The Prospect of operating sound Banking System in Developing Countries: The case of Pakistan

Zeeshan Saqib Mian

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Table of Contents

ABSTRACT **8**

REGULATIONS: STATUS AND NEEDS 10
ORIGIN AND HISTORIC EVOLUTION OF CENTRAL BANKS 11
HISTORICAL MODES OF PAYMENTS & ORIGIN OF MONEY 12
Characteristics of Money *13*
ORIGIN OF CREDIT 14
HISTORICAL BACKGROUND AND EVOLUTION OF BANK 14
HISTORICAL BACKGROUND OF BANKING IN PAKISTAN 15
THE STATE BANK OF PAKISTAN 16
IMPORTANCE & NEED OF A BANKING INDUSTRY 16
FUNCTIONS OF A CENTRAL BANK 17
CENTRAL BANK & ITS ROLE IN INFLATIONS CONTROL 18
FINANCIAL CRISIS 2007-2009: BLAME AND REMEDIAL ACTIONS 20
ASSUMPTIONS AND HYPOTHESIS OF THIS RESEARCH 21
HYPOTHESES 22
LITERATURE REVIEW 23
RESEARCH METHODOLOGY 23

CHAPTER 1: **25**

THE ROLE OF LAW IN DEVELOPING A SOUND BANKING SYSTEM **25**

1.1. INTRODUCTION **25**

1.2. ROLE OF LAW IN A SOUND BANKING SYSTEM **29**

1.2.1 COMPANY LAW 31
1.2.2 THE FINANCIAL SERVICES & MARKET ACT 2000 & OTHER LAWS IN THE UNITED KINGDOM 32
1.2.3 REGULATORY APPROACHES, LEGISLATIONS & DEVELOPMENTS IN THE USA 34
1.2.4 THE EUROPEAN UNION – SINGLE BANKING MARKET & EUROPEAN CENTRAL BANK 37
1.2.5 CONTRIBUTION OF INTERNATIONAL INSTITUTIONS – SOFT LAW 39
1.2.6 LAWS GOVERNING THE BANKING SYSTEM OF PAKISTAN 41

1.3 ESSENTIALS OF SOUND BANKING SYSTEM OTHER THAN LAW **44**

1.3.1 Liquidity *46*
1.3.2 Safety *49*
1.3.3 Stability *49*
1.3.4 Elasticity and Profitability *50*
1.3.5 Proper Risk Management *51*
1.3.6 Reserve Money and Expansion *54*
1.3.7 Market Discipline *55*
1.3.8 Other Essentials at a Sector Level *56*

1.4 ROLE OF A GOOD BANKING INSTITUTION IN SOUND BANKING SYSTEM **58**

1.5 THE LIMITS OF LAW TO STRENGTHEN A SOUND BANKING SYSTEM IN AN ECONOMY **63**

1.5.1 SELECTIVE APPLICATION OF PROCEDURAL LAW 63
1.5.2 OVER REGULATIONS 64
1.5.3 RESTRICTIVE NATURE 65
1.5.4 UNDUE COMPLEXITY 66
1.5.5 ENFORCEABILITY AND SANCTIONS 67
1.5.6 INADEQUACY 67
1.5.7 LEGISLATIVE PROCESS 69

1.5.8 Stakeholder's Influence 69
1.5.9 Proportionality 70
1.5.10 Banking Practices & Trade Usage 71
1.5.11 Disclosure and Information sharing 73
1.5.12 Failure of Corporate Governance 76
Co-operative Bank (2013) *77*
Co-operative Bank (August 2015) *77*
Aviva Investor Global Services Ltd (February 2015) *78*
1.5.13 Misleading Account and Audit 79

1.6 CONCLUSION 80

CHAPTER 2 85

PAKISTAN: BANKING SYSTEM, GROWTH AND FINANCIAL STABILITY 85

2.1 INTRODUCTION 85

2.2 PAKISTAN BANKING SYSTEM 87

2.2.1 Historical Background 88
2.2.2. Overview of the Banking Sector 89
2.2.2.1 Pre-nationalisation *90*
2.2.2.2 Nationalisation *90*
2.2.2.3 Denationalisation *91*
2.2.2.4 Removal of Restriction on Consumer Finance *91*
2.2.2.5 Micro financing *92*
2.2.2.6 Establishment of Small and Medium Enterprise Banks *92*
2.2.2.7 Reduction of Corporate Tax *92*
2.2.2.8 Introduction of Islamic Banking *92*
2.2.2.9 Mortgage Financing *93*
2.2.2.10 Introduction of Agriculture Credit Schemes *93*

2.3 PAKISTAN BANKING SYSTEM TODAY 93

2.4 CHALLENGES FACED BY BANKING SYSTEM OF PAKISTAN 102

2.4.1 Financial Inclusion 102
2.4.2 Fiscal Deficit 103
2.4.3 Poor Tax Mechanism 104
2.4.4 Training and Technology 104
2.4.5 Non-Performing Loans (NPLs) 104
2.4.6 Legal infrastructure, Political instability & Corruption 107

2.5 ESSENTIALS OF A GOOD BANKING SYSTEM IN A COUNTRY'S ECONOMY 113

2.6 FINANCIAL STABILITY & BANKING SYSTEM 126

2.6.1 Characteristics of Financial Stability 127
2.6.2 Pakistan Banking System and Financial Stability in Pakistan 128
2.6.2.1 Global Financial Crisis 2007/2008 *129*
2.6.2.2 Pandemic-Covid 19 response *135*

2.7 THE ROLE OF CENTRAL BANKS IN DEVELOPING AND IMPLEMENTING AN EFFECTIVE BANKING SYSTEM 144

2.7.1 Financial Stability Mandate in the Law 150
2.7.2 Deposit Protection Corporation (DPC) 150

2.8 THE CENTRAL BANK'S ROLE IN ECONOMIC GROWTH: THE STATE BANK OF PAKISTAN 151

2.9 CONCLUSION 154

CHAPTER 3: 158

THE NATIONAL SUPERVISORY AUTHORITIES AND A DYNAMIC BANKING SYSTEM 158

3.1 INTRODUCTION **158**

3.2 WHAT IS A “DYNAMIC BANKING SYSTEM”? **158**

3.3 ROLE OF NATIONAL SUPERVISORY AUTHORITIES IN CREATING A DYNAMIC BANKING SYSTEM **162**

3.3.1 MINISTRY OF FINANCE 162
3.3.2 REGULATORY AGENCIES 165
3.3.3 CORPORATE GOVERNANCE 166
3.3.4. INTERNATIONAL BODIES 168
3.3.5 LEGISLATIVE TOOLS & MECHANISM 168
3.3.6 REGULATORY MODES AND REGULATORY TOOLS 169

3.4 IDENTIFYING THE FUNCTIONS OF NATIONAL SUPERVISORY AUTHORITIES IN CREATING A DYNAMIC BANKING SYSTEM PARTICULARLY IN DEVELOPING COUNTRIES **172**

3.5.1 SUPPORT ROLE OF BASEL ACCORD FOR SUPERVISORY AUTHORITIES 173

3.5 SHOULD SUPERVISORY AUTHORITIES BE ONLY CONCERNED WITH ECONOMIC AND LEGAL MEASURES IN MAKING A BANKING SYSTEM DYNAMIC? **174**

3.5.1 MARKET INFORMATION 176
3.5.2 COSTS OF OPERATIONS 176
3.5.3 PUBLIC POLICY 177
3.5.4 BANKING INCLUSIVITY 181
3.5.5 INFORMATION SHARING & MONITORING 184

3.6 CONCLUSION **185**

CHAPTER 4: CONDUCT REGULATIONS VS. PRUDENTIAL REGULATIONS AND BASEL III: COMPARATIVE STUDY **187**

4.1 INTRODUCTION **187**

4.2 MEANING AND THE MODES OF REGULATIONS MODEL **190**

4.2.1 PRUDENTIAL REGULATIONS 191
METHODS OF PRUDENTIAL REGULATION 191
Minimum capital requirement *191*
Capital adequacy ratio (CAR) *191*
Legal Lending Limit (LLL) *192*
Fit and Proper Test *192*

4.3 REGULATORY MODELS IN DEVELOPED & DEVELOPING COUNTRIES INCLUDING PAKISTAN **194**

4.3.1 SUPERVISORY TOOLS APPLY BY THE STATE BANK OF PAKISTAN 196
4.3.1.1 On-site Assessment *196*
4.3.1.2 Off-site Supervision *197*
4.3.2 Implementation of Prudential Regulations in Pakistan *199*
4.3.2.1 Part B: Pre-Operations Obligations *200*
4.3.2.2 Operations: *201*
4.3.3 Disclosures *204*
4.3.4 Part C: Regulation *204*
4.3.4.1 Regulation R-1 Facilities to Related Persons and Proper Utilization of Clean Financing Facilities 204
4.3.4.2 Regulation R-2 Limit on Exposure against total consumer financing 204
4.3.4.3 Regulation R-3 Total Financing Facilities to be Commensurate with the Income 205
4.3.4.5 Regulation R-4 General Reserve against Consumer Finance 205
4.3.4.6 Regulation R-5 Rescheduling/Restructuring of Performing/Non-performing Consumer Finance Facilities 206
4.3.4.7 Regulation R-6 Classification & Provisioning of Receivables 206
4.3.4.8 Regulation R-7 Margin Requirements 206
4.3.4.9 Regulation R-8 Maximum Clean Limit for Credit Card and Personal Loan/Financing from All Banks/DFIs 207

4.4 NEEDS AND ADVANTAGE OF REGULATIONS **207**

4.5 REGULATIONS & BASEL ACCORD **208**
4.5.1 Basel I: the Basel Capital Accord 209
4.5.2 Basel II: The New Capital Framework 209
4.5.2.1 The objectives of Basel II *210*
4.5.2.2 Eligible regulatory capital *211*
4.5.2.2.1 Tier 1 capital 211
4.5.2.2 Tier 2 capital 211
4.5.2.3 Tier 3 capital 212
4.5.3 Risk-weighted assets 212
4.5.4 The approach to credit risk in Basel 212
4.5.4.1 The internal ratings-based approach *213*
4.5.4.2 Securitisations *213*
4.5.4.3 Operational risk *214*
4.5.4.4 Market risk *214*
4.5.5 The Second Pillar 214
4.5.6 The Third Pillar *215*
4.5.7 Basel III 215
4.5.7.1 Capital requirements *219*
4.5.7.2 Pro-cyclicality and systemic risk through leverage ratio *220*
4.5.8 Regulatory Approach adopted by Basel III *222*
4.6 A CRITICAL ANALYSIS OF BASEL III APPROACH: SAFEGUARDS AND WEAKNESSES **225**
4.6.1 Safeguards 225
4.6.2 Weaknesses of the Basel III 227
4.7 SUITABLE REGULATORY MODEL FOR DEVELOPING COUNTRIES **229**
4.7.1 Integrated vs Multiple Agencies – A case of Integration 231
4.7.2 Unified Supervisory Agency vs. Twin Peaks 236
4.7.3 The Twin Peaks 239
4.8 CONCLUSION **241**
CHAPTER 5: **245**
SHOULD BANKING REFORMS BE ACHIEVED BY LEGISLATION ONLY OR IN COMBINATION WITH CODES OF CONDUCT FOR ATTAINING GOOD CORPORATE GOVERNANCE? **245**
5.1 INTRODUCTION **245**
5.2 LIMITS OF LEGISLATION TO BRINGING A REFORM **246**
5.3 WHY THE CONTRIBUTIONS OF CODES OF CONDUCT MAY NOT BE DISREGARDED? **251**
5.4 WHAT ROLE MAY GOOD GOVERNANCE PLAY IN ESTABLISHING A SOUND BANKING SYSTEM: A QUALITATIVE AND EMPIRICAL STUDY **257**
5.4.1 Definition of Corporate Governance & its Application on Banking System 257
5.4.2 Theoretical Basis of Corporate Governance 262
5.4.3 Empirical Basis of Corporate Governance 263
5.4.4 The role of Corporate Governance in establishing a sound banking system 268
5.4.5 Evolution of Corporate Governance in UK & its Role 272
5.4.5.1 Cadbury report 1992, Greenbury Report 1995 and Hampel Report 1998 *273*
5.4.5.2 The Turnbull Report and FRC Guidance *273*
5.4.5.3 The Higgs Report 2003 *273*
5.4.5.4 The Smith Report 2003 *274*
5.4.5.5 The Walker Review 2009 *275*
5.4.5.6 The Turner Review 2009 *275*
5.4.5.7 Independent Commission on Banking published report 2011 *275*
5.4.5.8 The Kay Review 2012 *276*
5.4.5.9 Final Report 2013 *276*
5.4.5.10 Professor Lambert Report 2014 *277*

5.4.5.11 Green Paper on Corporate Governance Reform 2016 *277*
5.4.5.12 The UK Corporate Governance Code 2018 *277*
5.4.6 CORPORATE AND RISK GOVERNANCE FOR BANKS IN THE USA 278
5.4.7 CORPORATE GOVERNANCE IN PAKISTAN 279

