other financial institutions. Listed corporate securities number only eight debentures with a face value of Tk140 million ($2 million). Government bonds are eligible for trading on the exchanges, and although 44 issues are listed, secondary trading has not developed.

Grameen Bank (which, despite its name, is not licensed or supervised as a bank) and 10 large microcredit institutions collectively account for more than 80% of the microfinance market. The remainder comprises more than 4,200 mostly very small microfinance organizations, of which 335 have been licensed by the Microfinance Regulatory Authority.

Regulation, Supervision, and Prudential Standards

Bangladesh Bank is the supervisory authority for banks and financial institutions. Each state-owned commercial or specialized bank was originally incorporated under its own statute, which—combined with government ownership—limited Bangladesh Bank's ability to enforce prudential standards. The framework for supervision of private and foreign banks has been more satisfactory but suffers from the adverse impact of nonprudential requirements. Bangladesh Bank requires banks to disburse specific percentages of total loans to targeted sectors. This furthers its mandate to manage the credit system, promoting and maintaining a high level of production and employment. For example, all commercial banks have been advised to allocate a given share of their total annual loan disbursement to agriculture. This can undermine otherwise sound credit risk management and ultimately be counterproductive, burdening banks with loan losses that they might otherwise not incur as well as increased operating costs to manage the mandated lending programs.

New capital requirements based on Basel II have come into effect in Bangladesh from January 2009, running parallel with the preexisting Basel I-based framework until January 2010. This is consistent with the approaches taken to introduce Basel II in most other countries providing a period to ensure the integrity of Basel II reporting.

The interest rate spread is widely used as a parameter of bank profitability, intermediation cost, and the degree of efficiency of the banking sector. In Bangladesh, high interest rate spread resulted from several factors, including state control of lending, absence of risk management practices, accumulation of bad loans due to political interference on commercial lending decisions, and limited technical skills particularly in risk management. The interest rate spread, as measured by the difference between weighted average lending and deposit rates of commercial banks, shows a generally declining trend since June 2001, but will remain high as long as the inefficient state-owned banks provide an umbrella to shelter the rest of the banking system from effective competition.

Despite progressive deregulation of interest rates, there are still a number of restrictions, such as a rate limit of 12% on facilities for import of food staples. Such restrictions tend to restrict the supply of credit, as private and foreign banks are reluctant to lend unless the rate is commensurate with the risk. Combined with various subsidized interest rate programs, the effect is that the state-owned banks undertake a disproportionately large share of nonmarket rate lending, and are thus further burdened with underperforming assets.

The commendable 10% capital adequacy requirement is undermined by the failure to enforce provisioning requirements. Bangladesh Bank has introduced a range of prudential enhancements over the last few years, including publication of detailed financial information about the sector and bank credit ratings to enhance transparency and market discipline. Strengthened corporate governance requirements include institution of fitness and probity requirements for directors and senior officers, and the requirement of independent audit committees. A less positive development is the appointment of two independent directors to each bank board by Bangladesh Bank, as this blurs the distinction between the owners, directors, and supervisory authority.

To strengthen the financial asset base of banking companies, Bangladesh Bank has fixed the minimum amount of combined paid-up capital and reserves at Tk4 billion ($58 million), of which the minimum paid-up capital amount would be Tk2 billion ($29 million). In addition, Bangladesh Bank is formulating regulations to modernize the payment and settlement systems by July 2009, first in the 1,050 bank branches in Dhaka. The process of installing the automated clearing system is ongoing, and the system is expected to be set up at the central bank by June 2009.

The general provision requirement has been reduced from 2% to 1% on small enterprise financing by banks and nonbank institutions. While intended to encourage SME financing, the measure unfortunately serves to further weaken Bangladesh's lax provisioning standards. General provision requirements for other sectors and the specific provision requirements for classified loans remain unchanged.

The 2006 Microcredit Regulatory Authority Act requires all microcredit operations to be licensed. The new agency was overwhelmed with more than 4,000 license applications, of which 335 have thus far been approved. About 2,600 applicants currently do not meet the minimum standards and have a transitional period ending in June 2009 in which to do so.

Shortcomings in the legal framework and practice of insurance supervision have long been identified. New legislation has been prepared with international technical assistance, and considerable investment made in capacity building to transform the Office of the Chief Controller of Insurance into an effective supervisory body.[2] Progress has been slow, in part due to long delays in the new legislation.

The Securities and Exchange Commission oversees all capital market participants including both stock exchanges. Recognizing shortcomings in the legal framework and implementation, it has extensive action plans that include new and revised rules, strengthening market surveillance, improved governance in listed companies, and an oversight body to ensure the integrity of listed company financial statements. However,

2 Including the Asian Development Bank's 2006 Improvement of Capital Market and Insurance Governance Project.

the Securities and Exchange Commission, exchanges, and other market participants have capacity constraints. There are currently no minimum qualification requirements for market intermediaries, and the Securities and Exchange Commission suffers from high turnover.

Outreach

There are over 30 million loans provided by Bangladesh's various microfinance lenders (Table 17). Individuals frequently borrow from more than one source, with an estimated 18 million people, or about 13% of the population, being reached by the sector.[3] Direct government programs and indirect government interventions reach only about 4.3 million borrowers. Just over 25% of borrowers are served by self-funding institutions, Grameen Bank, and credit unions. While the large microfinance organizations all mobilize deposits, most are also dependent on wholesale financing and/or donor support.

Table 17: Microlending Outreach in Bangladesh

Institution	Borrowers	Loans Outstanding (Tk billion)	Average Loan Size ($)
Government Programs	1,997,240	7.7	56
State-Owned Commercial Banks	2,311,150	32.8	297
Private Banks	164,113	1.1	98
Credit Unions	98,400	1.4	208
NGO Microfinance Institutions	18,415,000	78.9	63
Grameen Bank	7,527,700	39.9	77
Total	30,513,603	161.8	77

NGO = nongovernment organization, Tk = taka.

Note: Data for state-owned commercial banks and private banks, end-2005; NGO microfinance institutions, June 2006; credit unions, end-2007; and Grameen Bank, June 2008.

Sources: Bangladesh Bank, Microcredit Regulatory Authority, and World Council of Credit Unions.

Issues and the Reform Agenda

Accelerating the long-delayed efforts to reform the state-owned commercial and specialized banks is the most pressing issue for financial sector development in Bangladesh. After deduction of goodwill from reported capital and adjustment for underprovisioning, it is clear that the state-owned banks are in a precarious position to face the potential fall-out from the global financial turmoil.

[3] See www.bangladesh-bank.org/

A major concern for the monetary authority is the adverse effect on bank balance sheets arising out of banks' high nonperforming loans. Along with other measures, Bangladesh needs to strengthen asset management companies to quicken recovery and to improve efficiency in the banking sector. An institutional safeguard mechanism is necessary to encourage banks to take precaution while extending loans to high-risk sectors and prioritizing loans to productive sectors.

The government faces an unpalatable choice. True recapitalization has significant fiscal implications. The needed restructuring to make recapitalization successful includes a more purely commercial mandate, which the government has been reluctant to adopt for state-owned institutions. However, the modest performance improvements from the drawn-out reform process may come to an end as economic headwinds increase. While Bangladesh's banks have little reliance on foreign borrowing, they do face increased loan losses as demand for exports drops, adversely affecting borrowers' repayment ability. Liquidity may also come under pressure as remittances from workers abroad decline. Failure to address the losses of state-owned banks means the banking sector as a whole will not play its proper role in supporting growth.

Progress with long-delayed initiatives to strengthen the insurance and capital market sectors is required for the financial system to become less bank-dependent over the medium to longer term. Financial sector deepening requires the development of an active secondary market in government paper. However, the operation of the primary dealer system for government securities needs to be improved before an active secondary market can develop. The key constraining factor is the authorities' inflexibility on interest rates that undermines the auction process and results in substantial devolvement of securities onto the primary dealers. Enactment of the new insurance law and revised Securities and Exchange Commission rules would be important steps to revitalize the process, which should then continue with more capacity building in both the industry and supervisory authorities.

Bhutan

Rapid credit growth in Bhutan's bank and nonbank sectors raises concerns of a possible credit bubble. Bank credit to the private sector has grown at an average of almost 30% annually since 2000, and despite a recent decline, remains well above 20% (Figure 14). The high levels of nonperforming loans of the two state-owned nonbank financial institutions and the surprisingly low reported nonperforming loans of the National Pension and Provident Fund heighten these concerns (Figure 14).

Table 18: Loans Outstanding and Nonperforming Loans, as of June 2008

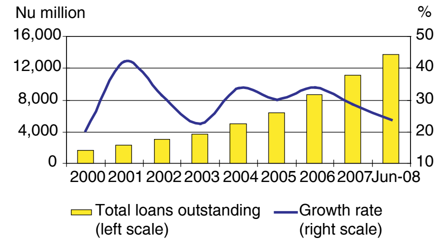
	Loans Outstanding (Nu million)	Nonperforming Loans (Nu million)	Nonperforming Loans/Loans Outstanding (%)
Banks	14,549	1,478	10.2
Nonbanks	4,353	1,058	24.3
National Pension and Provident Fund	4,232	11	0.3
Total	23,134	2,547	11.0

Nu = ngultrum.

Sources: Asian Development Bank, National Pension and Provident Fund, and Royal Monetary Authority of Bhutan.

Figure 14: Bhutan's Banks and Nonbanks Fueling the Credit Boom

Bank Credit Doubles in 2.5 Years



Nu = ngultrum.

Sources: Asian Development Bank, National Pension and Provident Fund, and Royal Monetary Authority of Bhutan.