5.5 IF SOUND CORPORATE GOVERNANCE CAN BE APPLIED TO THE PAKISTAN BANKING SYSTEM? 279

5.6 CONCLUSION 282

CHAPTER 6: 284

THE PROSPECT OF OPERATING A SOUND BANKING SYSTEM IN PAKISTAN: STRENGTHS & IMPEDIMENTS 284

6.1 INTRODUCTION 284

6.2 BANK AND NATURE OF ITS RELATIONSHIP WITH CUSTOMERS 285

6.3 THE BANKING LAWS IN PAKISTAN 288

THE NEGOTIABLE INSTRUMENTS ACT, 1881 289
THE STATE BANK OF PAKISTAN ACT, 1956 "THE 1956 ACT" 290
THE BANKING COMPANIES ORDINANCE, 1962 295
THE BANKING COMPANIES RULES 1963 302
THE BANKS NATIONALIZATION ACT 1974 303
THE BANKING COMPANIES ORDINANCE, 1979 303
THE MODARBA COMPANIES AND MODARBA (FLOATATION AND CONTROL) ORDINANCE, 1980 303
OFFENCES IN RESPECT OF BANKS (SPECIAL COURTS) ORDINANCE 1984 303
NATIONAL ACCOUNTABILITY ORDINANCE, 1999 304
THE STATE BANK OF PAKISTAN (BANKING SERVICES CORPORATION) ORDINANCE, 2001 304
MICROFINANCE INSTITUTIONS ORDINANCE, 2001 305
THE FOREIGN CURRENCY ACCOUNTS (PROTECTION) ORDINANCE 2001 308
ANTI-MONEY LAUNDERING RULES 2008 309
ANTI-MONEY LAUNDERING REGULATIONS 2008 309
THE ANTI-MONEY LAUNDERING ACT 2010 309
ELECTRONIC TRANSACTIONS ORDINANCE, 2002 310
PAYMENT SYSTEMS AND ELECTRONIC FUND TRANSFER ACT, 2007 310
CREDIT BUREAU ACT 2015 311
DEPOSIT PROTECTION CORPORATION ACT 2016 311
PUBLIC FINANCE MANAGEMENT ACT 2019 312
REGULATIONS FOR LENDER OF LAST RESORT (LOLR) FACILITY UNDER SECTION 17G OF THE STATE BANK OF PAKISTAN ACT, 1956 312
PRUDENTIAL REGULATIONS FOR CORPORATE/COMMERCIAL BANKING 315
IPF.1 – Credit Appraisal *315*
IPF.1.1 -- Analysis of Financial Model(s) 316
IPF.1.2 -- Requisite Expertise for Appraisal *316*
IPF.1.3 -- Minimum Information Requirements *316*
IPF.1.4 -- Assessment of Infrastructure Projects *316*
1.4.1 Development Phase 317
IPF.1.4.2 Construction and Start-up Phase 317
A. Responsibility of Assuming Completion Risk: 317
b. Physical and Financial Completion of Infrastructure Projects: 317
ANTI-MONEY LAUNDERING, COMBATING THE FINANCING OF TERRORISM & COUNTERING PROLIFERATION FINANCING REGULATIONS 318

6.4 THE STATE BANK OF PAKISTAN & ITS ROLE IN DEVELOPING SOUND BANKING SYSTEM 319

6.4.1 BANKING REGULATION DIVISION 322
6.4.2 LICENSING AND CORPORATE GOVERNANCE DIVISION 322
6.4.3 SUPPORT AND LIAISING DIVISION 322
6.4.4 COMPLAINTS REDRESSAL & SERVICES DIVISION 323
6.4.5 BANKING SURVEILLANCE DEPARTMENT 323
6.4.5.1 Main Objectives/Key Result Areas: *324*

6.4.5.2 Departmental Structure: *324*
6.5 Risk Management & Analysis Division (RMD) 324
6.6 Basel Accord & Core Principles Division (BA&CPD) 325
6.7 Banking Sector Assessment Studies Division (BSASD) 325
6.8 Credit Information Bureau (CIB) 325

6.5 THE ROLE OF INTERNATIONAL BODIES IN CREATING SOUND BANKING SYSTEM THROUGH CENTRAL BANKS 326

6.6 THE PROSPECT OF OPERATING SOUND BANKING SYSTEM IN PAKISTAN: ISSUES AND EVOLUTION 331

6.6.1 Major Issues faced by the Banking System of Pakistan 332
6.6.2 Banking Reforms 336
6.6.3 Effect of Reforms on Soundness of Banking System & adoption of International Standards 339
6.6.4 Adoption of Basel Accord in Pakistan Banking System 340

6.7 IF THE PAKISTAN BANKING INDUSTRY ADEQUATELY AND CAPABLY PERFORMS SUI GENERIS RESPONSIBILITY OF PROTECTING MONEY OF DEPOSITORS AND INVESTORS? 349

6.8 IF PAKISTAN HAS SOUND BANKING SYSTEM, THEN WHY IT FAILS IN PRODUCING NATURAL OUTCOME OF STRENGTHENING FINANCIAL STABILITY? 355

6.9 CONCLUSIONS 359

BIBLIOGRAPHY 367

ABSTRACT

This thesis discusses the prospect of establishing and maintaining a sound banking system in developing countries particularly in Pakistan. This thesis examines the contribution of legal infrastructure, corporate governance, effective regulations, and enforcement mechanisms of these regulations through the Central Bank.

This research has discussed that the banking System in Pakistan has adopted Basel Accord and sound corporate governance due to conditions imposed by the International Monetary Fund. Nevertheless, the State Bank of Pakistan, despite publishing positive outcomes of the adopting international standards, could not stop political interference, even after extensive banking reforms. This had resulted in cumulating huge non-performing loans, money laundering, and use of commercial banks by the Government to fund government's projects.

Therefore, this research also touches upon the judicial system of Pakistan and its contribution towards strengthening or weakening the banking system and consequential effect it may have on the economy of the country that continues to rely on borrowings and foreign aid to meet its budget deficits.

This research argues that prospect of establishing sound banking system does not only require elements such as good corporate governance, effective regulations, and enforcement of these regulations through the Central Bank, but stable political situation and strong legal infrastructure must be established to give effect to the said elements.

The need for a stable banking system is also emphasised with reference to its role in building the economy of a country.

Although the title of the thesis suggests that the thesis is to cover developing countries in general, the focus is limited to the banking System of Pakistan. Some comparative references of the Pakistan banking system with the other banking systems both of developed and developing world are to be found in this thesis.

Introduction of Thesis

The thesis is purposed to evaluate the strength of banking system in Pakistan, role of international bodies like World Bank and IMF in reforming banking system, status & functioning of the State Bank of Pakistan "The State Bank" as central bank, role of organs of state i.e., legislatures, executive and judiciary in supporting the functions of central bank and regulatory model that is followed by The State Bank.

The economy of a country fundamentally consists of money, financial instruments, financial markets, financial institutions, government regulatory agencies, and central banks. We use money, to pay for our purchases and to store our wealth. Financial instruments such as stocks, mortgages, and insurance policies are designed to convert savings into investments with the help of financial markets that facilitate the buying and selling of financial instruments; the Stock Exchange of a country is an example of a financial market. Financial institutions such as banks, securities firms, and insurance companies provide a myriad of services. Central banks monitor and stabilise the banking system and economy.[1]

Central banks also control the availability of money and credit in order to promote low inflation, high growth, and the stability of the financial system of a country. The central bank operations can be categorised into macroeconomic function and microeconomic function. The macroeconomic function is to preserve the value of the currency i.e., to maintain price stability. The microeconomic function is to maintain stability in the banking system.

Regulations: Status and Needs

This thesis will also examine if there is consensus or "no consensus in academe on why banks should be regulated, how they should be regulated, and whether they should be regulated at all. We ought to go back to what motivates banking regulation in the first place and then proceed to logically derive its desired bundle of rules and see how these rules are affected by the specificities of banks."[2] Regulation is the term usually reserved for the rulemaking, whilst "supervision" is the term for ensuring that these rules are complied with. Despite many

[1] Robert W. Kolb, Lessons from the Financial Crisis: Causes, Consequences, and Our Economic Future Understanding the Subprime Financial Crisis, (Wiley 2010) 69-75

[2] J. Tirole and M. Dewatripont, The Prudential Regulation of Banks (Cambridge: MIT Press, 1995)

regulatory and technological developments over the years, weaknesses still persist in the banking industry, and these have aided in making the banking sector more susceptible to systemic risks and increasingly more fragile.[3]

The banks play a vigorous role in maintaining financial stability, and immensely contribute to the GDP of the financial systems at domestic and international level. In the modern economic era, the banks have turned out to be an indispensable part of the financial system. However, flaws in the regulations allow the banking industry to become involved in risky financial activities which can create a financial crisis.[4] Banks around the globe played an important role in economic growth; however, owing to an inappropriate legal system, the banking industry might cause financial crises. Thus, many countries implemented mandatory deposit insurance policies in order to secure the deposits of the investors, but nothing has worked as a permanent solution. After the collapse of several banks around the globe, the G10 group[5] established the Central Bank of Governors in 1975, which constituted a committee i.e., the Basel Committee, to propose a solution for the banking system.[6]

The Basel Committee proposed a regulation to minimise risk, but that could not work because the method that was used by the Basel Committee to evaluate risk was obsolete. Therefore, the Basel Accord I was amended in November 1991 to cope with the challenges. The financial crises of different times prompted the policymakers to admit the need for international regulation of the banking system and the importance of the lender of last resort. There were many lacunae in the regulation of Basel I; hence the Basel Committee introduced Basel II in June 1999. Basel II was regarded as a suitable regulation to prevent a financial crisis. However, major concerns regarding its capacity arose after the financial meltdown of 2007–08. The Basel Committee introduced Basel III, but it is yet to be implemented.[7]

Origin and Historic evolution of Central Banks

[3] Sony Kapoor, ‘A simpler, smaller, safer, more diverse and more stable banking system is what we need’ (2009) The Future of Finance, What is a good banking system? <www. re-define. Org>. < www. http://re-define.org/sites/default/files(2).pdf> accessed 15 September 2019

[4] Charles W. Calomiris and Gary Gorton, “The origins of banking panics: models, facts, and bank regulation” in R. Glenn Hubbard (ed.), Financial Markets and Financial Crises (Chicago: University of Chicago Press, 1991), pp.109–174

[5] Belgium, Canada, France, Germany, Italy, Japan, Luxemburg, Netherlands, Spain, Sweden, Switzerland, UK, US

[6] Charles Goodhart, The Basel Committee on Banking Supervision: A History of the Early Years 1974–1997 (Cambridge: Cambridge University Press, 2011)

[7] Anumeet Toor, “International Financial Regulation and the Basel Accord: How the Impact of a Soft Law Whisper Results in Compliance throughout the Globe” (23 May 2017), SSRN, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2970253 [Accessed 31 May 2019].

Central banks have evolved over the period from large private banks that were engineered to finance wars to becoming regulators of the banking system and one of the most important institutions in a government. Commercial banks operated in ancient Athens were tools of financing the market economy of the Athenian empire, the Roman Empire, and proliferated in the latter middle ages, and especially in renaissance Italy, where cross-border trade based on continent-spanning networks of financiers proliferated, often funding the wars of feuding monarchs[8].

King William created the Bank of England in 1694 for the express purpose of raising taxes and borrowing to finance a war between Austria, England, and the Netherlands on one side and Louis XIV's France on the other. Eventually, these government treasuries grew into the modern central banks. While only a few central banks existed in 1900, now nearly every country in the world has one.[9]

Historical Modes of Payments & Origin of Money

The first means of payment were things with intrinsic value. These commodity monies included everything from silk in China to butter in Norway, whale teeth in Fiji, and salt in Venice. All these things had value even if they were not used as money. The worth of a block of salt, for instance, came from its value as a preservative. But successful commodity monies had other characteristics: They were usable in some form by most people; they could be made into standardised quantities; they were durable; they had high value relative to their weight and size so that they were easily transportable; and they were divisible into small units so that they were easy to trade. For most of human history, gold has been the most common commodity money.[10]

In 1656, a Swede named Johan Palmstruck founded the Stockholm Banco. Five years later he issued Europe's first paper money. At the time, the Swedish currency was copper ingots, which works poorly as money because of its low value per unit of weight. Thus, easy-to-handle paper was welcomed, at least at first. After a few years of printing paper currency, Palmstruck and his sponsor, the King of Sweden, became overly enamoured of the new money. The king needed to finance some wars he was fighting, so he convinced Palmstruck to print more and

[8] Tolek Petch, 'Why are banks subject to prudential regulation? [J.I.B.L.R.2022] 37(12) 445-461
[9] Petch (n.8)
[10] SG Cecchetti and KL Schoenholtz, Money Banking and Financial Market (4th edn, McGraw-Hill Education 2015) p.26

more notes. Because the bills were redeemable on demand for metal, the system worked only as long as people believed there was enough metal sitting in Palmstruck's vaults. As the number of notes increased, Swedes lost confidence in them and started to redeem them for the metal they supposedly stood for. But Palmstruck had issued too many notes, and his bank failed.[11] Other people tried issuing paper money during the early 1700s. In 1775, the newly formed Continental Congress of the United States of America issued "continentals" to finance the Revolutionary War. Twenty years later, revolutionary France issued the "assignat." Lacking any other source of funding for their wars, both governments issued huge quantities of the currencies, and both currencies eventually became worthless. After the Civil War, the United States reverted to the use of gold as money.[12] Both gold coins and notes backed by gold circulated well into the 20th century. Today, though, we use paper money—high-quality paper, nicely engraved, with lots of special security features. This type of currency is called fiat money because its value comes from government decree, or fiat.[13]

Characteristics of Money

Money has three characteristics. It is (1) a means of payment, (2) a unit of account, and (3) a store of value. The first of these characteristics is the most important. Anything that is used as a means of payment must be a store of value and thus is very likely to become a unit of account. Most of the money in the economy is created, not by printing presses at the central bank, but by banks when they provide loans.[14] Darling J in the case of Moss v Hancock[15] also engages with this exercise, agreeing with a well-cited definition:

> "Money as currency, and not as medals, seems to me to have been well defined by Mr Walker in 'Money, Trade, and Industry' as 'that which passes freely from hand to hand throughout the community in final discharge of debts and full payment for commodities, being accepted equally without reference to the character or credit of the person who offers it and without the intention of the person who receives it to consume it or apply it to any other use than in turn to tender it to others in discharge of debts or payment

[11] Cecchetti (n.10) 27
[12] Cecchetti (n.10) 27
[13] Cecchetti (n.10) 27
[14] https://www.bankofengland.co.uk/knowledgebank/how-is-money-created
[15] [1899] 2 Q.B. 111 QBD at 116

for commodities.”

Origin of Credit

Credit can be traced back to the Mesopotamia era, around 2000 BC[16], and ancient Greece.[17] This has developed over time from what was borrowing capital in exchange for seeds and grains, to ancient temples being the first recognisable banks, the first central bank; Bank of England in 1694, to the first building society namely Ketley’s Building Society.[18] In modern banking times, credit outside of the traditional banking system, including unregulated activities by regulated banks and financial institutions, can be pinpointed to the first half of the twentieth century; as Hayek stated “There can be no doubt that besides the regular types of the circulating medium, such as coin, bank notes and bank deposits, which are generally recognised to be money or currency, and the quantity of which is regulated by some central authority or can at least be imagined to be so regulated, there exist still other forms of media of exchange which occasionally or permanently do the service of money.”[19]

Historical Background and Evolution of Bank

The word ‘bank’ traces its origin to the French word ‘Banqui’ and the Italian word ‘Banca’. It then referred to a platform for keeping, lending, and exchanging of money or coins in the marketplace by money lenders and money changers. The first bank called the ‘Bank of Venice’ was established in Venice, Italy in 1157 to finance then monarch in his wars. The bankers of Lombardy were famous in England. But modern banking began with the English goldsmiths only after 1640. The first bank in the world was established in 1407 in the Republic of Genoa (the Bank of St George). Chanakya in his Arthashastra written in about 300 B.C. mentioned the existence of powerful guilds of merchant bankers who received deposits, and advanced loans and issued hundis (letters of transfer). The Jain scriptures mention the names of two bankers who built the famous Dilware Temples of Mount Abu during 1197 and 1247 A.D.[20]

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[16] Annabelle Amery, “A brief history of loans: business lending through the ages” Become, 23 October 2018, https://www.become.co/blog/a-brief-history-of-loans-business-lending-through-the-ages/ [Accessed October 2021].
[17] Scott B. MacDonald and Albert L. Gastman, A History of Credit and Power in the Western World (US and UK: Transaction Publishers, 2009), pp.24–26.
[18] Simon Rex, “The history of building societies” Building Societies Association, 18 April 2019, https://www.bsa.org.uk/information/consumer-factsheets/general/the-history-of-building-societies [Accessed November 2021].
[19] Friedrich A. Hayek, Prices, and Production (New York: Augustus M Kelly, 1931), https://mises-media.s3.amazonaws.com/Prices%20and%20Production_5.pdf [Accessed 9 October 2019].
[20] ‘Banking System and Regional Rural Banks in India’ (Evolution of Banking) ch III, ‘62ff’

Historical Background of Banking in Pakistan

The banking system was introduced in Pakistan during the colonial times when, in 1770, the Bank of Hindustan was established by Alexander & Co which was an English agency; this ceased to trade in 1782 resulting in closure of the bank as well. The first bank in the modern sense was established in the Bengal Presidency as the Bank of Bengal in 1806. The Bank of Bombay (established 1840) and Bank of Madras (established 1843) were other prominent presidency banks.[21] These banks were initially set up as quasi-state institutions and had the privilege of being the banker's banks.[22]

The second phase of constituents of the banking system were the Exchange Banks. These banks had access to the London Money Market and dealt in foreign exchange. The third important foundation of banking in India comprised of the Indian Joint Stock Banks. The impetus to the formation of joint stock banks was given in 1813, when the Charter Act was passed removing several of the restrictions regarding the settlement of Europeans in India.[23] Due to the absence of any regulator or state functionary, there was an overarching presence of a market in which all players were fighting to retain business for their survival. The crisis was triggered by the failure of The People's Bank of India, Lahore, which led to a major contagion that resulted in the collapse of 88 banks during 1913-1917.[24]

The failure of these banks and the wiping out of a significant amount of capital, especially of Indian Joint Stock banks, led to the widespread opinion that a proper institutional framework was needed as a panacea to the problems of the banking sector. This eventually led to the merger of the three Presidency Banks into the Imperial Bank of India in 1920; which Bank was proposed to be an institution with overall, as opposed to territorial, presence in India. The Imperial Bank of India "RBI" had the status of a quasi-central bank; it undertook banking functions and managed the Rupee debt of the government until the formation of the Reserve Bank of India in 1935. After the creation of RBI, the Imperial Bank acted as its agent, a

<http://shodhganga.inflibnet.ac.in/bitstream/10603/70339/10/10_chapter%203.pdf>'accessed 13 September 2019

[21] Arun Kumar Vaish, 'Development of a Credit Scoring Methodology for Assessment of Micro-Finance Borrowers'(DPhil thesis, Birla Institute of Technology and Science Pilani (Rajasthan)India 2013) 'accessed 13September 2019'

[22] Vaish (n.15)

[23] Tehreem Husain, 'A brief history of the evolution of The State Bank of Pakistan'[23June, 2013] The Express Tribune, Creative Faizan Dawood, <https://tribune.com.pk/story/567311/a-brief-history-of-the-evolution-of-the-state-bank-of-pakistan/>accessed 15 September 2019

[24] Husain (n.17)

structure continued to be followed even after the partition of India before The State Bank of Pakistan was finally formed in 1948.[25]

The State Bank of Pakistan

The State Bank is the Central Bank of Pakistan. Its constitution, as originally laid down in The State Bank of Pakistan Order 1948, remained unchanged until 1 January 1974 when the bank was nationalised and, resultantly the scope of its functions was considerably expanded. The State Bank of Pakistan Act 1956 with subsequent amendments formed the basis for its operations. Usually, the starting point for a central bank is regulating a banking system that is already in place. However, The State Bank of Pakistan is unique in the sense that it started its function in a newly born country, where it also had to shoulder responsibilities of developing and rehabilitating a banking system and the economy, in addition to the traditional central banking functions.[26]

The non-traditional or promotional functions performed by The State Bank include development of financial framework, provision of training facilities to bankers, and provision of credit to priority sectors. The State Bank has also been playing an active part in the process of Islamization of the banking system.[27]

Importance & need of a banking industry

The banking industry, being an essential component of the financial system, plays a crucial role in daily lives. The collapse of the banking system can cause recession affecting all sectors with consequential global impact. In its traditional role a bank obtains funds from depositors and by lending such deposited money to entrepreneurs (borrowers) allow them to create new businesses, enhance their business activities and create new employments.[28] The banks at the same time are obligated to ensure the security of the funds of depositors by maintaining a surplus supply of money. A bank performs the role of a guarantor and contributes to financial activities by providing funds to businesses. The absence of banking facilities in an economic

[25] Husain (n.17)
[26] www.sbp.org.pk
[27] https://mpra.ub.uni-muenchen.de/13614/
[28] Ibish Mazreku, Fisnik Morina and Sami Mazreku, "The Role of the Banking System on the Financing of the Businesses and the Determinants of the Lending Level on the SMEs in Kosova" (7 August 2016), SSRN, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2819539 [Accessed 13 May 2021].

system will dramatically shrink the number of business ventures, which will result in a diminution of Gross Domestic Product “GDP”.[29]

Hence, a good banking system has become the mainstay for the sustainability of the financial system,[30] because stability improves welfare. A less volatile overall economy makes it easier for each of us to stabilize our own financial lives. As individuals, we care about paying our bills and stabilizing our standard of living. As the deep recession that ended in 2009 highlighted, individual incomes still rise and fall in ways that can make it difficult for a person to stabilize his consumption. Individuals use credit in two ways: First, they borrow to purchase expensive things like cars and houses without having to save the full amount and pay cash with the help of loans and mortgages. Secondly, the ability to borrow means that an unemployed person will still have something to eat and a place to sleep. While credit can help us to smooth our consumption, it is only a stop-gap measure that we should use for as short a time as possible.

The banking industry can have a positive impact on the economy by promoting certain linked industries, namely insurance industry, investment both domestic and foreign, in addition to creating and progressively developing domestic capital markets, and real estate markets. On the other hand, the loss of confidence in banking systems and resulting instability in a country, irrespective of its rating, have long-term consequences and it adversely impacts the wider economy. Further, the effect of a banking crisis does not contain itself within national boundaries as was seen in the United States where issues linked to the country’s subprime mortgage system rapidly developed into a much wider problem that shook global banking sectors and economies to the core[31].

Functions of a Central Bank

Central banks and government mints were usually established to provide funding to those sovereigns, and to control the currency/money supply; other functions were added later or were

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[29] Neslihan Dincbas, Tomasz Kamil Michalski, and Evren Ors, “Banking Integration and Growth: Role of Banks’ Previous Industry Exposure”, HEC Paris Research Paper No.FIN-2015-1096 (21 July 2017), SSRN, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2630969 [Accessed 15 September 2022].
[30] Kelvin Mkwawa, “Importance of Banking Industry”, (3 May 2018), The Citizen, https://www.thecitizen.co.tz/magazine/businessweek/Importance-of-banking-industry/1843772-4543558-b68977/index.html [Accessed 31 May 2019].
[31] W. Calomiris C, 'The Subprime Turmoil: What’S Old, What’S New, And What’S Next' (Imf.org, 2008) <https://www.imf.org/external/np/res/seminars/2008/arc/pdf/cwc.pdf> accessed 9 January 2020]

assumed implicitly. Central banks then acquired some indirect control over the banking system, most notably through the lender-of-last resort function.[32] The traditional functions of a central bank are classified as the primary functions: including issue of notes, regulation of the financial system, lender of the last resort, and conduct of monetary policy; and the secondary functions including management of public debt, management of foreign exchange, advising the Government on policy matters, anchoring payments system, and maintaining close relationships with international financial institutions.

During the 1990s, a number of countries adopted a policy framework called inflation targeting in an effort to improve monetary policy performance. The keys to any successful central bank's policy is for policymakers to convince the public that they will keep inflation low. Often, central banks that employ inflation targeting operate under a hierarchical mandate, in which price stability comes first and everything else comes after. The Bank of England Act of 1998 for example granted the Bank of England independence and also dictated its objective: to deliver price stability, as defined by the government's inflation target. A nine-member Monetary Policy Committee meets monthly to determine short-term interest rates in an effort to meet this objective, which has been defined as consumer price inflation of 2.0 percent.

Central Bank & its Role in Inflations Control

The word inflation; for the ordinary person means price increase whereas for economists, inflation means a continually rising price level. There is a strong positive correlation between money growth and inflation, high level of inflation exceeds money growth and in moderate to low inflation, money growth exceeds inflation. The central bank controls the rate of money growth and plays a crucial role in the equation of exchange that tells us that the quantity of money times the velocity of money equals nominal GDP; whereas money growth plus velocity growth equals inflation plus real growth. If velocity and real growth were constant, the central bank could control inflation by keeping money growth constant. In the long run, velocity is stable, so controlling inflation means controlling money growth. In the short run, the velocity of money is volatile because shifts in velocity are caused by changes in the demand for money. The transaction's demand for money depends on income, interest rates, and the availability of alternative means of payment. Countries with high inflation can reduce inflation by controlling

[32] Kolb (n. 1)

money growth. Countries with low inflation can control inflation by targeting money growth.

Central bank, sound monetary policy in combination with responsible fiscal policy plays an important role to build a healthy economic and financial system. Argentina provides an interesting example of how external and domestic factors interact in the making of monetary policy. Over the years, Argentina has suffered from severe inflation. During the 1970s, inflation averaged about 100 percent, meaning that prices doubled every year, while the economy grew about 3 percent a year. By 1989, inflation had climbed to more than 2,000 percent per year and the price level was 60 billion times what it had been 20 years before. Needless to say, growth fell. In 1990, real GDP was below its 1973 level and Argentina's economy was at a standstill. In 1991, Argentineans implemented a mechanism called a currency board, which had two important attributes. First, Argentina's central bank, the Banco Central de la República Argentina, guaranteed that it would exchange Argentinean pesos for U.S. dollars on a one-for-one basis; it fixed its exchange rate. Second, the central bank was required to hold dollar assets equal to its domestic currency liabilities, again at a one-to-one exchange rate. The results were almost miraculous as inflation fell immediately; after a few years it had completely disappeared.[33]

Following the financial crises that enveloped Thailand and Indonesia in 1997, then Korea and Russia in 1998, many emerging markets suffered extreme stress. To reduce risk, foreign investors simply pulled out. They sold those countries' bonds, driving their prices down and their interest rates up, and then converted the proceeds into foreign currencies, driving the value of the domestic currencies down. Plummeting exchange rates and skyrocketing interest rates brought these economies to their knees. The typical response of countries experiencing such a financial crisis is for the government to borrow from other countries and the International Monetary Fund and to use the borrowed funds to meet its obligations.

But Malaysia adopted a different course. Believing there was nothing inherently wrong with the nation's economy and that the crisis resembled a bank run more than anything else, officials took the extreme step of implementing strict capital controls.[34] By placing severe limits on investors' ability to remove money from the country, they ensured that foreign investments would remain there. More importantly they could fix the value of their currency, the ringgit,

[33] Cecchetti (n.10) 523
[34] RP Buckley, "The Role of Capital Controls in International Financial Crises' (1999) 11 Bond Law Review 231

and lower domestic interest rates.[35] At the time, Western economists condemned the policy, claiming that it would destroy the country's economy for years to come. While experts continue to argue about the wisdom of Malaysia's capital controls, their initial response was clearly mistaken. Malaysia's recovery took only two years, compared to five years for Thailand and Indonesia.[36]

Financial Crisis 2007-2009: Blame and Remedial Actions

These financial crises began in the summer of 2007 with reports of alarming increases in subprime mortgage defaults, soon followed by the reverse of decades-long increases in home prices. Some blame the housing price "bubble" on policy failures, ranging from the Federal Reserve's loose monetary policy, failure to regulate high-risk lending, a broad political consensus to promote homeownership, which in turn encouraged the government-sponsored enterprises to invest in poor-quality mortgages, low bank capital requirements for mortgages and laws to promote lending to underserved communities. Others attribute the expansion to abuses by mortgage lenders, accused of misleading borrowers and investors and the greed of Wall Street that increasingly depended on revenues from complex financial products.[37]

When these crises began, most market participants thought it was limited to a portion of the US mortgage market (hence the term "subprime crisis"). However, it quickly turned into a financial crisis that froze up credit markets, threatened the largest global institutions and jeopardised the banking system worldwide. This triggered substantial efforts in 2008, through emergency acquisitions, monetary policy, and public capital injections, to stabilise the banking and credit markets. By the end of 2008, the financial crisis had turned into an economic crisis and the United States and much of the rest of the world were plunged into a deep recession.[38]

However, as we saw in the global crisis of 2007–2009, inflation targeting is not sufficient to prevent financial disruptions that undermine economic stability. The central banks set a target for the overnight interbank lending rate in an effort to stabilise the economy and keep inflation low. Quantitative easing is another mechanism to relax the monetary stance when the policy

[35] E Kaplan and D Rodrik, "Did the Malaysian Capital Controls Work?