The high concentration of lending to the housing sector, which accounts for about one fourth of all credit outstanding and much recent growth, further raises concerns about a credit bubble. The 2007 decision by the Royal Monetary Authority of Bhutan (RMA) to increase provisioning requirements for delinquent housing loans was a small step in the right direction, but is not sufficient to remedy the weak prudential standards for loan classification and provisioning, or to discourage institutions from overaggressive lending to the sector.[4]

Financial Sector Structure

State-owned institutions dominate Bhutan's small financial system. The larger of the two commercial banks is state-owned, as are the two nonbank financial institutions, the Royal Insurance Corporation of Bhutan and Bhutan Development Finance Corporation. Nonbanks play a larger role than in many developing countries, accounting for 23% of total bank and nonbank loans outstanding at end-June 2008. While not classified by RMA as a financial institution, the National Pension and Provident Fund has a loan portfolio equivalent to 22% of total finance sector loans outstanding. About two thirds of its loan portfolio consist of loans to state-owned enterprises, with the remaining one third comprising housing and education loans to individuals. The Royal Securities Exchange of Bhutan has about 15 listed companies with market capitalization at end-2005, equal to about 12% of GDP. There is no corporate debt market and very little secondary trading of either equities or government debt.

[4] Effective August 2007, financial institutions were required to establish provisions of 30% and 60% for housing sector loans more than 90 days and more than 360 days in arrears, respectively. These requirements are 10% more than the provisioning requirements for other loans.

Table 19: Bhutan's Financial Sector, 2007

Institution	Branches	Assets (Nu million)	Assets (percent of GDP)
Commercial Banks	34	28,820	66.5
Bank of Bhutan[a]	25	18,339	42.3
Bhutan National Bank[b]	9	10,481	24.2
Royal Insurance Corporation of Bhutan[c]	9	2,023	4.7
Bhutan Development Finance Corporation[d]	25	2,870	6.6
National Pension and Provident Fund	NA	5,592	12.9
Royal Securities Exchange of Bhutan	NA	NA	NA
Securities Depository[e]	NA	NA	NA
4 Securities Brokers[f]	NA	NA	NA

GDP = gross domestic product, NA = not applicable, Nu = ngultrum.

[a] 75% government-owned, 25% by the State Bank of India.

[b] Publicly held, government retains minority ownership. Seven branches plus 2 extension branches.

[c] 100% government-owned.

[d] 87% government-owned, balance by other state-owned institutions (Royal Insurance Corporation and Bank of Bhutan).

[e] Operated by the Royal Monetary Authority of Bhutan.

[f] Subsidiaries of the Bank of Bhutan, Bhutan National Bank, Royal Insurance Corporation, and Bhutan Development Finance Corporation.

Note: The GDP was Nu43,363 million ($980 million) at end-2007.

Sources: Annual financial statements of Bhutan National Bank, Bhutan Development Finance Corporation, National Pension and Provident Fund, and Royal Insurance Corporation of Bhutan; Royal Monetary Authority of Bhutan; and World Bank.

Regulation, Supervision, and Prudential Standards

The current legal framework for regulation and supervision of the financial sector has significant shortcomings. RMA is the only supervisory authority; it has built some capacity in bank supervision but lacks expertise and resources for insurance and capital markets oversight. Prudential regulations introduced in 2002 have adopted some elements of international best practices; however, there are deficiencies. The 8% capital adequacy requirement does not reflect the Basel Committee recommendation for higher capital requirements in developing countries. Classification and provisioning requirements are notably weak, with 20% provisions required for substandard loans (91–360 days in arrears), and 50% for doubtful loans (up to 720 days in arrears).

Since there is no specific legal framework for insurance or development finance institutions, both banks and nonbanks are regulated and supervised in an essentially similar manner. This is particularly problematic for the Royal Insurance Corporation of Bhutan, which is neither operated nor regulated as a true insurance company. There are no specific securities or capital markets statutes, with prospectus and offerings requirements established in the Companies Act.

Extensive technical support has been provided to strengthen the legal foundation for regulation and supervision of the finance sector and to build capacity of RMA.[5] This has included preparation of a new RMA statute, the revised Financial Institution Act, prudential guidelines, and training. Progress with enacting and implementing the new legal framework has been slow, so the deficiencies noted continue.

Outreach

The 34 commercial bank branches and 25 Bhutan Development Finance Corporation locations (22 branches plus 3 regional offices) provide a level of outreach above that in neighboring countries—roughly 9 branches for every 100,000 persons (compared to Bangladesh's 4.7, India's 6.7, and Nepal's 1.7). The government-owned Bhutan Development Finance Corporation was established to meet the financial needs of micro, small, and medium enterprises with a special focus on agricultural development. While use of banking services is widespread, the challenging terrain and lack of a road network connecting all areas of the country mean there are remote rural areas without access to formal financial services. In these areas, informal credit is often provided by money lenders and monasteries.

Issues and the Reform Agenda

Progress with the previously identified reform agenda is required to strengthen the legal framework for the financial sector and RMA's capacity to exercise effective prudential oversight. The reported capital adequacy of banks (13.5% at end-June 2008) and especially nonbanks (21.2%) is significantly overstated due to weak classification and provisioning requirements. Reported nonperforming loans of the National Pension and Provident Fund seem implausibly low compared to the reported performance of the finance sector. Failure to establish and enforce stringent classification and provisioning requirements means that early indications of credit quality problems are obscured. This makes it more difficult to take remedial action and increases the risks that losses in the predominantly state-owned lending institutions may have fiscal consequences, requiring government recapitalization when the full effects of credit losses become evident.

India

More than 15 years of gradual reform in India has improved the resiliency of its banking system (Figure 15). Improved efficiency, profitability, and asset quality as well as increased capital adequacy—especially for state-owned banks that account for 70% of banking sector assets—resulted

[5] Including an Asian Development Bank loan for the Finance Sector Development Program, which also contained components for development of a credit reference bureau and national clearing system, as well as support for banking and capital markets development provided by IMF, World Bank, and other partners.

from initiatives which included interest rate deregulation, entry of new private sector banks, and gradual strengthening of prudential standards.

The strong retail deposit base, accounting for about 75% of India's total bank funding, has provided some insulation from the effects of tightening global liquidity, although some individual banks are reliant on overseas wholesale funding. A more significant impact has come from the drying up of international credit for India's corporations, leading to increased demand for credit from domestic banks. Through September 2008, year-over-year bank credit growth was 27% overall. Lending to industry and services increased sharply, reflected in annual growth rates of 33% and 32%, respectively. Consumer lending growth decelerated from 20% in the previous year to 15% for the 12 months ending September 2008, reflecting increased concerns about the outlook for unsecured personal loans, which had been a major contributor to the banking sector's loan growth (Reserve Bank of India 2008).

India's large capital markets have continued to function in an orderly manner despite the sharp downturn in 2008 (Figure 16). Mutual funds faced redemption pressures, which in turn squeezed the liquidity of nonbank financial companies that are heavily reliant on the sale of short-term debt to finance their medium- and longer-term lending. The increased demand for bank credit from corporations also limited the bank credit available to nonbank finance companies.

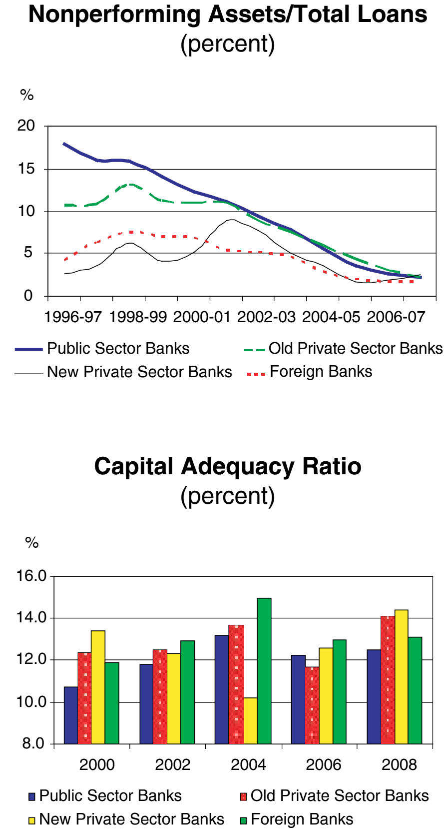
The policy response of the Reserve Bank of India (RBI) has included reduction in interest rates and bank reserve requirements, as well as providing central bank financing for export credit; foreign exchange swap facilities for foreign currency liquidity; and easing of restrictions on foreign commercial borrowings by banks, corporations, and nonbank financial companies. RBI has also adopted a countercyclical approach to capital adequacy, providing some relief for banks in the form of a modest relaxation of provisioning requirements.

Financial Sector Structure

India's finance sector includes all the components of a modern financial system, although some elements, such as derivatives markets, are in early stages of development. Scheduled commercial banks account for about three fourths of the financial system's assets. State-owned banks' market share has declined from 90% of banking assets in 1990 to 75% in 2003 and 70% today. There are more than 100,000 other deposit-taking institutions, including rural and urban cooperative banks. Banks are required to direct 40% (32% for foreign banks) of their lending to designated priority sectors—agriculture, exporters, and small business. Banks are also subject to very high liquid reserve requirements,[6] which essentially co-opt bank deposits to meet government financing requirements.

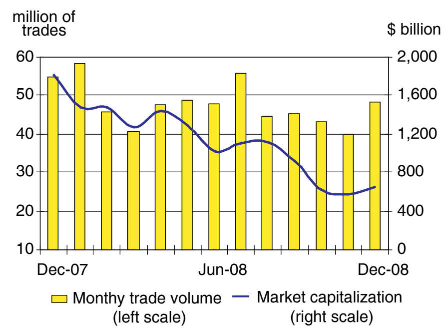
[6] Twenty-five percent, reduced to 24% in 2008, as part of RBI's response to the global financial turmoil.

Figure 15: Increased Resiliency in India from Improved Asset Quality and Higher Capital



Source: Reserve Bank of India.

Figure 16: India's Stock Market Trends



Source: Bombay Stock Exchange.

Table 20: India's Financial Sector Overview as of end-March 2008

Institution	Number	Assets (Re billion)	Assets (percent of GDP)
Scheduled Banks	79	43,264.9	100.5
Public Sector Banks[a]	28	30,222.4	70.2
Nationalized Banks	19	18,803.7	43.7
State Bank Group	8	10,111.7	23.5
Private Sector Banks	23	9,401.5	21.8
Old Private Sector Banks	15	1,945.6	4.5
New Private Sector Banks	8	7,455.9	17.3
Foreign Banks	28	3,641.0	8.5
Regional Rural Banks	91	1,235.4	2.9
Local Area Banks	4	6.5	0.0
Urban Cooperative Banks	1,770	1,794.2	4.2
Rural Cooperative Credit Institutions	98,343	3,707.2	8.6
Development Finance Institutions[b]	4	1,487.9	3.4
Nonbank Financial Companies—Non-Deposit-Taking	12,445	4,331.6	10.1
Nonbank Financial Companies—Deposit-Taking	368	702.9	1.6
Primary Dealers	19	150.4	0.3
Insurance Companies[c]	35	7,355.3	17.1
Life	17	6,790.0	15.8
General	17	414.6	1.0
Reinsurance	1	150.7	0.3
Foreign Institutional Investors	1,319	NA	NA
Stock Exchanges[d]	19	NA	NA
Depositories	2	NA	NA
Brokers[e]	59,193	NA	NA
Merchant Banks	155	NA	NA
Underwriters	35	NA	NA
Venture Capital Funds[f]	203	NA	NA
Portfolio Managers	205	NA	NA
Mutual Funds	40	3,262.9	7.6
Credit Rating Agencies	5	NA	NA

GDP = gross domestic product, NA = not applicable, Re = Indian rupee.

[a] Includes IDBI Bank Ltd., which is not a nationalized bank or part of the state bank group.

[b] All state-owned: EXIM Bank, National Bank for Agriculture and Rural Development, National Housing Bank, and Small Industries Development Bank of India.

[c] End-March 2007 data. There are eight state-owned insurers: one life, six general, and one reinsurance company. The state-owned Life Insurance Company of India has over 90% of the life insurance market. The six state-owned general insurers have about 65% of the market.

[d] Includes two derivatives markets.

[e] Includes 44,074 subbrokers.

[f] Includes 97 foreign venture capital investors.

Note: The GDP was Re43,036.5 billion ($936 billion) at end-March 2008.

Sources: Insurance Regulatory and Development Authority, Reserve Bank of India, and Securities and Exchange Board of India.

At end-2007, India had the eighth largest stock market capitalization of any country in the world, equivalent to $1,817 billion or about 167% of GDP, and about 4,900 listed companies. By end-2008, market capitalization had fallen almost two thirds to $646 billion (Bombay Stock Exchange). Most of the 15 regional stock exchanges are virtually inactive, with the Bombay Stock Exchange and National Stock Exchange accounting for over 99% of trading. Both operate electronic trading systems and have a sound supporting infrastructure of depositories, custodians, and clearing and settlement systems. In addition to equities trading, the exchanges operate the wholesale debt market for government and corporate debt, trade futures and options, and currency derivatives.

Nonbank financial companies play a significant role as credit providers, with total assets equivalent to about 10% of the banking sector. Most of these institutions are dependent on wholesale financing from banks and mutual funds, with the consequence that they have become liquidity-constrained. As part of its response to the global financial turmoil, RBI has provided extraordinary discount window access to support nonbank financial companies.

India has the most developed insurance market in the region, with life insurance premiums amounting to 4.1% of GDP and total assets of the insurance industry equivalent to about 17.0% of GDP.[7] The industry is dominated by the state-owned institutions that have 90% of the life insurance market and about 65% of the general insurance market.

Regulation, Supervision, and Prudential Standards

RBI is the supervisory authority for scheduled commercial banks and most other categories of deposit-taking institutions, as well as primary dealers and nonbank financial companies. Supervisory authority is shared between RBI and state governments with respect to urban cooperative banks, while rural cooperative institutions are registered and supervised pursuant to each state's cooperative legislation.

The quality of prudential standards and their enforcement has improved since the beginning of the reform process in the 1990s. The capital adequacy requirement is commendably set at 9%, in line with the Basel Committee recommendation that minimums should exceed 8% in countries where all preconditions for effective supervision may not be in place.

The stringent capital adequacy requirement is, however, undermined by the loan classification and provisioning standards. While the requirements have been strengthened, notably by the adoption of the international norm of classifying loans as nonperforming when 90 days in arrears rather than the previous 180-day period, minimum provision requirements remain low. Minimum provisions are not required until a loan has been nonperforming for 12 months, and full provisioning

7 Insurance Regulatory and Development Authority, 2007.

or write-off is not required until a loan has been in arrears for more than 4 years.

In December 2008, as part of its response to current economic conditions, RBI revised classification requirements to permit banks to continue to treat loans as performing even if restructured twice. This is intended to provide countercyclical capital relief to banks and to encourage corporate restructurings and workouts. However, this measure will result in some overstatement of banks' true capital positions.

The Basel II standardized approach for capital adequacy has been implemented effective from 2008 for India's banks. The overall result is a small net decrease in reported capital adequacy compared to the Basel I regime. The introduction of a capital charge for operational risk more than offset any reduction in required capital arising from the lower risk-weights for some assets. Banks have responded by further increasing capital, largely through equity injections, with the result that reported capital adequacy ratios have increased.

The Insurance Regulatory and Development Authority has a dual and potentially conflicting mandate, as promoting insurance industry development may not be wholly consistent with maintenance of a sound prudential base. The legislation dates from 1999, and together with regulations it has issued, comprises a comprehensive framework for licensing and ongoing supervision of insurance companies and intermediaries. As with the banking sector, the insurance sector is subject to mandated social priorities, required by regulation to ensure minimum numbers or percentages of policies are written for rural, unorganized, or disadvantaged sectors.

The structure for capital market regulation and oversight is complex, with responsibility shared by the Department of Economic Affairs, Ministry of Company Affairs, RBI, and Securities and Exchange Board of India (SEBI). The activities of these agencies are coordinated by a high-level committee on capital markets. Most of the powers under the Securities Contracts Regulation Act, which pertain to securities trading and operation of stock exchanges, are exercisable by the Department of Economic Affairs and also concurrently exercised by SEBI. RBI has concurrent authority over the sale of gold-related securities, money market securities, and related derivatives and forwards. The SEBI Act and the Depositories Act are mostly administered by SEBI, and the powers under the Companies Act relating to issue and transfer of securities are administered by SEBI with respect to listed companies.

Outreach

The diversity of the sector and the size of the population present challenges in developing a comprehensive overview of financial sector outreach in India. Over 1 billion deposit accounts are held by scheduled banks and over 61,000 commercial bank branches, of which almost one third are in rural areas. In addition to the commercial banks, there are well over 100,000 other financial institutions, most of which take deposits as well as offering credit products. However, these numbers have to be considered against a growing population of 1.1 billion.

There are two specific approaches to provision of microfinance. One is the self-help group bank link program, which involves banks as providers of wholesale financing and self-help groups to administer credit granting and small savings among their members. Some of these partnerships involve provision of technical assistance by the partner bank, but the more common model is involvement of an NGO to assist the self-help group. The second approach to microfinance is the development of a range of specialized providers.

Table 21: India's Microfinance Outreach, 2007

Institution	Borrowers	Loans Outstanding (Re millions)	Average Loan Size ($)
Self-Help Group Bank Partnerships	26,300,000	105,200	100
NGO Microfinance Providers	2,950,093	14,414	124
Nonbank Financial Institutions	6,944,081	38,279	140
Cooperatives	411,433	2,127	131
Banks	136,828	769	142
Others	437,366	1,100	64
Total	37,179,801	161,889	109

NGO = nongovernment organization, Re = Indian rupee.

Source: Ghate 2007 and MIX Market (www.mixmarket.org/en/home_page.asp).

Available data may double count some microfinance outreach. Many reporting microfinance institutions rely in part on bank funding, and thus may be reporting the same borrowers included in the self-help group bank link program data. However, overall, the estimates of microfinance outreach are more likely to understate the number of small borrowers served. This is because self-reporting institutions and specialized microfinance organizations included in research studies[8] generally exclude more than 100,000 formal financial institutions—rural cooperative credit institutions, urban cooperative banks, local area banks, and regional rural banks—that are focused on the smaller end of the market. These institutions collectively have total assets equivalent to about 10 times the assets of self-reporting microfinance institutions.

8 See, for example, India Microfinance: A State of the Sector Report 2007 available at www.microfinanceindia.com. Sa-Dhan microfinance association reported 184 members, with 10.5 million total borrowers at end-2007, data broadly consistent with the Mix Market data for nongovernment and nonbank microfinance providers in Table 21 as many smaller members of Sa-Dhan do not provide data to Mix Market.

Weaknesses in the networks of cooperative credit institutions have long been recognized. The *Report of the Task Force on Revival of Cooperative Credit Institutions*, building on several other reviews, recommended the establishment of true cooperatives in place of the current structure. The governance and oversight arising in true cooperatives from the mutual self-interest of savers are missing in the current borrower-driven model, with the primary tier disbursing credit and the upper tier providing refinance. This fundamental flaw is compounded by the role of the states, which control elections of the cooperatives' boards, provide audit services, and periodically waive interest and principal repayments, further weakening any sense of local control and mutual ownership and undermining any culture of repayment of credit. Beyond establishment of true savings and credit cooperatives, recommendations for reform include financial assistance to deal with accumulated losses, legal reforms including a clear oversight mandate for RBI and strengthened prudential standards, and capacity building to improve management quality and efficiency.