[36] M Ariff and A Wan Abdul Kadir, "The Near-Term Outlook for the Malaysian Economy' (Conference Paper, ISEAS Regional Conference, 6 January 2000) 2.

[37] Philip R. Wood The Law and Practice of International Finance Series Vol. 5: International Loans, Bods, Guarantees, Legal Opinions 3rd Edn. ISBN: 978-0-414-04469-2

[38] Wood (n 37)

target rate is close to zero. Quantitative easing occurs when the central bank expands the supply of aggregate reserves to the banking system beyond the level that would be needed to maintain its policy rate target. The central bank uses the proceeds from this reserve expansion to buy assets, thereby expanding its overall balance sheet. In contrast to quantitative easing targeted asset purchases shift the composition of the balance sheet toward selected assets in order to boost their relative price and stimulate economic activity.

Assumptions and hypothesis of this research

The banking system in developing countries does not get due consideration due to various factors including lack of understanding of importance of banking on the part of governments. Therefore in developing countries it is not uncommon to find lack of banking infrastructure such as proper capital markets, appropriate regulatory authorities; appropriate training of bank officials, the lack of appropriate domestic economic policies, the lack of efforts for making the banking industry sufficiently attractive, and most of all, the lack of public awareness of the merits of sound banking systems with prudential management structures originated by central banking authorities.

Risk management has always been a thorny issue in banking. Risk Management varies from jurisdiction to jurisdiction and the business environment. Banks face many pitfalls in their daily operations; the well-known examples are unsound lending practices (lending to unstable economies or un-creditworthy customers), hazardous dealings in foreign currencies, and liquidity crisis caused by investment received on short term loans in long term transactions. This last practice was arguably the primary cause of the banking crisis in the UK in 2007-2008.

The banking sector deals in public funds, the money deposited by members of the public. Therefore, it is vital for constant flow of money in any economy that the banks enjoy unblemished records and the people do not suspect that their deposits would have some risk of losing their value. This may be only possible if the regulatory bank is independent of any political or social influence and the rules governing a regulatory bank gives it sufficient autonomy to perform its functions and implement the rules without any restrictions.

This research deals with these issues with reference to the banking system and central bank of Pakistan; the UK's banking system is referred to as the reference banking system mainly

because both are common law jurisdictions. Additionally, the banking practices in certain other jurisdictions for example Africa, Asia, and USA have been referred to with a view of giving a wider perspective.

This thesis aims at exploring how the current banking system may be improved in Pakistan and how "capacity building" may be achieved in the world of banking in Pakistan. It is acknowledged that the banking industry, like many other industries, might never be perfect in any jurisdiction; there will always be room for improvement. Nevertheless, it would be possible to develop and implement the minimum standards of efficiency particularly in the following aspects of banking: supervision and control by supervising authorities; training of staff and banking advisers; stock exchanges, making the banking industry sufficiently attractive and making it accountable to provide assurances to investors and consumers.

The first chapter has provided a detailed description of factors including law to establish a sound banking system in a country viz a viz obstructions in establishing and maintaining a sound banking system. In the second chapter, we will see the essentials of a good banking system in a country and the reforms that have been adopted by the Pakistan banking system to attain growth and financial stability. The third chapter describes the ingredients and benefits of a dynamic banking system. The chapter 4 discusses the different modes of regulatory models and chapter 5 explores the role of legislation, codes of conduct and corporate governance in achieving banking's reforms. In the last chapter, the current standing of the Pakistan Banking system is discussed and the prospect of operating and maintaining a sound banking system is examined.

Hypotheses

1. That the banking industry is an industry which is primarily run-on others' money (investors and consumers); a special kind of responsibility lies with the industry which may be described as a kind of sui generis responsibility.[39]
2. That the banking industry is a particularly risk-prone industry; thus, it would be important for supervisory authorities to exercise what may be described as "prudential supervision

[39] Chapter 1, 2, and 3.

and control" over its commercial banks with a view to protecting the interests of investors and consumers.[40]

3. That in theory a sound banking system should be based on a sound corporate governance system, but whether that might be possible to achieve in developing countries where the appointments are based on political and social connections.[41]

Literature Review

Fortunately, legislation, rules and regulations and legal education and practice in higher courts of Pakistan is in the English language, however there is limited published works specifically on banking regulations and supervision in Pakistan. One example of a good source of material is the regulator's own website i.e., website of the State Bank of Pakistan;[42] however such resources might be used with caution. The other major source is papers and publications of international bodies, such as International Monetary Funds, World Bank of Reconstruction & Developments, Asian Development Funds etc., on the banking system in Pakistan.

It has proven difficult, due to limited publications within Pakistan, to find any critical analysis of the functions and effectiveness of the Central Bank by local jurists or academics. The material available on regulators' website[43] is produced with caution because it may not reflect accurate position with respect to successful application and implementation of its directions given to banks by way of circulars. In addition to relying on the current banking legislation and certain judicial decisions on banking issues in Pakistan, most of the research in this thesis is based on the UK banking system, the EU and Basel Committee Reports (Basel I, II and III).

Research Methodology

This research is primarily be based on primary sources of information, such as the banking legislation in Pakistan and the UK, the precedents set by courts in Pakistan and in England and Wales; various reports published on banking, namely, the Turner Report, the current reports on PRA and FCA; various Codes of Conduct on corporate governance, namely the Cadbury

[40] Chapter 4 and chapter 6
[41] Chapter 5.
[42] https://www.sbp.org.pk/
[43] www.sbp.org.pk

Report 1992, the Combined Code 1992, and the Stewardship Report 2013; secondary sources of information, such as books and articles have been referred to where necessary.

In addition to undertaking research from above resources, interviews of banking professionals at management position, in-house banking lawyers, lawyers, and some officials of central bank were conducted in order to explore the answer to the question if there is sound banking system in Pakistan and prospect of operating sound banking system in Pakistan.

CHAPTER 1:
THE ROLE OF LAW IN DEVELOPING A SOUND BANKING SYSTEM

1.1. INTRODUCTION

There is no agreed definition of a sound banking system. A system that can be equated to a sound and stable banking system referred and discussed by the Sri Lanka Central Bank's Pamphlet series number two[44] that describes a banking system's stability as:

> "the resilience of the banking system to internal and external shocks, be it economic, banking, political or otherwise. Sound Banking System can also be described as the absence of macroeconomic costs of disturbances in the system of financial exchanges between households, businesses, and financial institutions. Financial system stability is evidenced by and reflected through (i) an effective regulatory infrastructure, (ii) effective and well-developed financial markets and (iii) effective and sound financial institutions".[45]

The Basel Committee on Banking Supervision and role of corporate governance for banking organisations, where recognised the special role that banks play in maintaining a stable economy it also put emphasis on requirements of strong corporate governance for the effective banking system:

> "Banks are a critical component of any economy. They provide financing for commercial enterprises, basic financial services to a broad segment of the population and access to payments systems. In addition, some banks are expected to make credit and liquidity available in difficult market conditions. The importance of banks to national economies is underscored by the fact that banking is virtually universally a regulated industry and that banks have access

[44] 'Financial System Stability'(October 2005) Pamphlet Series 2 Central Bank of Sri Lanka https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/publications/Banking%20System%20Stability%20%282005%29.pdf> accessed 05 July 2021

[45] Charles Goodhart, The Basel Committee on Banking Supervision: A History of the Early Years 1974–1997 (Cambridge: Cambridge University Press, 2011)

> to government safety nets. It is of crucial importance therefore that banks have strong corporate governance.” [46]

The practical issues faced by banking lawyers have also changed significantly: the days where banking law was dominated by issues over cheques and other bills of exchange are gone, and modern litigation now involves a wide spectrum of claims, from the mis-selling of derivatives[47] to other banking products, and claims involving fraud and money laundering.[48]

In many respects, the financial crisis of 2007–2009 resembled those that came before: it followed a period of excess borrowing and easy lending, which fuelled rapidly rising asset prices, especially in the housing sector, and ended in a series of bank failures. However, these crises also reflected important changes in the financial system: the majority of financing for the asset price bubble remained outside the regulated banking system. By the mid-2000s, many nonbank firms had accumulated vast pools of cash that were too big to invest in insured bank deposits. In search of safe places to put this cash, firms turned to structured investments and very short-term funding vehicles, including commercial paper, money market funds and repurchase (“repo”) agreements.[49] A “shadow banking” system thus emerged outside regulated institutions; none of its individual components necessarily made for systemic risk. However, when they came together, the result had the fragilities of conventional banking that was prone to investor runs and asset fire sales without the oversight or the safety net. [50]

The Basel Committee on banking supervision has laid down capital adequacy rules. These rules are, however, criticized for their arbitrariness and potential inflexibility. In the face of the possibility of a worldwide systemic crisis the lender of last resort function still remains largely the endeavour of national central banks. The issues, whether emergency liquidity assistance should be provided not only for banks but also for other financial intermediaries and whether the lender of last resort function should be provided at the international level remain heavily debated.[51]

[46] Basel Committee on Banking Supervision 'Enhancing Corporate Governance For Banking Organisations' (BCBS, 1999), para.8.
[47] Edwards S, Legal principles of derivatives, J.B.L. 2002, Jan, 1-32
[48] Wadsley J, Painful perceptions, and fundamental rights - anti-money laundering regulation and lawyers Comp. Law. 2008, 29(3), 65-75
[49] Z. Poszar, “Institutional Cash Pools and Triffin Dilemma of the US Banking System,” IMF Working Paper, WP/11/190 (2011)
[50] G. Gorton and A. Metrick, “The Financial Crisis of 2007—2009,” Working Paper (April 18, 2012).
[51] Cecchetti (n.10) p.972

The regulation of banking and financial markets is becoming the major challenge for public authorities due to increased competition between financial institutions are fading, financial innovations are multiplying off balance sheet activities, and internationalisation is rendering the control by national authorities more and more difficult.[52] The goal of banking regulation and supervision is often explicitly stated as to prevent banks from assuming unacceptably high risks which may endanger the interests of creditors, that is, deposit holders and savers in general.[53] Thus, the regulatory structure of banking institutions, even though not forming part of the banking structure directly, plays a crucial role, i.e., that of monitoring and regulating a banking system.[54] This is primarily done by Federal Banks or Central Banks depending on the jurisdiction.[55] We have discussed the role of the State Bank of Pakistan, in chapter 2 and in chapter 6, to introducing and implementing banking reforms and capital adequacy rules.

Banks specifically are faced with a two-sided asymmetric information problem; borrowers may fail on their repayment obligations rendering the poor quality of loan portfolio. On the liabilities side savers and investors may withdraw their funds on short notice. Banks cannot observe true liquidity needs of depositors. A true liquidity risk arises when depositors collectively decide to withdraw more funds than the bank has immediately available. It will force the bank to liquidate assets probably at a loss. A liquidity crisis may then also endanger the solvability of the bank and eventually lead to its bankruptcy.[56] Therefore, financial regulations are designed to contain a whole framework for controlling the volume of money in circulation by way of monetary policy instruments.

According to Kaminsky and …., the effect of a banking crisis in an economy is usually so severe that economic growth would normally resume after about one to three years after the onset of a banking crisis.[57] There can be an extensive decline of output in a banking sector and sometimes the output remains below its pre-crisis period even though the economy stretches through its survival. This has a long-term impact on the economy, GDP, and the banking sector

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[52] Hermans D, Regulation of Banking and Financial Markets at pg.950
[53] Cecchetti (n.10) p 951
[54] Goodheart C A E, The Changing Role of Central Banks BIS Working papers No. 326 November 2010 accessed on 05 July 2021
[55] Spong, Kenneth, (2000), Banking regulation: its purposes, implementation, and effects, Federal Reserve Bank of Kansas City
[56] Cecchetti (n.10) p 958
[57] Kaminsky Graciela,L. & Carmen M.Reinhart, 'The Twin Crises: The Causes of Banking and Balance-of-Payments Problems' (1999) vol 89(3) American Economic Review 473- 500 accessed 15 September 2019

in general. Cerra and Saxena, in this context, have discussed that, the output stayed about 7 per cent below the pre-crisis trend even ten years after a banking crisis had occurred.[58] IMF has also shown that the banking sector has a direct impact on both the reduction of employment and capital and hence should be managed in an economically sound and sustainable manner.[59]

The law, irrespective of its source (i.e., legislation or precedent or customs or international treaties or international organisations or international law), plays a fundamentally crucial role in establishing, maintaining, and developing a sound banking system. Financial system's stability is evidenced by and reflected through (i) an effective regulatory infrastructure, (ii) effective and well-developed financial markets and (iii) effective and sound financial institutions.[60]

The banking industry is a very crucial industry in any economy due to fundamental role it plays in all the modern economies of the world. Many regulatory developments have developed liberalisation of the banking sector and advancements in the financial world; however, some weaknesses still persist that make the banking sector more susceptible to systemic risks and increasingly more fragile.[61]

The Basel Committee on Banking also recognised a special role of banks: "Banks are a critical component of any economy. They provide finance to commercial enterprises, basic financial services to a broad segment of the population and access to payments systems. In addition, some banks are expected to make credit and liquidity available in difficult market conditions. It is of crucial importance therefore that banks operate a strong corporate governance system."[62]

The effect of a banking crisis does not contain itself within national boundaries and, as has been seen recently, a subprime mortgage system that started in the United States rapidly

[58] Cerra, Valerie & Sweta Chaman Saxena, 'Growth Dynamics: The Myth of Economic Recovery' (2008) vol 98 (1), American Economic Review 439-457< https://www.aeaweb.org/articles?id=10.1257/aer.98.1.439 > accessed September 2019

[59] 'World Economic Outlook', Sustaining the Recovery (October 2009) vol28 World economic outlook (International Monetary Fund0251-6365) <
<https://www.imf.org/~/media/Websites/IMF/imported-flagship.../2009/.../_textpdf.ashx> accessed August 2019

[60] SG Cecchetti and KL Schoenholtz, Money Banking and Financial Market (4th edn, McGraw-Hill Education 2015)

[61] Sony Kapoor, 'A simpler, smaller, safer, more diverse and more stable banking system is what we need' (2009) The Future of Finance, What is a good banking system? <www. re-define. Org>. < www. http://re-define.org/sites/default/files(2).pdf> accessed September 2019

[62] Basel Committee on Banking Supervision, "Enhancing Corporate Governance for Banking Organizations" (Bank of International Settlements, 1999), http://www.ecgi.org/codes/documents/basel_committee.pdf [Accessed October 2010].

developed into a destructive force that shook the global banking sectors and economies to the core.[63] Therefore, the regulatory structure of banking institutions, even though not forming part of the banking structure directly, has an indispensably crucial role, that of monitoring and regulating the system.[64] This is primarily done by Federal Banks or Central banks depending on the jurisdiction.[65]

1.2. ROLE OF LAW IN A SOUND BANKING SYSTEM

The law irrespective of the origin of its source plays a fundamentally crucial role in establishing, maintaining, and developing a sound banking system. In modern states, law serves three critical governance roles. First, it is through law and legal institutions that States seek to order the behaviour of individuals and organisations so that the outcome of the economic and social policies is achieved. Second, law defines the structure of government by ordering power, that is, establishing and distributing authority and power among government actors and between the state and citizens. And third, law also serves to order contestation by providing the substantive and procedural tools needed to promote accountability, resolve disputes peacefully, and change the rules.[66]

The role of law as a system for structuring the power's exercise by monetary authorities has changed. The paradigm shifts for interventions of central banks in currency management, from an action manipulated and controllable by administrative rules (rule-based instruments) to an action in which these institutions operate primarily as participants in open market operations (market-based instruments).[67]

Alexander relies on the notion of externalities (which is generally accepted in economics) to state that

> "Financial regulation is necessary to control systemic financial risks; Without

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[63] Charles W. Calomiris, "The Subprime Turmoil: What's Old, What's New, and What's Next, Paper presented at the 9th Jacques Polak Annual Research Conference, Hosted by the International Monetary Fund Washington, D.C., November 13-14, 2008, at http://www.imf.org/external/np/res/seminars/2008/arc/pdf/CWC.pdf [Accessed October 15, 2010]

[64] Charles AE Goodhart, 'The Changing Role of Central Banks' (2011) 18(2) Financial History Rev Financial Markets Group 35, 135-154 <www.bis.org/events/conf100624/goodhartpaper.pdf> accessed 09 January 2020.

[65] Kenneth Spong, 'Banking Regulation', Its Purposes, Implementation, and Effects, Division of Supervision and Risk Management, (fifth edn, 2000) Federal Reseve Bank of Kansas 1-281 <https://www.kansascityfed.org/publicat/bankingregulation/RegsBook2000.pdf >accessed 15 September 2019

[66] https://openknowledge.worldbank.org/bitstream/handle/10986/25880/9781464809507_Ch03.pdf?sequence=35

[67] Bernard J. Laurens, Monetary policy implementation at different stages in market development IMF Occasional Paper (2005) 244, International Monetary Fund.

> regulation, the externalities caused by systemic risk would amount to a tragedy of the commons, as the motivation of market participants is to protect themselves but not the financial system or commons. Thus, even if market participants were able to act collectively to protect the financial market commons by controlling systemic risk, they might not choose to do so as the externalities of systemic failure include social costs that are not fully incurred by market participants but, rather, are imposed on other third parties in society at large."[68]

Therefore, the role of law takes a step further, i.e., from conceiving instrumental rules for policy actions (ex-ante regulation) to establishing legal mechanisms to render discretionary actions accountable (a model of ex post regulation). Lord Denning observed,

> "If we never do anything which has not been done before, we shall never get anywhere. The law will stand still whilst the rest of the world goes on; and that will be bad for both".[69]

The legal structure for an accountability relationship is ex-post since it constitutes the assessment of an act (or of its omission) that was already implemented by the monetary authority. Even if it takes into consideration previous parameters for a central bank's behaviour, this ex-ante element has properly a cognitive nature. In turn, the accountability's legal relationship implies the scrutinization of a discretionary action, based on parameters previously defined by a normative instrument. Furthermore, if monetary regulation is constituted as a process (a deferred exercise of power by central banks), the legal system for the policy's evaluation and judgement would also match its design, namely, a sequence of procedures.[70]

Law and regulation are being moulded constantly by the interaction between structure, content, form, and ideology to provide just outcomes on an individual basis whilst delivering universal norms, and the elements in this equation can ebb and flow. Differential levels of power relations inevitably impact on these processes, shaping and sometimes distorting the legal structures that are produced.[71]

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[68] Kern Alexander, Principles of Banking Regulation (Cambridge: Cambridge University Press, 2019). Pg. 45

[69] Packer v Packer [1954] P. 15; [1953] 3 W.L.R. 33; [1953] 2 All E.R. 127

[70] Marie-Anne Frison-Roche, Le couple ex ante-ex post, justification d'un droit propre et spécifique de la régulation in Marie-Anne Frison-Roche (ed), Les engagements dans les systèmes de regulation (Paris: Dalloz, 2006) p.34).

[71] R. Posner, Overcoming Law (Harvard University Press, Cambridge, MA, 1995).

Law and regulation are reflexive in that, as they contribute to the construction of the social world, they are simultaneously being constructed by that social world. One example of this process is the continuing interaction between a jurisdiction's contemporary legal culture and the production of its legislative instruments. This notion of law being "worked upon" by the social actors it affects has been researched extensively by McBarnet, who argues that law is a facilitative structure available for use and manipulation:

> "if law is in the interests of capital, it is not simply because it is handed over by predetermined structures, however complex or by a captive state, but because of continuous work upon it on a day-to-day pragmatic basis to try and make it fit the specific, dynamic, and sometimes conflicting interests of the moment … Lawyers are not just translators, but transformers and transcenders of the law … What is more, they are legal entrepreneurs, routinely "making law" by establishing legal practice … practical lawyers are always working in someone's interests. Given market forces … that clientele is dominated by private and corporate capital."[72]

The following paragraphs examines different areas of law and their application and relevance with the banking system in four jurisdictions:

1.2.1 Company Law

The financial services sector has received much academic and technocratic attention from a company law perspective, but this analysis has not prioritised the broader social, political, and cultural context within which company law has developed. This is not a huge surprise because company law "is a web of law, not susceptible to analysis as a sequence".[73]

The banks are corporate entities. The model of the company itself obviously lies at the heart of company law and contractual theory sees the company as a free agreement amongst shareholders. Real entity theory perceives the company as existing separately from

[72] D. McBarnet, "Law and Capital: The Role of Legal Form and Legal Actors" (1984) 12 International Journal of the Sociology of Law 231-238 at 233.
[73] D. Wishart, Company Law in Context (Oxford University Press, Auckland, 1994), p. xi.

shareholders.[74] The managerial theory of company law is influenced by economics and emphasises the role of company managers in the control of a company.[75] Autopoietic theory analyses company law as issues of self-referentiality.[76] This perspective stresses the capacity of companies for self-organisation and self-reproduction through their own action systems, and company law continually reproduces itself from its own genetic material.[77] Concession theory perceives the incorporation of the company as a concession from the state and therefore it gives justification for state intervention into corporate affairs in order to protect the public interest.[78] In the 1980s, the new economic theory of the firm evolved which prioritised contractual notions and the influence of "transaction cost engineers" such as investment bankers and financial entrepreneurs.[79] The communautaire theory of company law spreads issues of corporate governance and control between different stakeholders in a company.[80]

1.2.2 The Financial Services & Market Act 2000 & other laws in the United Kingdom

In the immediate aftermath of the financial crisis, Sir David Walker under the then British Prime Minister Gordon Brown's directions conduct a review of bank corporate governance in 2009; his final recommendations were published[81] for the structure and composition of the board of a bank. These recommendations were incorporated into the regulations for banks by the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) and the UK Corporate Governance Code 2018. These same requirements are adopted as a significant part of the European Banking Authority's "Guidelines on Internal Governance".[82]

The UK Houses of Parliament Commission proposed a new regime of personal responsibility and liability for senior management in the financial sector which was adopted in legislation.[83] Sections 66A & 66B were added in Financial Services and Markets Act 2000 by the Financial

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[74] M. Stokes, "Company Law and Legal Theory", in S. Wheeler (ed.), The Law of Business Enterprise: Selected Essays (Oxford University Press, Oxford, 1994), pp. 80-116 at pp. 89-90.
[75] A. Berle and G. Means, The Modern Corporation and Private Property (Macmillan, New York, 1932).
[76] S. Wheeler, "Introduction", in S. Wheeler (ed.), Company Law (Dartmouth, Aldershot, 1993), pp. xi-xxi at p. xi.
[77] G. Teubner, "Enterprise Corporatism: New Industrial Policy and the "Essence' of the Legal Person", in Wheeler, n. 15 above, pp. 3-28 at pp. 6 and 8.
[78] Basel Committee on Banking Supervision 'Enhancing Corporate Governance For Banking Organisations' (BCBS, 1999), p. 7.
[79] W.B. Bratton Jr, "The New Economic Theory of the Firm: Critical Perspectives from History", in Wheeler, pp. 117-179.
[80] J. Dine, "Models of Companies and the Regulation of Groups", in B.A.K. Rider (ed.), The Corporate Dimension (Jordans, Bristol, 1998), pp. 287-301.
[81] David Walker, "A review of Corporate Governance in UK banks and other financial industry entities: Final Recommendations" (November 2009).
[82] European Banking Authority, "Guidelines on internal governance", EBA/GL/21/03/2018.
[83] House of Lords and House of Commons, Changing Banking for Good (Report of the Parliamentary Commission on Banking Standards) (June 12, 2013).

Services (Banking Reform) Act 2013 ss.66A, 66B making senior persons in banks to personally liable for misconduct if such persons contravene the Code of Conduct applicable to them. Senior management must be approved with a statement of responsibilities and the failure to carry on such responsibilities also means that specific liability will be attached to the relevant senior person. The Act also allows the Prudential Regulation Authority, Financial Conduct Authority, Secretary of State or Director of Crown Prosecutions to institute criminal proceedings against senior management who have knowingly taken a decision for the business, despite risk, that has fallen below the standard of a reasonable person in his shoes.

The aim of AML regulation is to encourage participants in the system to behave as custodians and guardians of the public interest in preventing money laundering.[84] The various "gatekeeper strategies" are consolidated in the Proceeds of Crime Act 2002 (POCA) and the Money Laundering and Terrorist Financing (Amendment) Regulations 2019 (AML Regulations). Banks are mandated multiple roles: they are "bouncers" performing customer due diligence and "know your customer" upon individuals or firms opening an account and they are also chaperones with a duty to monitor their customers' transactions on an ongoing basis. A bank is mandated to cease transactions going through a customer's account and terminate any business relationship with the customer where it is unable to apply customer due diligence measures. A bank could be liable for primary offences under three different sections of POCA: under s. 327 (1) (c) a bank can be criminally liable for converting criminal property; s. 328 makes a bank criminally liable if "it enters into or becomes concerned in an arrangement which it knows or suspects facilitates (by whatever means) the acquisition, retention, use or control of criminal property by or on behalf of another person"; s. 329 operates in cases of acquiring and possessing money over £250 that can be categorised as criminal property. In addition, s.330 imposes disclosure obligations, "whistle-blower strategy", that compels a bank that knows or suspects or has reasonable grounds for knowing or suspecting that another person is engaged in money laundering to disclose its suspicion to the authorities. To avoid liability of a principal money-laundering offence, banks can make an authorised disclosure by submitting a Suspicious Activity Report (SAR) and seek appropriate consent from the authorities to do a prohibited act, i.e., to comply with their customer's instructions.

The inefficiency of banks' gatekeeping role forms the lion's share of UK banks' conduct costs

[84] M. Steward, "The Importance of Purposeful Anti-money Laundering Controls" https://www.fca.org.uk/news/speeches/importance-purposeful-anti-money-laundering-controls [Accessed November 2022]

and the fines for non-compliance can be substantial.[85] This has significant explanatory power for the high-profile cases which reveal a cost-benefit approach of banks to potential legal sanctions and costs.[86] In March 2021, the FCA brought the first prosecution against a bank under the AML regulatory regime.[87] This prosecution signals a shift in the FCA enforcement approach which now pursues a dual track, i.e., simultaneous civil and criminal enforcement routes. Burrows J in The Federal Republic of Nigeria v JP Morgan Chase Bank NA[88] was strongly inclined to the view that there was an additional duty on the bank to make reasonable enquiries to ascertain whether or not there is substance to those reasonable grounds. In analysing the suitability of such duty, he noted that: "in the fight to combat fraud, banks with the relevant reasonable grounds for belief should not sit back and do nothing. Moreover, the duty of inquiry on banks would not be unduly onerous because it would always be limited by what an ordinary prudent banker would regard as reasonable enquiries in a situation where there are reasonable grounds for believing that the customer is being defrauded."[89]

1.2.3 Regulatory Approaches, legislations & Developments in the USA

The United States legislative power, since the creation of the first American central bank, has positioned itself as the principal agent, by delegating authority to the central bank and being responsible for its accountability. The American Congress, in order to achieve this, has inherent power to ensure the central bank's accountability and reports.[90] The Federal Central bank's return in 1913 with the Creation of the Federal Reserve Banking system.[91] The Federal Reserve was granted the power to issue Federal Reserve Bank Notes. One of the major purposes of the Federal Reserve Banking system was to make sure that it would never be necessary to close a United States bank.[92] However, the monetary policy implemented by the Fed during the time of the Great Depression actually magnified the problem causing more banks than necessary to fail.[93] The American Congress has relevant institutional resources: the possibility to amend

[85] FCA's largest AML penalty to date was issued in 2017 to Deutsche Bank, £163,076,224: https://www.fca.org.uk/publication/final-notices/deutsche-bank-2017.pdf [Accessed November 2022].
[86] C. Matthew, "What the FinCEN Leaks Revel about the Ongoing War on Dirty Money", Brookings, September 2020
[87] Based on reg.45 of the Money Laundering Regulations 2007 (SI 2007/2157). M. Steward, "Partly Contested Cases, The Pipeline and AML Investigations" (London: Global Investigations Review Live event, 4 April 2019); N. Megaw and C. Binham, "FCA Brings Money Laundering Charges Against NatWest", Financial Times, 16 March 2021
[88] [2019] 1 C.L.C. 207
[89] Burrows (n 88) 30
[90] Federal Reserve Act ss.2B, a, b; 10(7); 10(10); 10B(b), 2H.
[91] The Federal Reserve Act (Ch.6, 38 Stat. 251, enacted December 23, 1913, 12 U.S.C. Ch.3).
[92] The Federal Reserve Act (Ch.6, 38 Stat. 251, enacted December 23, 1913, 12 U.S.C. Ch.3).
[93] Lawrence M. Stratton and Paul Craig Roberts, "The Fed's 'Depression' and the Birth of the New Deal", Policy Review, 2001, No. 108 at http://www.hoover.org/publications/policy-review/article/6214 [Accessed August 2022].