Issues and the Reform Agenda

The banking system's sound capital position at the onset of the global financial turmoil has provided some flexibility in the policy response. Accumulation of capital during the preceding boom means that the banks are better positioned to absorb credit losses and to work with borrowers on restructurings facilitated by RBI's countercyclical decision to ease provisioning requirements. While there are exceptions among individual banks, the system overall is liquid with a diversified portfolio. Nonbank financial companies are under the most pressure, and while the majority does not take deposits, RBI's policy response has treated these companies as systemically important because of their role as credit providers. Many problems remain in the rural, local, urban, and rural cooperative banks, but these predate the current downturn.[9]

Despite progress since the 1991 Narasimham Committee report, a considerable reform agenda remains for India's finance sector (Box 4). The 2009 report of the Committee on Finance Sector Reforms made 35 main proposals, many of which echo the recommendations of numerous previous reviews (Government of India, Planning Commission 2009). The fact that many of the proposals have been previously made but not implemented over the 15-year period of reform is evidence of the difficulties in moving away from the old model of centrally planned outcomes and direct government interventions. The current global financial turmoil may provide an opportunity for further progress in the reform of India's financial and capital markets.

[9] These include poor asset quality, undercapitalization, and ongoing losses, as well as governance issues with over 45% of elected boards of rural institutions having been superseded (Reserve Bank of India 2008).

Box 4: India: Recent Calls for Reform

The 2007 Report of the High Powered Expert Committee on Making Mumbai an International Financial Centre (the Percy Mistry Committee) identified a range of needed reforms to deepen the financial sector to serve India's economy better and to bring high value created by finance sector activities to Mumbai by transforming the financial sector into a producer and exporter of international financial services. The first phase is connection of India's financial services with the rest of the world, followed by competition with and attraction of market shares from existing international finance sector, such as London, New York, and Singapore. Key recommendations include

- establishment of the "missing" bond market, a currency market, and a derivatives market for currencies and interest rates;
- addressing India's deficiency in institutional investors;
- adopting principles-based regulation;
- increasing competition by removing the compartmentalization and restrictive nonprudential licensing regime applicable to financial services in India;
- reforming the tax system;
- fully liberalizing capital accounts;
- creating a single financial services modernization act to bring needed legal reforms to the entire finance sector;
- removing barriers to entry and restrictions on acquisitions; and
- strengthening the legal basis for commercial transactions, including improved dispute resolution and contract enforcement.

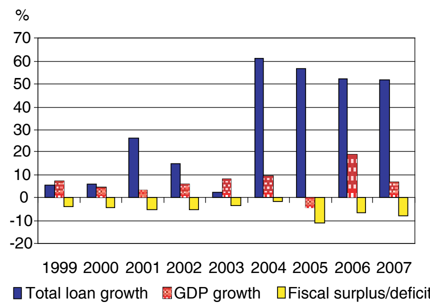
The Committee on Finance Sector Reforms (the Raghuram Rajan Committee) was tasked with proposing the next generation of reforms for India's finance sector with a view to including more Indians in the growth process, to foster growth itself, and to improve financial stability. Its 2009 report, *A Hundred Small Steps*, echoes the Percy Mistry Committee and other preceding reviews. The main proposals include

- opening the rupee corporate and government bond markets to foreign investors;
- bringing all capital markets regulation under the Securities and Exchange Board of India;
- privatizing state-owned banks, starting with the smaller institutions;
- strengthening the boards of state-owned banks, making the boards accountable, and removing state-owned banks from additional government oversight and direction;
- removing nonprudential restrictions, for example, by allowing banks to open branches or ATMs anywhere;
- allowing more entry from private, well-governed and well-capitalized small banks to serve specific areas;
- completing the reforms of the rural and urban cooperative banks;
- revising the priority sector loan requirements;
- adopting more principles-based finance sector legislation, and establishing clear mandates and objectives for the regulatory authorities, with each reporting annually to a standing committee of Parliament;
- bringing all deposit-taking institutions under the supervision of the Reserve Bank of India; and
- revising the broader framework for commercial transactions, including improving land registration and titling, and amending the company law with respect to bankruptcy.

Maldives

In the Maldives, the global financial turmoil is bringing to light underlying weaknesses in its financial sector. Against a backdrop of strong domestic growth (except after the 2004 tsunami) financed by large fiscal deficits and increasing external debt, there has been a significant decline in the liquid assets of the banking sector, increased reliance on foreign funding, and rapid growth in credit to the public and private sectors. Faced with expected steep declines in tourism revenues, sharply reduced access to international financing, and indications of a credit bubble with total loan growth exceeding 50% annually since 2004, the banking sector and the fixed rufiyaa exchange rate are under a worrying degree of pressure.

Figure 17: The Credit Boom in the Maldives



GDP = gross domestic product.

Sources: Maldives Monetary Authority and Asian Development Bank (2008a).

Financial Sector Structure

Financial services in the Maldives are dominated by the banking sector (Table 22). The majority state-owed Bank of Maldives accounts for 45% of all finance sector assets and virtually the same proportion of banking assets. The state-owned Allied Insurance Company is the major player in the still very small insurance sector. A branch of the Sri Lanka Insurance Corporation operates in Malé, and several other insurance companies from India and Sri Lanka have local agents serving the Maldives.

The nascent nonbank sectors and capital markets have been supported by recent government policy initiatives and establishment of new state-sponsored institutions. The only leasing business, Maldives Finance Leasing Company, was established in 2002 by domestic and foreign investors, including the state-owned Maldives Transport and Contracting Company and the Bank of Maldives. The state-owned Housing Development Finance Corporation was established in 2004.

The privately owned Maldives Stock Exchange and Maldives Securities Depository were licensed in 2008, taking over interim securities trading facility and depository functions that had been operated by the Capital Market Development Authority (the regulatory authority) since 2006. There are five listed companies (all small public floats of state-owned companies), with total market capitalization of Rf2.6 billion ($0.2 billion) at end-2008. Four firms were licensed as capital market intermediaries at end-2008.[10]

[10] See www.cmda.gov.mv/

Table 22: Maldives Financial Sector Overview, 2007

Institution	Assets (Rf million)	Assets (percent of GDP)
Five Commercial Banks	18,570	137.5
Bank of Maldives[a]	8,603	63.7
Four Foreign Bank Branches[b]	9,967	73.8
Allied Insurance Company	166	1.2
Sri Lanka Insurance Corporation	NA	NA
Maldives Finance Leasing Company[c]	227	1.7
Housing Development Finance Corporation	223	1.7
Maldives Stock Exchange	–	–
Maldives Securities Depository	–	–
Four Securities Broker-Dealers and Advisors	–	–

– = data not available, GDP = gross domestic product, NA = not applicable, Rf = rufiyaa.

[a] The government owns 51.0% directly, 19.7% indirectly, with the balance publicly traded.

[b] Bank of Ceylon, Habib Bank, Hong Kong and Shanghai Banking Corporation, and State Bank of India.

[c] 2006 data.

Note: The GDP was Rf13,508 million ($1.1 billion) at end-2007.

Sources: Capital Markets Development Bank of Maldives Annual Report, Housing Development Corporation Annual Report, Maldives Finance Leasing Company (2006), Maldives Monetary Authority, and State Trading Organization Plc Annual Report.

Regulation, Supervision, and Prudential Standards

The Maldives Monetary Authority (MMA) is the banking and insurance regulator, with the Capital Market Development Authority overseeing the stock exchange, securities depository, and licensed intermediaries. Oversight of the previously unregulated insurance sector remains at an early stage, although regulations were promulgated in 2004 to give MMA oversight authority and establish licensing requirements after a transition period. Interest rate restrictions were removed from banks for US dollar transactions in 1995 and for local currency loans and deposits in 2001.

Bank prudential regulation has been strengthened in recent years; however, further reforms are required to enhance the soundness and stability of the finance sector, specifically the Bank of Maldives. The capital adequacy requirement of 8% does not meet the Basel Committee recommendation that higher capital requirements should apply in countries lacking some preconditions for effective supervision and is below the requirements in neighboring countries (i.e., Sri Lanka's 10% and India's 9%).

The weak loan-loss provisioning requirement is of even greater concern. Bank of Maldives 2007 financial statements[11] have a qualified

[11] See ebanking.bankofmaldives.com.mv/

audit opinion due to the use of MMA provisioning standards (Table 23) and failure to disclose information about the credit quality of financial assets. Appropriate provisions to ensure that loans are carried at the best estimate of realizable value would reduce the profitability and capital levels of the Bank of Maldives. The failure to disclosure information as noted in the auditor's qualification of opinion means that the true profitability and capital levels of the bank cannot be estimated.

Table 23: Maldives Monetary Authority Provisioning Requirements

Period in Arrears	Provision Required, (%)
3–6 months	5
>6–12 months	10–20
>12–24 months	35–50
>24 months	100

Source: Maldives Monetary Authority.

Outreach

The highly dispersed population of Maldives creates logistical challenges in the provision of financial services. The four foreign bank branches, all in Malé, focus primarily on commercial business and higher-end retail customers. The Bank of Maldives has a network of 25 branches, including 5 mobile branches and 14 in island communities outside Malé, as well as 19 ATMs on the outer atolls. This is a remarkable number of service locations for a bank with total assets of about $675 million at end-2007. The costs for this extensive outreach are supported by large spreads between lending and deposit rates, producing a net interest margin of 5.5%, and high fee income.

The Bank of Maldives has 205,000 deposit holders who represent 31% of the total population, suggesting that most households have access to banking services. The bank had 58,000 loans outstanding at end-2007. The Maldives Finance Leasing Company served 268 clients at end-2006 with an average lease size equivalent to $55,000, indicating a focus on the commercial mid-market. The Housing Development Finance Corporation had an outstanding portfolio equivalent to about $14 million at end-2007. New loan activity has ceased due to lack of funding, with much of the concessional rate financing (bonds with 5% coupon) provided by government-related entities having been repaid. Privatization talks are ongoing.