Federal's legal basis, as well as various regulatory provisions that ensure with some frequency the central bank accountability.[94] In historical moments of crisis, like the 1970s and post 2008, the Congress majority composes itself in order to create new statutes to scrutinise monetary authority powers.

In the aftermath of the Great Depression bank regulation was a high priority. With the crash of the stock market, runs on banks and the subsequent closing of over 5,000 banks between the crash and March 1933.[95] In 1933, Congress passed the Glass-Steagall Act of 1933[96] to restore confidence and order to the United States banking system. One of the main areas of regulation in this act was the prohibition of combining commercial banking, investment banking, and insurance companies in one financial institution which was thought to be a major contributing factor to the market crash and bank closings. From 1933 through 1999 this Act was technically in force however, Glass-Steagall only applied to Federal Reserve member commercial banks. Banks could avoid the act by either not being a member bank or giving up membership.

The banking regulations established during the crisis of the 1930s in which banks gained government support in exchange for stricter regulatory supervision created the most stable financial sector in US history for over 50 years. However, beginning in the 1970s, banks began successive efforts to dismantle the regulatory structure in order to seek higher profits through a wider variety of investments.[97]

According to Borio," … financial busts and an aggressive and prolonged monetary response to them can undermine the central bank's independence. If central banks engage in extensive balance-sheet policy, that independence will come under threat even earlier."[98] But history has proven that deregulation results in economic disaster. For example: In 1982, the savings and loan institutions nicknamed "thrifts" were deregulated resulting in a push by the thrifts into risky investments such as "junk" bonds and questionable real estate transactions to increase their profits.[99] These investments collapsed in the mid 1980s, almost 300 thrifts failed and the

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[94] Federal Reserve Act ss.2B, a, b; 10(7); 10(10); 10B(b), 2H
[95] David M. Kennedy, Freedom from Fear, The American People in Depression and War, 1929–1945 (1999), pp.162–163
[96] Banking Act of 1933 (also known as the Glass-Steagall Act of 1933), (Pub.L. 73-66, 48 Stat. 162, enacted June 16, 1933).
[97] Simon Johnson and James Kwak, 13 Bankers: The Wall Street Takeover and the Next Financial Meltdown (2010), pp.36–37
[98] Claudio Borio, Central banking post-crisis: what compass for uncharted waters? BIS Working Paper (2011) 353, Bank for International Settlements p.6.
[99] Matthew Bishop and Michael Green, The Road from Ruin: How to Revive Capitalism and Put America Back on Top (2010), p.87

final cost to the taxpayers for the government to clean up the problem was USD $125 billion. The Gramm-Leach-Bliley Act of 1999 (GLBA)[100] repealing Glass-Steagall ended the 1930s approach to regulating banks by ending the separation of banking, investment, and insurance activities in the banking industry. The deregulation of the banking industry, lax administration of the remaining regulatory restrictions and the evolution of the unregulated shadow banking system, set the stage for the financial crisis of the 2000s.[101]

The most recent financial crisis then led to a new round of banking regulation. On July 21, 2012, President Obama signed into law the Dodd-Frank Act[102] to ensure prevention of the return of the banking crisis by introducing regulatory reforms and new laws such as Bank and Savings Association Holding Company and Depository Institution Regulatory Improvements Act 2010 and The Bank and Savings Association Holding Company and Depository Institution Regulatory Improvements Act 2012. These Acts represent a significant overhaul of the current and future regulatory landscape in the United States. The Dodd-Frank Act implements numerous and far-reaching changes that affect financial companies, including banks and bank holding companies. The Dodd-Frank bill that was enacted into law was over 2,000 pages and consisted of 16 sections that contained only a limited framework for the creation and implementation of rules. Many of the requirements outlined in Dodd-Frank were the creation of new financial regulatory agencies and the expansion of the roles and responsibilities of current regulators.

These Acts also imposed limitations on bank shareholder investment in proprietary investments, banks investment in Hedge funds, Insured State chartered bank investment in derivative transactions and increased bank capital requirements. Dodd-Frank further created the Financial Stability Oversight Council (FSOC). The FSOC is composed of ten voting members that include the Secretary of the Treasury, and the Chairman of the Federal Reserve. The FSOC is charged with overseeing the entire financial system. The Council's purpose includes enhancing market efficiency and stability, promoting market discipline by the elimination of expectation that the government will bail out inefficient companies, and proactively responding to emerging threats to the stability of the United States Financial Markets.

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[100] Financial Services Modernization Act of 1999 (also known as Gramm-Leach-Bliley Act of 1999), (Pub.L. 106–102, 113.1338, enacted November 12, 1999).
[101] Paul Krugman, The Return of Depression Economics, and the Crisis of 2008 (2009), pp.158–162.
[102] Dodd-Frank Wall Street Reform and Consumer Protection Act Pub.L., 111–203, H.R. 4173, enacted July 21, 2010

The Wall Street Transparency and Accountability Act of 2010, another of the Dodd-Frank Acts, offers a mechanism to regulate Credit Default Swaps and Credit Derivatives. Under this Act, the Commodities Futures Trading Commission and the Securities and Exchange Commission are charged with the regulation of these transactions. Part of this derivatives regulation dealt with how these security transactions would clear through the financial markets.[103] The US Congress created political mechanisms for accountability, initially through the Emergency Economic Stabilisation Act of 2008 which in its section129 obligated the Federal board of governors to submit the updated reports to the Congress on financial assistance granted under the Federal Reserve Act s.13(3).

1.2.4 The European Union – Single Banking Market & European Central Bank

In the EU, the First Banking Directive in 1977 represented a remarkable progress, as it allowed banks to establish branches in other Member States, after applying the freedom of establishment by the Treaty of Rome (art.43). Even though the Member States under this Directive maintained their local authorisation, it was a significant step towards harmonisation and cooperation between Member States in the banking sector.[104] Since then, a number of changes and legislative activities have been made so that the single market is created in the financial services. All the progress made towards the single banking system is outlined in this thesis, so as to end in the current situation and the conclusion on whether the single banking objective has finally been accomplished.

In 1992 the Maastricht Treaty introduced a significant change not only for the European countries but for banking law as well. Several Member States agreed to change their own monetary policy in order to participate in common policy within the European Union.[105] This change has been incredibly important for the establishment of an internal system in financial services, as the countries would no longer be able to control the exchange rate for their own benefit.[106] As for the banking sector specifically, the EMU eliminated the transaction costs, and the banking services became much easier. The common monetary policy is conducted by

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[103] ” Derivatives” at http://www.sec.gov/spotlight/dodd-frank/derivatives.shtml [Accessed July 2021].
[104] E. P. Ellinger, Ellinger’s Modern Banking Law, 4th edn (Oxford University Press, 2009) p.54
[105] N. Murphy, “European Union Financial Developments: The Single Market, the Single Currency, and Banking” (2000) 13 FDIC Banking Review
[106] R. Dixon, Banking in Europe, The Single Market (Routledge, 1991) p.110

the European Central Bank in association with the national banks of the Member States participating in the EMU.[107] However, the EMU also introduced a development in the banking supervision system: namely, a financial regulator is in charge of the banking supervision, while the national authorities supervise only the monetary policy.[108] The main purpose of the common monetary policy is to maintain price stability and the European Central Bank is responsible to serve this purpose. It is generally acceptable that the single currency contributed to the creation of a single banking system to a great extent.[109]

In 1999, the European Commission published a "Financial Services Action Plan", which contained 42 measures for the purpose of a single banking market and set as a timetable for its adoption the year 2005.[110] It was a legislative and regulatory program, the purpose of which was to remove the barriers for the cross-border function of financial institutions.[111] The banking market established with the White Paper for EC1992 as part of the single market, despite claims, was not completely established. In May 2010 Mario Monti in his report[112] for the European Commission expressed the opinion that the internal market has not been completely established and several measures remain to be taken. More specifically, in the financial sector, Monti mentioned that the Member States showed the tendency to follow their own regulation and supervision of the banking services, and this led to delays regarding the adoption of a single banking policy.[113] Dragomir also highlighted that the financial crisis of 2008 revealed the gaps in the process for the implementation of a single banking market. Indeed, the economic crisis was a difficult test for the banking services; several legislative measures were considered to have failed, whereas the European Union regulators' first reaction to the crisis was to resort to new developments in the legislative framework.[114] Despite the desire of the Member States to succeed in the integration of the banking market, the measures implemented until 1993 were not useful to serve this purpose and the gaps became obvious during the crisis.[115]

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[107] D. Chalmers, European Union Law, 2nd edn (Cambridge, 2010) p.714-715
[108] L. Panourgias, Banking Regulation and World Trade Law, GATS, EU, and "Prudential" institution Building (Hart Publishing, 2006) p.160
[109] N. Murphy, "European Union Financial Developments: The Single Market, the Single Currency, and Banking" (2000) 13 FDIC Banking Review.
[110] L. Dragomir, European Prudential Banking Regulation and Supervision, The legal dimension (Routledge, 2010) p.87.
[111] W. Fonteyne, "EU: From Monetary to Financial Union", 43 Finance and Development, magazine of the Internation Monetary Fund, June 2006.
[112] M. Monti, "A New Strategy for the European Market: at the Service of Europe's Economy and Society" Report to the President of the European Commission José Manuel Barroso [2010].
[113] European Banking Authority, "Guidelines on internal governance", EBA/GL/21/03/2018.
[114] L. Dragomir, European Prudential Banking Regulation and Supervision, The legal dimension (Routledge, 2010) p.35.
[115] J. Pelkmans, "Single Market: Deepening and Widening over Time", for the forum "The European single Market-How Far from Completion?" [2011] Intereconomics, Review of European Economic Policy Vol.46 issue 2, March-April

1.2.5 Contribution of International Institutions – Soft Law

In addition to the national authorities, the international soft law institutions including FSB Basel Committee, the Committee on the Global Financial System, Committee on Payment and Settlement Systems, Financial Action Task Force on Money Laundering, International Association of Deposit Insurers, IAIS, International Accounting Standards Board, International Auditing and Assurance Standards Board, IMF, IOSCO, OECD and World Bank are key players of setting standards to be followed by national authorities.[116] These international soft law institutions lead and govern the direction of policy development in international banking by providing standards or regulatory guidance covering the "economic and institutional sectors such as the government and central bank, banking, securities, insurance industries and the corporate sector."[117]

The Basel accords on their own lack force of law and their implementation can only be made through international and national legislation and regulations. The Capital Requirements Directive (CRD) IV, the Capital Requirements Regulation (CRR), as well as an extensive set of Regulatory Technical Standards, are all aimed at implementing Basel III in the EU.[118] CRD IV not only made the content of the Basel III requirements directly binding and enforceable across EU member states, but also introduced Binding Technical Standards that ensure a uniform approach. This approach vastly differs to the one taken for Basel II, which had resulted in two directives (2006/48 and 2006/49).[119] The implementation of CRD IV further ensures consistency and convergence across the EU in relation to corporate governance, information asymmetries and the treatment of liquidity risks. Basel III was introduced after the 2007 financial crisis implying that by then the need for high quality assets that could be converted into cash easily and readily had already become apparent. As a result, Basel III introduced additional liquidity standards. These standards are non-risk-based, and they comprise the Liquidity Coverage Ratio (LCR) with the objective of promoting short-term resilience for banks under stress conditions, the aim of which being to meet liquidity needs for a 30-calendar day liquidity stress scenario. In addition to that, the Net Stable Funding Ratio was aimed at

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[116] Financial Stability Board, "Who Are the Standard-Setting Bodies" at https://www.financialstabilityboard.org/cos/wssb.htm [Accessed July 2020].
[117] Financial Stability Board, "What Are Standards?" at https://www.financialstabilityboard.org/cos/standards.htm [Accessed July 2020]
[118] Crockett, "Marrying the Micro- and Macro-Prudential Dimensions of Financial Stability", Eleventh International Conference of Banking Supervisors (2000), Geneva
[119] Directive 2006/48 relating to the taking up and pursuit of the business of credit institutions and 2006/49 on the capital adequacy of investment firms and credit institutions.

meeting medium to long term funding requirements and is designed to be complementary to the LCR.