Issues and the Reform Agenda

Near-term concerns relate to the need to strengthen prudential standards for the banking sector in the Maldives. While the foreign bank branches are subject to the more stringent requirements of their home country supervisors, the Bank of Maldives will be an ongoing threat to the government's fiscal position without higher standards. Lax classification and provisioning requirements may create the illusion of profitability and strong capital, but cannot hide the liquidity problems that arise when loans are not repaid. The increase in borrowing from foreign banks, difficulties in repaying foreign currency deposits, and broad decline in liquid assets are all evidence of deteriorating asset quality and undercapitalization. In the medium to longer term, authorities face the ongoing challenge of fostering private sector development more broadly and encouraging greater private sector participation in the finance sector.

Nepal

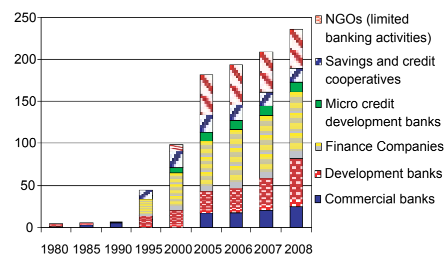
Numerous new institutions have entered Nepal's financial sector since 2000 (Figure 18), raising concerns about the stringency of licensing requirements and adequacy of ongoing supervision. The importance of state-owned institutions has declined as two large insolvent banks, Nepal Bank Limited and Rastriya Banijya, have stagnated for the last 5 years while privately owned banks have grown rapidly in both number and size. The credit boom in 2007 and 2008, fueled almost exclusively by private banks, raises questions about credit quality and the resiliency of the financial sector in the face of an economic downturn (Figure 18), especially in light of the dominance of financial listings on the Nepal Stock Exchange.

Financial Sector Structure

Despite rapid growth in the number of institutions, commercial banks still account for the majority of finance sector assets and have increased in number to 25, up from 20 in July-2007 and 10 in 2000 (Table 24). The largest bank is state-owned Agricultural Development Bank Limited, operating as a commercial bank since 2005 with restructuring assistance from the Asian Development Bank.[12] Two other state-controlled institutions that dominated the banking sector 5 years ago, Nepal Bank Limited and Rastriya Banijya, remain big players, although now matched in size by three privately owned banks. Plans to privatize these two banks with World Bank assistance have now been revised to focus on continued operational restructuring and gradual recovery through earnings of the banks' significant capital deficiencies.

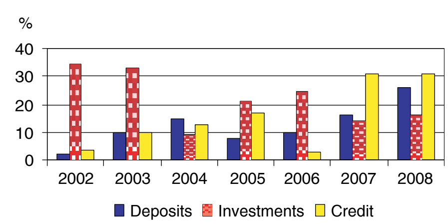
Figure 18: Nepal's Institutions and Credit Boom

Number of Financial Institutions



NGO = nongovernment organization.

Commercial Bank Growth
(percent annual increase)



Source: Nepal Rastra Bank.

[12] Including technical assistance for a financial and operational review of the Agricultural Development Bank of Nepal and Nepal Industrial Development Corporation in 2000 as well as the 2006 Rural Finance Sector Development Cluster Program.

Table 24: Nepal's Financial Sector Overview, July 2007

Institution	Number	Assets (NRs million)	Assets (percent of GDP)
Commercial Banks	20	439,735	60.5
State-Owned[a]	3	138,455	19.0
Private	17	301,288	41.5
Development Banks	38	22,716	3.1
Finance Companies	78	53,588	7.4
Microcredit Development Banks	12	10,281	1.4
Savings and Credit Cooperatives	17	3,590	0.4
NGOs (Limited Banking Activities)	47	2,891	0.3
Contractual Savings Institutions	1	100,377	13.8
Insurance Companies[b]	21	31,982	4.4
State-Owned[c]	1	19,200	2.6
Employees Provident Fund	1	59,970	8.2
Citizens Investment Trust	1	8,425	1.1
Postal Savings Bank	1	425	0.0
Stock Exchange	1	NA	NA
Brokers	23	NA	NA
Underwriters and Dealers	8	NA	NA

GDP = gross domestic product, NA = not applicable, NGO = nongovernment organization, NRs = Nepalese rupee.

[a] Rastriya Banijya Bank is 100% government-owned, Agricultural Development Bank is 65% government-owned, and Nepal Bank Limited is 49% government-owned—with the balance widely held.

[b] Four life, 16 general insurance companies, and 1 state-owned company (Rastriya Beema Sansthan) offering life and general insurance.

[c] Assets estimated from Rastriya Beema Sansthan website (www.beema.com.np/eng_index.html).

Note: The GDP was NRs727,089 million ($10 billion) in July 2007.

Sources: Insurance Board of Nepal, Nepal Rastra Bank, Rastriya Beema Sansthan, and Securities Board of Nepal.

Development banks and finance companies are not permitted to take demand deposits and have lower minimum capital requirements than commercial banks. The policy intent is to encourage new entrants to the financial sector, particularly to provide small and microlending and other basic financial services in rural areas. Both development banks and finance companies report overall strong capitalization, although this is because many of the institutions are newly established and have not yet advanced significant loan volumes. Capital ratios declined markedly in 2008 due to losses by four development banks and four finance companies, and modest increases in loans outstanding (Nepal Rastra Bank 2008).

NGOs, savings and credit cooperatives, and microfinance development banks all focus on the smaller end of the market, particularly in rural areas. The savings and credit cooperatives are largely self-sustaining, with about 85% of funding coming from deposits and retained earnings. NGOs and microfinance development banks mobilize few deposits, relying instead on apex funding (e.g., Rural Microfinance Development Centre, Rural Self-Reliance Fund, and Small Farmer Bank Program) and borrowing from other financial institutions (Nepal Rastra Bank 2008, World Bank 2007b). In addition to the microfinance sector regulated by Nepal Rastra Bank (NRB), an estimated 2,900 cooperatives registered with the Cooperative Department provide financial services (South Asia Network of Economic Research Institutes 2007).

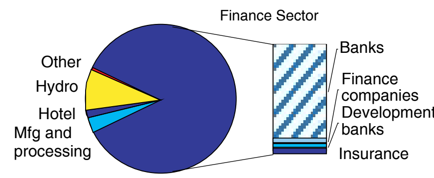
The Nepal Stock Exchange Limited operates a screen-based automated trading system with 130 listed companies as of July 2008, up from 116 as of July 2007. Market capitalization more than doubled during the period, reflecting a large run-up in the financial sector issues that dominate the listings (Figure 19).

Contractual savings and institutional investors are largely government entities. While there are four privately owned life insurance companies, state-owned Rastriya Beema Sansthan has 65% of the life insurance market. The private sector accounts for two thirds of the general insurance market; however, unlike life insurance, there is no intermediation component to general insurance. The majority of the assets of the (government) Employees Provident Fund is invested in state-owned banks and government bonds as well as some direct lending. Citizens Investment Trust, a government entity, operates a range of investment schemes to pool individual savings for investment in corporate securities, government bonds, and loans.

Figure 19: Market Capitalization in Nepal Dominated by the Financial Sector

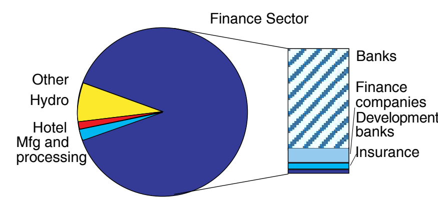
as of July 2007

Total market capitalization = NRs 169.8 billion



as of July 2008

Total market capitalization = NRs 366.2 billion



NRs = Nepalese rupee.

Source: Nepal Stock Exchange Limited.

Regulation, Supervision, and Prudential Standards

NRB has supervisory responsibility for all deposit-taking institutions. Previously, nonbank financial institutions were largely unregulated, but as part of the government's Finance Sector Reform Program launched in 2000, these have come under the ambit of the central bank. Following completion of a self-assessment of compliance with the Basel Core Principles of Effective Banking Supervision, NRB has implemented a series of measures to strengthen supervision. One laudable result has been the publication of detailed financial sector data, including financial information on individual institutions. This is wholly in keeping with the spirit of Basel II. The publicly available data highlight challenges faced by NRB.

NRB faces capacity constraints in effectively overseeing the burgeoning number of financial institutions. Small institutions require disproportionally large amounts of supervisory resources, and the issue is not only routine supervision. Some private banks, development banks, and finance companies—as well as two large state-owned banks—continue to operate with inadequate capital, ongoing losses, and very high nonperforming loan levels, calling into question NRB's ability to take decisive supervisory action to deal with identified problems. This is of particular concern in light of the recent credit boom, which suggests more problem institutions will emerge in the near future.

NRB has identified deficiencies in the legal framework for supervision and prepared draft legislation. A revised licensing policy has been developed, which is welcome given concerns about rapid growth in the sector. Risk-focused supervision is being implemented, but the risk-management capabilities of financial institutions vary widely, posing challenges to the reliability of off-site data used for risk identification as a central component of a risk-based approach.

The Securities Board of Nepal was established in 1993 as an apex regulator of securities markets, with responsibilities for the stock exchange and capital market participants pursuant to the Securities Exchange Act of 2006. The stock exchange exercises self-regulatory authority among its members and listed companies, enforcing listing and trading rules.

The Insurance Board, part of the Ministry of Finance, has supervisory responsibility for all insurance companies pursuant to the Insurance Act of 1992. The responsibilities established for the Insurance Board result in potential conflicts of interest, as it is charged with serving as an advocate to the government for industry, adjudicating conflicts between customers and insurance companies, arbitrating the settlement of liability claims, licensing companies, registering brokers and agents, and prescribing rules for the insurance business. Insurance companies, like banks, are required to invest in priority sectors, with the sectors and amounts prescribed by the Insurance Board.