Transnational Regulatory Networks ("TRNs") is another source giving national authorities to legislate corresponding regulatory laws. TRNS involve dialogue among like-minded government officials because throughout the world, regulators experience or encounter the same or very similar regulatory problems.[120] TRNs operate through negotiation in a consensus-building informal process rather than in a traditional treaty-making process which is very formal. A TRN, comprised of central bankers, international policy makers (such as the Basel Committee and the FSB), practitioners and industry leaders, is a body that sets international regulatory standards based on shared knowledge and beliefs on particular technical issues. These networkers may generate certain regulatory prototypes (soft law) that can both reflect and guide the industry service providers' future behaviour in the area of banking and finance.[121]

TRNs and soft law dominate international financial regulation because "they provide some incentives for compliance while preserving the benefits of speed, flexibility and expertise".[122] The Basel III capital standards can be seen as a TRN solution being played out and tested by national central bankers. The Basel Committee suggested that "public consultation is an integral element of the Basel Committee's standard setting." It should be noted that the Basel Committee has positioned itself as merely providing "a forum for regular cooperation on banking supervisory matters," meaning where standard setting is concerned, its objective is to: "enhance understanding by banking regulators as well as the subject of their regulation of key supervisory issues and improve the quality of banking supervision worldwide".[123]

The soft law law-making institutions such as the Basel Committee, the FSB and, to some extent, even the IMF all play a substantial role in influencing domestic legislation policy.[124] Soft law regulatory product is "often seen as a steppingstone to hard law, permitting states to begin cooperation informally when they fear the impact of a fully legally binding

[120] Sungjoon Cho and Claire R. Kelly, "Promises and Perils of New Global Governance: A Case of The G20" (2012) 12(2) Chicago Journal of International Law 491, 500–501
[121] Sungjoon Cho and Claire R. Kelly, "Are World Trading Rules Passé" (2013) 53(3) Virginia Journal of International Law 623, 627
[122] Pierre-Hugues Verdier, "The Political Economy of International Financial Regulation" (2013) 88(4) Indiana Law Journal 1405, 1407
[123] Basel Committee on Banking Supervision, "Monetary and Financial Stability" at http://www.bis.org/bcbs/ [Accessed July 2022]
[124] Lawrence G. Baxter, "Capture Nuances in Financial Regulation" (2012) 47(3) Wake Forest Law Review 537, 543, 558 (original fnn.21, 89).

commitment".[125]

Soft law dominates international finance in the interest of making and developing international financial regulatory norms[126] because soft law financial regulations provide "guidelines" which are an important tool for fostering convergence of supervisory practices, across all participants in the TRN.[127] The soft law model invites participation from multiple countries, multiple levels of policy makers, and multiple market players, sidestepping concerns about the feasibility and legitimacy of a world government. Moreover, soft law instruments benefit from the collective knowledge of industry experts. Transnational regulatory networks rely on independent agencies from around the world, which focus on technical regulatory priorities rather than political agendas.[128] Collective decision-making is the hallmark of legislative governance. Operational methods of TRNs rely mostly on group consensus and, if required, peer pressure. In light of this, TRNs may contribute to the economic, political, and financial interests of Basel member countries and may exert pressure or influence in the construction and implementation of international agreements or guidelines by introducing and promoting the new Basel III capital requirements.[129]

1.2.6 Laws governing the Banking System of Pakistan

It is discussed in chapter 2 and chapter 6 that international institutions have obligated Pakistan to adopt soft law in particular Basel Accord in banking regulations. Basel I adoption in Pakistan was also a result of IMF and World Bank conditionality, over the course of the late 1980s and 2000s, Pakistani politicians, whether civilian or military, increasingly shifted away from prioritizing state-led industrial development, to embrace a more international orientation and championing financial services exports in particular. By 2007/8, however, the situation dramatically reversed, with the domestic banks taking the lead on adoption, while the SBP lost some of its steam after international financial standards were discredited in Pakistan for failing to stop the global financial crisis. The banks understood the need to comply with international

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[125] Sungjoon Cho and Claire R. Kelly, "Promises and Perils of New Global Governance: A Case of The G20" (2012) 12(2) Chicago Journal of International Law 491, 515

[126] Chris Brummer, "Why Soft Law Dominates International Finance and Not Trade" (2010) 13(3) Journal of International Economic Law 623–643

[127] European Banking Authority, "Implementing Basel III Europe: CRD [which stands for Capital Requirement Directive] IV package" at http://www.eba.europa.eu/regulation-and-policy/implementing-basel-iii-europe [Accessed July 2022]

[128] Stavros Gadinis, "The Financial Stability Board: The New Politics of International Financial Regulation" (2013) 48(2) Texas International Law Journal 157, 162

[129] Timothy Meyer, "From Contract to Legislation: The Logic of Modern International Law Making" (2014) 14(2) Chicago Journal of International Law 559, 571

standards as a vital signalling mechanism to preserve their global position. For its part, although the SBP was less zealous about Basel III than it had been about Basel II, in order to compensate for Pakistan's FATF blacklisting, it not only went ahead with Basel III adoption, but modified certain elements to make them even more stringent than the original standard.

The laws governing the banking system of Pakistan, viz., SBP Act, 1956, Banking Companies Ordinance, 1962 and Banks Nationalization Act, 1974 have been subject to a number of changes to give exclusive authority to The State Bank for regulating the banking sector, conducting an independent monetary policy, and setting limit on Government borrowings from the Bank. A bill, passed in February 1994, amended The State Bank of Pakistan Act, 1956, in terms of which monetary policy was made the sole responsibility of The State Bank of Pakistan. More specifically, the Central Board of the Bank was given larger responsibility to regulate and supervise the monetary and credit system keeping in view the national policy objectives of the Government. The relevant sections of the banking laws are reproduced in chapter 6.

In 1997, services of an international consultant were acquired by the Bank to undertake an in-depth review of the banking supervisory system and monitoring techniques. The consultants recommended risk-based inspection of financial institutions and CAMELS (Capital, Asset quality, Management soundness, Earnings, Liquidity & Sensitivity to other risks) system of off-site surveillance. The training of Bank officials (both in the country and abroad) and up-gradation of information technology system is a continuing process for effective implementation of the consultant's recommendations. As part of the Banking Sector Reform Program, the following laws have been passed:

- Banking Companies (Recovery of Loans, Advances, Credits, and Finances) Act, 1997;
- Banks (Nationalization) Act, 1997 (Amendment);
- Banking Companies Act, 1997 (Amendment); and
- The State Bank of Pakistan Act, 1997 (Amendment).

Various amendments have also been made to the Banking Companies Ordinance of 1962 to enhance the effectiveness of The State Bank as a supervisory and regulatory body and to safeguard the interests of banks and depositors. Until 1997, there were two parallel systems of bank loan recovery courts: special banking courts, with jurisdiction over interest-based transactions; and banking tribunals, with jurisdiction over non interest based (or so-called Islamic) transactions.

To increase effective court capacity, the Government has established 34 banking courts, pursuant to the new law. The thrust of the 1997/98 reform program is to improve the environment for, and ability of, bank owners, bank management, bank regulators, the markets, and the courts to provide better governance and regulation in order to promote efficient financial intermediation. The reform program focuses on:

- speeding up the privatization of State-owned institutions, and assuring necessary restructuring
- and improved management;
- improving the legal and judicial process for enforcement of financial contracts;
- centralizing the regulatory authority in the SBP;
- strengthening the SBP's capabilities to perform its enhanced responsibilities; and
- improving prudential regulations and the supervision of financial institutions the Banking Companies (Recovery of Loans, Advances, Credits, and Finances) Act of 1997.

Attachment of collateral is permitted before judgement and appointment of a receiver. In cases where a bank is authorized to recover or take possession of the collateral without filing proceedings, the bank may, at its discretion, recover its loan by selling the collateral. An incentive package was offered to defaulter's vis-a-vis State-owned banks and financial institutions to voluntarily repay their overdue loans without facing legal action under the new law Efforts to reduce the stock of bad loans through vigorous recovery have also started. The Government and The State Bank launched a loan recovery program consisting of two phases. The first phase, from 5 June to 5 September 1997, was an amnesty program under which defaulters and "sick units" were given incentives to settle their overdue amounts. Cash settlement is typically 10 percent down payment, with the 90 percent balance due by 5 December 1997. Under this program, some 34,000 defaulters and 770 sick units with loans amounting to PRs28.5 billion and PRs34.4 billion, respectively, were covered. The law and regulation may be adequate to ensure that there is sound banking practice. The law provides for various obligations in banking such as capital requirements, disclosure, banking reporting, anti-money laundering and corporate governance to protect investors and depositors. By

complying with this requirement then it creates a practice of accountability in the banking sector.[130]

1.3 ESSENTIALS OF SOUND BANKING SYSTEM OTHER THAN LAW

In considering the essentials of a sound banking system other than law, we need to understand the range of core services as well as other indirect services that a banking system provides:

Current accounts: Otherwise known as cheque accounts, these are the most flexible accounts offered by banks and by some building societies. They provide security for customers' money, easy access to it and many other services such as direct debits, standing orders and the provision of foreign currency, but pay little or no interest on credit balances.

Deposit accounts: These accounts, also known as bank savings accounts or building society share accounts, are less accessible than current accounts, but still offer a very liquid i.e., accessible depository for money which might be needed in the near future. Rates of interest vary widely depending on the institution, the amount of money deposited and any special features such as a fixed term or notice period for withdrawals.

Mortgages and loans: Traditionally provided by both banks and building societies to finance the purchase of property and assets.

The main indirect services offered by banks and building societies include the following:

Portfolio management: Most high-street banks, but as yet very few building societies, offer a portfolio management service to investors investing substantial amounts of money on the UK stock market, but have neither the time nor the expertise to manage a balanced portfolio of securities for themselves. The bank's specialist investment managers establish and manage a suitable portfolio of financial assets, taking all the relevant decisions to meet the investment objectives of the investor. This is known as a discretionary service. Alternatively, the bank will administer the client's own portfolio of shares or unit trust or other financial assets portfolio,

[130] Gilles Favarel-Garrigues, Thierry Godefroy and Pierre Lascoumes, 'Reluctant Partners? Banks in the Fight Against Money Laundering and Terrorism Financing in France' (2011)42 (2) Security Dialogue SAGE 179,196<https://hal-sciencespo.archives-ouvertes.fr/file/index/docid/972811/filename/security-dialogue-2011.pdf> accessed 08 January 2020.

making suggestions to their clients regarding holdings that should be bought or sold. These services allow the bank's clients to choose the level of involvement they want in the management of their investments.

Stockbroking services: Banks offer stockbroking services to enable customers to buy and sell securities, gilts and/or corporate bonds called an execution-only service.

Wills and executorship: This service is one that is offered primarily by the major high-street banks, promoting themselves on the basis of their accumulated expertise, experience, and continuity of service.

Collective investment: Collective investment services offer access to collective investments and some even have their own unit trust subsidiary. Investors in the unit trusts are attracted mainly through the firm's branch network. This allows for those seeking a wide spread of investments, without wanting day-to-day control of investment decisions. It is also a more appropriate and cost-effective alternative for lower levels of capital investment. For those firms with their own unit trust company these funds are typically distributed by the tied or multi-tied financial services arm of the firm, rather than an independent financial adviser subsidiary.

Insurance and pensions: Most high-street banks and building societies have now established divisions or subsidiaries to transact life insurance and pensions business. Many banks also offer various general insurance products, with motor, household, travel, and payment protection insurance being those that are most frequently sold.

Banks run on depositors' money; therefore, it is vital alongside effective laws, codes of conduct and regulations, there are designated bodies in addition to bank regulators to support and supplement the efforts employed by the regulators. This is to ensure the soundness of a banking system. In the UK the Financial Stability Board coordinates national financial authorities and makes recommendations about the global financial system. The Financial Action Task Force sets international standards on anti-money laundering. The International Organization of Securities Commissioners brings together the world's securities regulators to set common standards. The International Association of Insurance Supervisors supervises and sets common standards for the international insurance sector. The International Swaps and Derivatives Association represents participants in the privately negotiated derivatives industry, including

interest rate, currency, commodity, credit, and equity swaps. The Bond Market Association represents firms trading fixed-income securities. The International Securities Market Association is a trade association and self-regulating organisation, supervising markets in international debt.

The Basel Committee on Banking Supervision is the primary standard setter for the prudential regulation of banks and provides a forum for banking supervisory matters. According to Professor Douglas W. Arner[131]Basel II was intended to provide an overall system of risk-based supervision and risk management (internal and market) for banks. In attempting to do so, Basel II focused on five categories of risk: (1) credit; (2) market; (3) operational; (4) liquidity; and (5) legal. To that end, Basel II framework involved four levels of banking supervisory mandates as well as banks' internal functions: (1) identification of risk; (2) risk management; (3) risk disclosure; and (4) internal risk management.

A great deal of financial services regulation is expressed in broad standards and its mobilisation depends upon a vast interorganizational network of stock issuers, brokers, independent gatekeepers (lawyers, accountants, and the like), regulators, and investors who transcend the form and content of their constituent agencies to create a shared, albeit temporary and contingent, regulatory authority.[132]

Modern Bankers are expected to understand that the essentials of sound banking system include:[133]

1.3.1 Liquidity

Liquidity was central to the 2008 financial crisis. The downfall of numerous financial institutions (such as Northern Rock in the United Kingdom and Washington Mutual Inc (Wamu) in the United States) highlighted a problem in Basel II that was devoid of any regulation pertaining to a crucial factor: liquidity. In the absence of Basel II liquidity regulations, banks became precariously over-reliant on the capital and interbank markets to

[131] Douglas W. Arner, Financial Stability, Economic Growth, and the Role of Law (New York: Cambridge University Press, 2007), p. 212
[132] SG Cecchetti and KL Schoenholtz, Money Banking and Financial Market (4th edn, McGraw-Hill Education 2015)
[133] Basel Committee on Banking Supervision, "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems", June 2011

fund themselves. In thriving securitisation markets, these failed banks operated under the assumption that they could continuously generate sufficient liquidity to fund their origination operations to meet their interest payment obligations and satisfy deposit withdrawal demands, as there would always be purchasers of the bank's assets (e.g., subprime mortgages) or securities issued based on them (e.g. subprime mortgage-backed securities).[134] Sound operations hold that the management of any bank must be able to guarantee that there are sufficient funds available at reasonable costs to meet any potential demands from the borrowers and fund providers.[135]

But when the global financial crisis of 2007–2009 worsened, investors first sought only high-quality assets; then, the capital markets' liquidity dried up. The stability of the banking industry is nonetheless backed by trust: if the public loses its confidence in the banking system, this will indeed increase the demand for liquidity, which could cause a financial crisis. Hence, an efficient banking system has become the mainstay for the sustainability of the financial system.[136] The shutdown of the securitisation market affected the interbank loan market as well. With the widespread use of securitisation, it was difficult to determine how exposed any given financial institution was to securitised mortgages so, when the capital markets' liquidity dried up, it was difficult to determine the size of losses that banks were sitting on and whether or not they were still acceptable credit risks.