Outreach

The government has undertaken many direct interventions intended to increase the availability of financial services, especially in rural areas, including

- requiring banks to direct specific percentages of credit to low-income households and small businesses;
- requiring banks to open one branch outside the Kathmandu Valley for each new branch authorized in the valley;
- creating or sponsoring institutions (e.g., regional development banks, apex funds, and postal savings banks) to target the underserved; and
- licensing new institutions with lower capital requirements (e.g., finance companies and development banks).

Despite some success, these efforts have had serious unintended consequences. They contribute to higher operating costs for banks, which are borne in the form of high spreads and fees, or in the case of state-owned banks, in accumulated losses. The proliferation of new institutions has strained NRB's supervisory capacity and may lead to significant losses to depositors and other creditors if the institutions fail.

There is some overlap among customers of the various financial institutions, but even assuming that each depositor and/or member deals with only one institution, only about 12% of the population has an account with a formal financial institution (Table 25).

A reason for the relative lack of success of government direct interventions is the continued overhang of the insolvent state banks. These institutions consume deposits to cover expenses rather than intermediating—they have shrunk in absolute terms over the last five years while the sector overall has more than doubled in size.

Table 25: Nepal's Formal Financial Sector Outreach

Institution	Depositors/Members	Borrowers
Commercial Banks	2,917,870	285,000
Savings and Credit Cooperatives	180,000	28,000
Microfinance Development Banks	103,215	104,548
Regional Rural Development Banks	106,277	190,000
Total	3,307,362	607,548

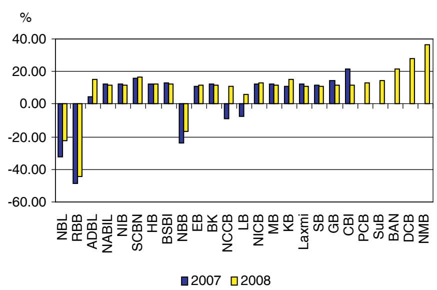
Sources: Beck, Demirgüç-Kunt, and Martinez Peria 2007; and World Bank (2007b).

Issues and the Reform Agenda

The most significant challenges in the near term are dealing with the finance sector's rapid growth as the domestic economy is affected by ongoing international turmoil. The credit boom is a particular concern given the number of institutions operating with less than the minimum 8% required capital and new institutions with unseasoned loan portfolios. These, and the rapidly growing portfolios of some longer-established private banks, are likely to develop into volumes of problem loans as economic growth slows.

Legal amendments to address identified deficiencies in the legal framework for supervision are crucial. Even more importantly, NRB needs to take decisive action to deal with emerging problem institutions, requiring a combination of capacity building for NRB and the industry itself to improve risk management and reporting, operational independence for the supervisory authority, and political support for the resolution of state-owned institutions. In the medium to longer term, the government needs to enhance its focus on establishing a facilitating environment for the development of financial services and to move away from direct interventions such as mandated lending.

Figure 20: Nepal's Commercial Bank Risk-Weighted Capital Adequacy Ratios (%)



ADBL = Agricultural Development Bank, BAN = Bank of Asia Nepal, BK = Bank of Kathmandu, BSBI = NSBI Bank, CBI = Citizens Bank International, DCB = Development Credit Bank, EB = Everest Bank, GB = Global Bank, HB = Himalayan Bank, KB = Kumari Bank, Laxmi = Laxmi Bank, LB = Lumbini Bank, MB = Machhapuchhre Bank, NABIL = NABIL Bank, NBB = Nepal Bangladesh Bank, NBL = Nepal Bank, NCCB = Nepal Credit and Commerce Bank, NIB = Nepal Investment Bank, NICB = Nepal Industrial and Commercial Bank, NMB = NMB Bank, PCB = Prime Commercial Bank, RBB = Rastriya Banijya Bank, SB = Siddhartha Bank, SCBN = Standard Chartered Bank Nepal, SuB = Sunrise Bank.

Source: Nepal Rastra Bank.

Pakistan

The initial policy response to deteriorating macroeconomic conditions in 2007 threatened to undermine the benefits of a decade of reform in Pakistan's financial sector. Privatization of some state-owned banks, adoption of market-determined interest rates, and strengthening of prudential standards and the practice of supervision have led to a much more resilient banking system. However, the benefits in terms of increased credit to support private sector growth are imperiled by recourse to the banking system to finance sharply increased fiscal deficits (Figure 21). Banks have experienced liquidity pressures, with the State Bank of Pakistan (SBP) responding by reducing the cash reserve requirement by 4% in two steps in the third quarter of 2008, and expanding the range of assets eligible to meet the statutory liquidity requirement.

Pakistan's attractiveness to international investors, already diminished as a result of general global financial turmoil, was further impaired by the imposition of a price floor on stock exchange trading from 28 August to 15 September 2008 (Figure 21). Since the downward price pressures continued and were exacerbated by the price floor, the policy measure effectively halted trading as purchasers had no interest in securities priced at or above the floor. The result was complete illiquidity of all traded equities and a freezing of mutual fund assets. The confidence of both domestic and foreign investors in Pakistan's capital markets will now have to be rebuilt.

Financial Sector Structure

Pakistan's financial sector includes a wide variety of institutions, although banks remain dominant in terms of total assets (Table 26). The banking system has been transformed over the last decade from one dominated by weak state-owned institutions to a largely healthy system in which the remaining state-controlled banks' market share has been reduced to 20%. Asset quality, profitability, and capitalization have improved; however, the satisfactory overall position of the banking sector obscures some weak smaller and medium-sized institutions. SBP has increased minimum capital requirements and maintained a moratorium on new banking licenses to encourage consolidation, and in 2008 became more directly involved in encouraging mergers to resolve weak institutions.

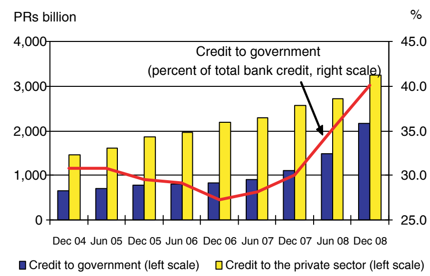
Pakistan's three stock exchanges (Islamabad, Karachi, and Lahore) had a combined 652 listed companies and market capitalization equivalent to about 27% of GDP at end-2008.[13] Market infrastructure includes a securities depository and clearing and settlement system. At end-2007, there were 312 brokers and dealers licensed by the Securities and Exchange Commission. Debt markets are dominated by government-issued market treasury bills and Pakistan investment bonds. Bond issues in fiscal year 2008 raised only 73% of the targeted amount (SBP 2008c), suggesting that government financing needs are crowding out the private sector. Corporate issues outstanding at end-June 2008 amounted to about 1% of GDP.

Pakistan has a small number of microcredit organizations. About 20 institutions, including NGOs, six microfinance banks, and four government programs, account for virtually all of the microfinance market. SBP is spearheading the Financial Inclusion Program, launched in 2008 with international support, to expand microfinance throughout the country.

[13] The Karachi Stock Exchange is by far the most active, and almost all companies listed on the Islamabad and Lahore exchanges are also listed on the Karachi.

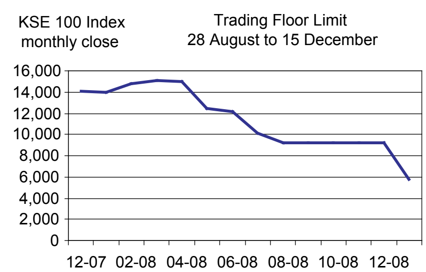
Figure 21: Benefits of Pakistan's Financial Sector Reform under Threat

Banks Finance Deteriorating Fiscal Position



PRs = Pakistan rupee.

Karachi Stock Exchange Index Declines 60%



KSE = Karachi Stock Exchange.

Sources: State Bank of Pakistan and Bloomberg.

The government retains a major presence in the nonbank financial sector, accounting for about 75% of insurance assets and half of the mutual fund industry. In addition, the Central Directorate of National Savings administers several government savings programs. These pool a range of private savings primarily for investment in government securities, effectively contributing to further crowding out of private intermediation by government financing needs.

Table 26: Pakistan's Financial Sector Overview, 2007

Institution	Number	Assets (PRs billion)	Assets (percent of GDP)
Banks	39	5,171.4	62.8
Public Sector Commercial Banks	4	1,036.0	12.6
Local Private Banks	25	3,835.7	46.6
Foreign Banks	6	172.7	2.1
Specialized Banks	4	127.1	1.5
Development Finance Institutions[a]	6	95.3	1.1
Investment Banks	11	44.6	0.5
Leasing Companies	18	63.9	0.8
Modarabas[b]	27	26.3	0.3
Housing Finance Companies[c]	4	17.7	0.2
Discount Houses	1	1.4	0.0
Venture Capital Companies	NA	4.1	0.0
Microfinance Banks	6	11.0	0.1
NGO Microfinance Institutions	30	4.1	0.0
Rural Support Programs	4	4.8	0.0
Insurance Companies[d]	61	323.4	3.9
Life	5	191.7	2.3
General	52	121.3	1.5
Reinsurance	1	10.4	0.1
Central Directorate of National Savings	1	1,108.3	13.5
Stock Exchanges	3	NA	NA
National Clearing and Settlement System	1	NA	NA
Central Depository Company	1	NA	NA
Broker-Dealers	312	NA	NA
Investment Advisory and Asset Management	51	NA	NA
Mutual Funds[e]	95	313.6	3.8
Credit-Rating Agencies	2	NA	NA

GDP = gross domestic product, NA = not applicable, NGO = nongovernment organization, PRs = Pakistan rupee.

[a] Joint ventures between the Government of Pakistan and foreign governments, with the exception of state-owned Pakistan Industrial Credit and Investment Corporation.

[b] Sharia-compliant investment vehicles whereby one party entrusts money to the other party to use its management expertise and employ the funds in an agreed manner.

[c] The state-owned House Building Finance Corporation accounts for almost all assets.

[d] State-owned insurance companies account for about 75% of insurance assets. There are also three small *takaful* (Islamic insurance) companies in addition to life, general, and reinsurance companies.

[e] State-owned mutual fund companies account for about one half of mutual fund assets, with state-owned National (Unit) Trust alone comprising almost one third of the sector.

Note: The GDP was PRs8,226.5 billion ($136 billion) at end-2007.

Sources: Securities and Exchange Commission and State Bank of Pakistan.

Regulation, Supervision, and Prudential Standards

SBP is the supervisor of banks, microfinance banks, and development financial institutions. The prudential framework has been strengthened, notably by the 2008 decision to increase the minimum capital adequacy requirement from 8% to 10%, effective in 2009. This followed the introduction of more stringent provisioning requirements, which removed in 2007 the ability to net the full "forced sale" value of collateral against required provisions, and earlier supervisory action to enforce loan classification and provisioning requirements.

SBP is implementing Basel II, expecting banks to adopt the standardized approaches. The impact will largely be capital-neutral, with the lower risk-weights for some assets offset by the new capital charge for operational risk. SBP has made good progress with the disclosure and transparency requirement to effectively implement Basel II's pillar 3, market discipline. Commendably, SBP regularly publishes a wide range of financial sector- and institution-specific data. The practice of supervision has improved, but as noted by SBP, it remains largely rules-based and compliance-oriented (SBP 2008d).

The Securities and Exchange Commission is responsible for capital markets oversight, the insurance sector, and nonbank finance companies. It has achieved a high level of compliance with the International Organization of Securities Commissions (IOSCO) Objectives and Principles for Securities Regulation, although there are some deficiencies in the legal framework and questions about the adequacy of supervision of market intermediaries. The supervisory responsibilities for insurance previously were vested in a department of the Ministry of Commerce and transferred to the Securities and Exchange Commission with the enactment of the Insurance Ordinance of 2000. The law itself has some deficiencies, such as inadequate remedial action provisions, and the Securities and Exchange Commission is challenged to develop the capacity for onsite examinations and specialized insurance expertise, such as actuarial skills.

Oversight of nonbank finance companies has proven problematic. Originally vested in SBP, responsibility now lies with the Securities and Exchange Commission. This creates an anomalous situation in that entities, which may be authorized to accept deposits from the public, are not subject to bank-like regulation. There are capital requirements for each authorized business line, and new regulations promulgated by the Securities and Exchange Commission will require those accepting deposits to be listed on a stock exchange and also to obtain a license specifically for deposit-taking. This, and new requirements for specific licenses and firewalls between investment dealing, underwriting, commercial finance, and leasing, are intended to curtail the practice of using low-capital nonbank finance companies to engage in universal banking.

Outreach

Microfinance has been growing rapidly from a relatively small base in Pakistan. At end-2007, formal microfinance providers served close to 90% of districts. Microfinance banks fund about two thirds of their lending by deposit mobilization, while NGOs and rural support programs rely on wholesale and donor funding and government support, respectively. Only microfinance banks are permitted to mobilize deposits, as other microfinance organizations are outside of the regulatory framework. The Financial Inclusion Program targets reaching 3 million borrowers by 2010 and 15 million by 2015. Incentives include a 5-year tax holiday for microfinance banks and targeted programs for SMEs and agricultural finance.

Table 27: Microlending Outreach in Pakistan, End-2007

Institution	Borrowers	Loans Outstanding (PRs millions)	Average Loan Size ($)
Microfinance Banks	435,407	4,456	167
NGO Microfinance Providers	418,234	4,104	163
Rural Support Programs	404,179	4,057	167
Total	1,257,820	12,617	167

NGO = nongovernment organization, PRs = Pakistan rupee.

Source: Pakistan Microfinance Network—details for 19 microfinance providers estimated to comprise 99% of the market.

Issues and the Reform Agenda

Pakistan faces multiple challenges in staying the course on financial sector reforms implemented to date, extending the successful restructuring and privatization program from the banking to the nonbank sectors, and building supervision capacity in the nonbank sectors.

Banking sector reform is very advanced. Despite the progress so far, SBP has identified several further issues to be addressed as part of its banking sector reform strategy, including

- developing a legislative amendment to permit consolidated supervision of banking and financial conglomerates;
- promulgating a new banking act to replace the Bank Companies Ordinance, providing a more comprehensive framework for licensing, ongoing supervision, permissible activities, and governance; clarifying and elaborating on SBP's powers with respect to remedial measures, liquidation, and winding-up of banks; and establishing legal basis for coordination between SBP and the Securities and Exchange Commission and clarifying overlapping responsibilities;

- creating new prudential guidelines, including tightening loan concentration limits and new liquidity requirements; and
- adopting a principles-based supervisory approach in place of the current rules-based compliance focus.

Capital markets and insurance reform lag behind that of the banking sector. Despite assistance from ADB[14] and other partners, the Securities and Exchange Commission still has a considerable reform agenda ahead. The enhanced resiliency of the banking sector and increased credit to the private sector resulting from the decade of reform should encourage the pursuit of a similar program for the nonbank sectors. This would include divestment of the government's stake in the insurance, housing finance, and mutual fund sectors, coupled with capacity building in the Securities and Exchange Commission to enhance both capital markets and insurance oversight.

Sri Lanka

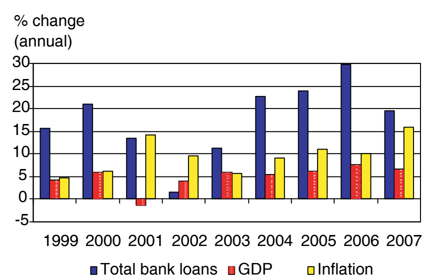
In Sri Lanka, credit growth moderated in 2007 and 2008 against the backdrop of a slowdown in economic growth and increasing inflation (Figure 22), but the 120% increase in bank credit outstanding from 2003 to 2007 raises concerns about a possible credit bubble. Loan growth outstripped that of deposits (Figure 22), resulting in Sri Lanka's financial sector relying increasingly on wholesale financing as institutions around the world began to experience liquidity shortfalls in 2007.

While the resiliency of the finance sector had improved as a result of stronger financial performance coupled with enhanced supervisory capacity by Central Bank of Sri Lanka (CBSL), some significant risks remain.

- Sri Lanka's loan classification and provisioning requirements are lax by international standards,[15] and there is evidence that the standards are not uniformly implemented, potentially overstating banks' asset quality, income, and capital (ADB 2005).
- Previously identified vulnerability to liquidity shocks (IMF 2007) has increased, particularly for banks and nonbank institutions without a strong retail deposit base.
- The multitude of unregulated deposit-taking institutions presents serious contagion risk as public confidence in the regulated sector can be affected by losses in institutions such as rural banks and credit cooperatives that can legally accept deposits but are not subject to prudential oversight by CBSL or any other supervisory authority.

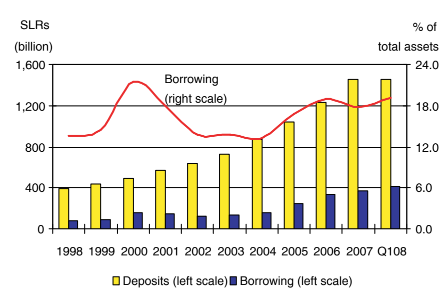
Figure 22: Sri Lanka's Credit Boom Outstrips Deposit Growth

Bank Loans and the Macro Context



GDP = gross domestic product.

Licensed Commercial Banks



SLRs = Sri Lanla rupee.

Source: Central Bank of Sri Lanka.

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14 Second Generation Capital Market Reform Program.

15 No provisions are required until a loan is more than 6 months in arrears, and no haircut is required on collateral until a loan is more than 18 months in arrears.

- Due to reliance on short-term liabilities to fund longer-term assets, most financial institutions are exposed to losses if interest rates increase.

The impact of these risks started to become visible in 2007, as interest rates rose to combat inflation, and increased in 2008, as finance and leasing companies came under stress and CBSL intervened in Seylan Bank, a large private bank.

Financial Sector Structure

Sri Lanka's financial sector is remarkably diverse for a developing economy of 20 million people. In large part, this reflects a long history of establishing state-owned special purpose institutions to meet identified economic needs. The banking sector, with total assets equivalent to about 70% of GDP, includes two large state-owned commercial banks and 12 government-owned specialized banks established to serve different regions and/or specific development objectives (Table 28). Specialized banks and finance companies may not offer demand deposits, but otherwise have similar business powers to commercial banks.

The combined market share of state-owned institutions is about 47% of all banking assets, a decline from 55% over the last 5 years as privately owned institutions have grown somewhat more rapidly. Unlike most other countries, Sri Lanka continues to create new state-owned financial institutions, establishing Sri Lanka Savings Bank in 2007, Lankaputhra Development Bank in 2006, and SME Development Bank (which was merged with Lankaputhra in 2008) in 2005.

Sri Lanka has a sizable nonbank financial sector, with pensions, insurance, and other contractual savings institutions having total assets equivalent to about 25% of GDP, or about one third the size of the banking sector. The Colombo Stock Exchange had 235 listed companies with a market capitalization equivalent to about 23% of GDP at end-2007. Banks are the main issuers of corporate debt securities, primarily medium-term debentures qualifying as tier 2 capital. The commercial paper market is small, with SLRs4.4 billion ($40 million) outstanding at end-2007, equivalent to 0.3% of total bank loans.

Regulation, Supervision, and Prudential Standards

CBSL regulates commercial banks, specialized banks, finance companies, finance leasing companies, and primary dealers. Since 2002, the regulatory framework and practice of bank supervision have been strengthened. CBSL has begun to introduce risk-based supervision, and has introduced new governance and risk management requirements for licensed institutions. In response to the credit boom in 2007, CBSL increased risk-weights for residential mortgage loans and introduced a general provision requirement for all performing advances.

Table 28: Sri Lanka's Financial Sector Overview, 2007

Institution	Number	Assets (SLRs million)	Assets (percent of GDP)
Licensed Commercial Banks	23	2,100.0	58.7
State-Owned[a]	2	818.6	22.8
Domestic Private	9	785.4	21.9
Foreign	12	496.0	13.9
Licensed Specialized Banks[b]	15	406.6	11.3
Regional Development Banks[c]	6	30.6	0.1
National Savings Bank	1	273.1	8.4
Long-Term Lending Institutions[d]	3	67.5	1.9
Housing Finance Institutions[e]	2	22.9	0.6
Other Savings and Development Banks[f]	3	12.5	0.3
Other Deposit-Taking Institutions[g]	9,663	177.1	4.9
Registered Finance Companies	31	142.5	4.0
Cooperative Rural Banks[h]	265	28.7	0.8
Thrifts and Cooperative Credit Societies	8,325	5.9	0.2
Samurdhi Banking Societies	1,042	NA	NA
Specialized Financial Institutions	34	134.8	3.8
Leasing Companies	20	96.0	2.6
Merchant Banks	9	31.4	0.8
Unit Trusts	5	6.3	0.2
Venture Capital Companies	NA	1.1	NA
Contractual Savings Institutions	203	884.6	24.7
Insurance Companies[i]	15	133.1	3.7
Employees Provident Fund	1	560.0	15.7
Employees Trust Fund	1	78.8	2.2
Private Provident Funds	185	96.2	2.7
Public Service Provident Fund	1	16.5	0.5
Capital Markets Participants	64	NA	NA
Stock Exchange	1	NA	NA
Primary Dealers	11	54.2	1.5
Stock-Broking Companies	20	3.8	0.1
Underwriters and Dealers	32	NA	NA

GDP = gross domestic product, NA = not applicable, SLRs = Sri Lanka rupee.

[a] Peoples Bank and Bank of Ceylon.

[b] All majority state-owned except Ceylinco, DFCC Bank, National Development Bank, and Sanasa Development Bank.

[c] Kandurate, Ruhuma, Rajarata, Sabaragamuwa, Uva, and Wayamba, which are all state-owned conduits for government-subsidized credit programs.

[d] DFCC Bank (private ownership), Lankaputhra Development Bank, and SME Bank Limited. State-owned Lankaputhra and SME Bank Limited were amalgamated on 1 January 2008 as Lankaputhra Development Bank

[e] Housing Development Finance Corporation Bank and State Mortgage and Investment Bank.

[f] Sanasa, established in 1997 by thrift and cooperative societies, their district unions, and the Federation of Thrifts and Cooperatives; Ceylinco, part of the Ceylinco Group and thus affiliated with Seylan Bank (private licensed commercial bank intervened by CBSL in December 2008); and government-owned Sri Lanka Savings Bank, which was created in 2007 to take over the business of the defunct Pramuka Savings Bank, intervened by the CBSL in 2002.

[g] Only registered financial companies are supervised by CBSL. Cooperatives and thrifts are subject to registration with the Department of Cooperatives. *Samurdhi* banking societies administer government saving and lending programs under the Samurdhi Department.

[h] Approximately 250 multipurpose cooperatives and 1,600 rural cooperative bank branches accepting deposits and making loans to their members and 14 district cooperative federations.

[i] Twelve composite, 2 general, and 1 life insurance company, all privately owned.

Note: The GDP was SRLs 3,578 billion ($32 billion) at end-2007 .

Sources: Central Bank of Sri Lanka, financial institution annual reports, and World Council of Credit Unions.

Commendably, the capital adequacy requirement was increased in 2002 to 10% of risk-weighted assets, in line with the Basel Committee recommendation that capital requirements in excess of 8% are warranted in countries where the preconditions for effective banking supervision may not be in place. The adoption of a modified version of the Basel II standardized approach to capital adequacy in 2008 had a further modest strengthening effect, as the introduction of an operational risk capital charge appears to have more than offset the reductions in risk-weightings for some assets. The overall effect has been to reduce reported capital adequacy by 80 to 100 basis points, thus requiring banks to hold more capital to maintain the same capital adequacy ratio.[16] The positive impact of strengthening capital requirements is, however, undermined by the previously noted weakness in loan classification and provisioning.

The Insurance Board of Sri Lanka was established in 2001 as an independent supervisory authority. Modern approaches to insurance regulation and supervision are gradually being developed and implemented, and would be facilitated by enactment of the new insurance legislation currently under public consultation. Tariff controls have been removed; however, the requirement introduced in 2006 for insurance companies to place up to 50% of their reinsurance business with the state-owned National Insurance Trust Fund is a very significant government direct intervention in the industry to keep reinsurance business onshore. Reinsurance is an international business driven by the need to spread risks. Moreover, there is no certainty that the National Insurance Trust Fund, which provides insurance benefits to civil servants and operates government benefit schemes for needy persons, will have the financial resources to meet reinsurance commitments.

The Securities and Exchange Commission of Sri Lanka licenses and oversees stockbrokers and dealers, underwriters, the Colombo Stock Exchange, securities depository, unit trusts, and credit rating agencies. It is in the process of preparing major revisions of its enabling legislation to bring it in line with IOSCO core principles.

Outreach

The formal financial sector has a remarkable outreach given its modest size—equivalent to about $23 billion in total. There were 4,830 branches and service locations of commercial and specialized banks at end-2007, as well as almost 10,000 small deposit-taking institutions not regulated by CBSL, and hundreds of NGOs. There were an estimated 15 million deposit accounts held by all institutions in 2005 (Consultative Group to Assist the Poor 2006). Even allowing for multiple account holders, the data suggest that virtually all of the population is in a household with access to basic financial services.

[16] FitchLanka 2009.

All unregulated institutions and many commercial and specialized banks are active in microfinance. The 8,300 Sanasa movement cooperatives operate on a self-sustaining basis, funded by deposits. The other institutions involved in microfinance participate through a range of government- and donor-sponsored initiatives, although many also raise part of their funding through deposits.

This extensive outreach comes at a cost. Although there have been improvements, state-owned banks are less efficient than private sector banks. The plethora of small institutions tend to have high operating costs, despite a minimal investment in facilities due to their very small operations, making the provision of credit very expensive. Government-sponsored credit schemes may have undermined the repayment culture and created a sense of entitlement to subsidized credit throughout the agriculture sector. This is not a conducive environment for banks and other institutions to provide financing on market terms and conditions, so while government programs may meet short-term policy objectives, in the longer term, they may actually be discouraging the expansion of private banks into the rural areas.

Structural issues in the microfinance sector were exacerbated by the influx of financial support following the 2004 tsunami. These include

- grants and subsidized loans blurring the distinction between social support and microfinance,
- too many programs and too much money provided relative to the absorption capacity,
- pressures to disburse and interest rate ceilings incompatible with sustainability, and
- insufficient attention to capacity building (Consultative Group to Assist the Poor 2006).

Issues and the Reform Agenda

Sri Lanka faces challenges to enhance the soundness and stability of its finance sector while simultaneously moving the provision of microfinance to a more sustainable basis. All of the supervisory authorities—CBSL, Insurance Board of Sri Lanka, and Securities and Exchange Commission of Sri Lanka—are engaged in programs to bring the legal framework more fully in line with international standards. These important initiatives must be matched by equivalent progress in the practice of supervision, especially taking decisive action to address identified problems in institutions. Microfinance legislation incorporating best practices (i.e., a light regime for organizations reliant on wholesale funds and capital, and more bank-like oversight of deposit-taking microfinance institutions) and savings and credit cooperatives legislation recognizing the important differences between general and financial cooperatives would help address the problems arising from unregulated deposit-taking.

Extensive involvement of the government—CBSL, National Development Trust Fund, and ministries and departments—has resulted in numerous overlapping programs. There is a need for consolidation and coordination for more efficient use of resources, and for a clear distinction between interventions for social support and the subsidized credit programs that discourage private sector expansion into underserved areas. The government should establish a facilitating environment for the private sector as an alternative to establishing government institutions and programs for direct provision of financial services.

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South Asia Economic Report

This issue of the South Asia Economic Report (SAER) is the fourth in a series of reports on economic and development issues in South Asia. It aims to provide information to policy makers, academicians, and Asian Development Bank management and staff. It highlights issues that help promote debate and foster appropriate policies and greater cooperation and integration in the region. The themes of the first, second, and third issues of the SAER were, respectively, "Banking, Governance, and the Investment Climate," "Social Sectors in Transition: Accelerating Inclusive Growth and Human Development," and "Foreign Direct Investment in South Asia." This issue's theme is "Financial Sector in South Asia: Recent Developments and Challenges."

The key messages of this fourth SAER are the following:

- Sustaining high economic growth depends in large part on developing an enabling environment for increasing domestic savings and investment efficiency in the region.
- Development of financial markets is a vital component of robust economic growth and poverty reduction.
- Liberalization and reform have led to the deepening of domestic financial markets in the region.
- Challenges to further deepening and development of financial markets in the region include the absence of some basic government infrastructure for financial services and commercial transactions; a lack of macroeconomic stability; costs of doing business; and issues with rule of law, transparency and governance, and limited financial inclusion.
- To address challenges, the following actions are recommended: (i) creating prudent fiscal policies, (ii) strengthening the legal foundation and government infrastructure, (iii) lifting nonprudential restrictions, (iv) reforming and privatizing state-owned financial institutions, (v) removing remaining capital account restrictions, and (vi) improving the quality and application of accounting standards.

About the Asian Development Bank

ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries substantially reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to two-thirds of the world's poor: 1.8 billion people who live on less than $2 a day, with 903 million struggling on less than $1.25 a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.

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