As we have discussed, the primary functions of any banking institution are those of credit creation, credit allocation and maturity transformation: these functions can help in outlining the essentials of a banking system from an institutional perspective.[137] Kashyap pointed out that one of the essentials is that of liquidity which needs to be maintained.[138] The secret of successful banking is claimed to be to distribute resources between the various forms of assets in such a way as to get a sound balance between liquidity and profitability, so that there is cash,

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[134] Bank for International Settlements (BIS), "Basel III: A global regulatory framework for more resilient banks and banking systems" (16 December 2010) available at: http://www.bis.org/publ/bcbs189.htm [Accessed May 2021]

[135] Nicola Cetorelli and Linda S Goldberg, 'Liquidity Management of US Global banks: Internal Capital Markets in the Great Recession'(2012) 88(2) 299, 311 Journal of International Economics(Elsevier)<http://isiarticles.com/bundles/Article/pre/pdf/14555.pdf> accessed 04 January 2020

[136] Kelvin Mkwawa, "Importance of Banking Industry", (3 May 2018), The Citizen, https://www.thecitizen.co.tz/magazine/businessweek/Importance-of-banking-industry/1843772-4543558-b68977/index.html [Accessed May 2021]

[137] Franklin Allen and Elena Carletti, 'The Roles of Banks in Banking Systems'[21 March 2008] University of Pennsylvania< http://finance.wharton.upenn.edu/~allenf/download/Vita/Allen-Carletti-Oxford-Handbook-210308.pdf>. Accessed 04 January 2020.

[138] Anil K Kashyap and others, 'Banks as Liquidity Providers: An Explanation for the Coexistence of Lending and Deposit-taking' (December 2002) 33,73 The Journal of Finance <https://doi.org/10.1111/1540-6261.00415> accessed 04 January 2020.

on hand or quickly realizable), to meet every claim, and at the same time enough income for the bank to pay its way and earn profits for its shareholders.[139]

Basel III liquidity demands fall under two broad categories: (1) increasing the required proportion of high-quality, liquid assets (such as cash and highly rated government bonds); and (2) increasing the required proportion of long dated and stable wholesale funding, with the intention that this measure will reduce the risk that such funding will need to be renewed in times of stress. The 2011 regulatory changes "required banks to adjust not only their capital and liquidity structure, but also their business models, governance structure, and investment strategies."[140] Business model modifications induced include the following:

- reducing the market in securities and structured credit, rendering originate-and-sell lending business models less viable;
- reducing OTC derivatives volumes and migrating such derivatives to clearinghouses;
- emphasising customer facilitation activities while reducing trading inventories, especially with regard to assets of lesser liquidity (e.g., low-credit quality, commodity, and emerging market instruments), thereby reducing such market segments' liquidity and enhancing block trading opportunities;
- investing in businesses focused on trade clearing, trade processing and servicing activities;
- transferring proprietary trading to hedge funds;
- responding to a more crowded market, with increased competition for both clients and human capital, due to the entrance of less regulated firms;
- appraising new structuring opportunities arising from contingent capital instruments; and
- altering pricing strategies where firms cannot deliver acceptable returns to clients over the medium term.

[139] Samuel Ogunbiyi and Peters O Ihejirika, 'Interest Rates and Deposit Money Banks' Profitability Nexus: The Nigerian Experience' (June. 2014) 3(11)133ff Arabian Journal of Business and Management Rev accessed 04 January 2020. <https://www.researchgate.net/publication/282653877_Interest_Rates_and_Deposit_Money_Banks'_Profitability_Nexus_The_Nigerian_Experience>

[140] Luca Amorello, "Beyond the Horizon of Banking Regulation: What to Expect from Basel IV" (2016) 58 Harvard International Law Journal 22, 37

Structurally, Basel III continues to use Basel II framework which built on three pillars: Capital Requirement (Pillar 1); Supervisory Review (Pillar 2); and, Market Discipline (Pillar 3), to improve banks' risk management and governance as well as to strengthen their transparency and disclosure. There is an inverse correlation between credit availability and pricing and, as such, many practitioners have underlined the importance of the new capital requirements. Heightened capital requirements are necessary, hence Basel III is a step in the right direction, because: "capital is the basic protection for financial institutions against the effect of [investment and other internal decision-making] mistakes… the recent crisis has demonstrated once again how harmful those effects can be and therefore just how important capital is." [141]

1.3.2 Safety

The major reasons for the requirement of safety of the banking system includes protection of bank's customers, investors and to safeguard the stability of the system itself. Small investors are unable to judge the soundness of their bank, but they heavily rely on the government to protect against mismanagement and malfeasance. The combustible mix of liquidity risk and information asymmetries means that the banking system is inherently unstable. One way to prevent bankers from exploiting their safety net is to restrict banks' balance sheets. Such regulations take two forms: restrictions on the types of asset banks can hold and requirements that they maintain minimum levels of capital while banks are allowed to build big office buildings the size of the loans, they can make to particular borrowers is also limited Sound operations of banks is also determined by safety that can refer to various aspects such as privacy, customer identification, money laundering, investment risks, etc. Therefore, since these institutions keep large sums of money for their depositors, it is only prudent that the security of such monies should be guaranteed. Banks should thus only make safe investments and loans. In addition, unreasonable and unnecessary risks must be avoided.

1.3.3 Stability

One of the key functions of financial regulation is to protect the market from negative consequences of a bank failure as well as to provide safety, soundness, and solvency regulation.

[141] Douglas J. Elliott, "Comment on Proposed BCBS Capital Standards" at http://www.brookings.edu/research/opinions/2010/04/15-capital-standards-elliott [Accessed July 2022].

In other words, financial regulation helps: "to protect fixed amount creditors (depositors) from losses arising from the insolvency of financial institutions owning those amounts, while ensuring stability within the financial system."[142]

Rationality and stability are two connected essentials of a sound banking system. A bank must operate in a manner whereby there is no undue expansion or contraction of its credit structures. There is no measurable unit of rationality and stability as this is highly dependent on industry. For instance, if an institution restricts creating credit at a time when the industry and trade requires it most, the effect will be to harm the interests of the business. On the other side of the coin, if the bank stretches its credit at the time when the prevailing economic conditions are not suitable, the result will be "inflation". This implies that a banking system that strives to be sound must be able to follow a sound and stable lending policy. In order to ensure sound operations, the US, for instance, has the Bank Lending Policies and Procedures[143] and the UK has her own codes of conduct.[144]

1.3.4 Elasticity and Profitability

A crucial point was illustrated by Diamond and Raghuram that the stability for operation of banks must not be confused and misinterpreted to mean rigidity.[145] A banking system should be able to demonstrate that it has sufficient elasticity in the lending operations. The banking system must be sustainable and able to expand, and contract based on the supply and availability of loanable funds held by the banking institutions. This must be in line with the legal directives that are issued by the regulatory body.[146]

The elasticity and profitability are essential features which have to go hand in hand. It is without any doubt that a sound banking system must be able to record good Banking performance. Profitability is crucial for a system to remain viable and allow investors to invest in more capital

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[142] B. Ely, "Financial Regulation" in David R. Henderson (ed), Concise Encyclopedia of Economics, 2nd edn (2008).
[143] Loans' (20 February 2017) (8-16) sec 3.2 RMS Manual of Examination Policies, Federal Deposit Insurance Corporation(FDIC) <https://www.fdic.gov/regulations/safety/manual/section3-2.pdf> accessed 04 January 2020.
[144] 'The Lending Code: Setting standards for banks, building societies, credit card providers and their agents'[March 2011] British Bankers Association & The UK Cards Association, rev 28th September 2015 <https://www.lendingstandardsboard.org.uk/wp-content/uploads/2016/06/The-Lending-Code-Mar-2011-revised-2015-1.pdf> accessed 04 January 2020
[145] Douglas W Diamond and Raghuram Rajan, 'Illiquid Banks, Banking Stability, and Interest Rate Policy'(April 2011)120(3)552, 591 Journal of Political Economy, NBER Working Paper 16994<https://www.nber.org/papers/w16994.pdf>> accessed 04 January 2020.
[146] Stanley Fischer 'Why Are Central Banks Pursuing Long-run Price Stability?'(1996) 2 Achieving price stability <https://www.kansascityfed.org/publicat/sympos/1996/pdf/s96fisch.pdf> accessed 04 January 2020

to boost the industry.[147] A banking system should be able to cover the corporate taxes, just like other industries, cover all the interests promised to the depositors, ensure that the shareholders are able to get dividends, if possible, pay for the salaries and other banking expenses.

1.3.5 Proper Risk Management

In their operations, banking institutions invariably meet with various risks which have the potential of adversely affecting the operations. These potential risks, if not handled well, within the banking system may lead to serious consequences. Risk management has been defined as the forecasting and evaluation of the monetary and banking risks as well as identification of the systems and procedures which can be applied to minimise and avoid the impact of risks.[148]

A sound banking system would have a proper risk management identification, assessment, and measurement system with the goal of minimising negative impacts. Saunders and another and Froot and others,[149] suggests that a practice of sound risk management should cover core aspects in risk management like special units, in charge of risk management, that would prescribe policies and procedures for the management of risk, risk measurement and assessment tools based on risk identification models. Turner[150] also added that it is sound practice for banks to be aware of various secondary risks like interest rate risk, risk of change in market prices, and foreign exchange risks and know how to prevent or mitigate these risks to maintain the integrity of the banking sector. No major financial institution failed during the financial crisis because it ran out of capital. In each case they ran out of money.[151] The risk-

[147] Fadzlan Sufian and Royfaizal Razali Chong, 'Determinants of Bank Profitability in a Developing Economy: Empirical Evidence from the Philippines'(2008) 4(2) Asian Academy of Management Journal of Accounting & Finance(AAMJAF) 91,112 <www.researchgate.net/journal/1985-8299_Asian_Academy_of_Management_Journal_of_Accounting_and_Finance> accessed 04 January 2020

[148] Alexander J. McNeil, Rüdiger Frey and Paul Embrechts, Quantitative Risk Management: Concepts, Techniques and Tools (rev edn Princeton University Press May 2015) 1,720 ISBN 9781400866281; Joel Bessis, Risk management in banking (3rd edn John Wiley & Sons 201) 1,840. ISBN-10: 0470019131, ISBN-13: 978-0470019139

[149] Anthony Saunders and Marcia Millon Cornett, Banking Institutions Management: A Risk Management Approach (McGraw Hill/Irwin Business & Economics (2006)1, 856 ISBN-13: 978-0078034800 ; Kenneth A Froot, David S Sharfstein and Jeremy C Stein, Risk management: Coordinating Corporate Investment and Financing Policies , National Bureau of Economic Research, 1992) 48(5) &(The Journal of Finance April 2012) 1629ff <https://doi.org/10.1111/j.1540-6261.1993.tb05123.x> accessed 04 January 2020.

[150] Philip Turner The Global Long-term Interest Rate, Banking Risks and Policy Choices in EMEs (Bank for International Settlements (BIS) Working Paper Feb 2014) 441 ISBN 1682-7678; Jill L Wetmore and John R Brick, 'Commercial Bank Risk: Market, Interest Rate, and Foreign Exchange' (1994) 17(4) 585,596 Journal of Banking Research<https://onlinelibrary.wiley.com/doi/pdf/10.1111/j.1475-6803.1994.tb00167.x> accessed 04 January 2020.

[151] Alistair Darling: 'RBS said it would run out of money in early afternoon'", The Guardian, https://www.theguardian.com/business/2017/aug/09/alistair-darling-rbs-said-they-would-run-out-of-money-in-early-afternoon.

asset ratio seems an inefficient means of ensuring that the banking system in one country, or globally, is protected from systemic risk when banks are likely to have similar risk profiles within and across jurisdictions.[152]

Operational risk has a greater potential to transpire in greater and more harmful ways than many other sources of risk, given the increased size and complexity of the banking industry. It is commonly defined as the risk of some adverse outcome resulting from acts or omission in carrying out business activities, inadequate or failed internal processes and information systems, misconduct by people or from external events.[153] This definition includes legal risk from the failure to comply with laws as well as prudent ethical standards and contractual obligations but excludes strategic and reputational risk. Internal operational risk attributes loss exposure to the potential for failure of people, processes, and technology in the course of regular business operations, such as breaches in internal controls and monitoring, internal and external fraud, legal claims or business disruptions and improper business practices. The State Bank defines operational risk as the tendency of employees/ line management to hide human error and inadequacies.[154]

These risks are more specifically described as: (i) process risk associated with operational failures stemming from the breakdown in established processes, failure to follow processes or inadequate process mapping within business lines; (ii) people risk from management failure, organisational structure or other human failures, which may be exacerbated by poor training, inadequate controls, poor staffing resources, or other factors; and (iii) systematic risk, which reflects the operational exposure to disruptions and outright system failure in both internal and outsourced operations.[155] External operational risk (or external dependency risk) arises from environmental factors, such as a new competitor that changes the business paradigm, a major political and regulatory regime change, unforeseen (natural) disasters, terrorism, vandalism, and other such factors that are outside the control of the firm.[156]

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[152] J. Tirole and M. Dewatripont, The Prudential Regulation of Banks (Cambridge: MIT Press, 1995) p.455
[153] Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework--Comprehensive Version (June 2006b, BCBS Publications No. 128, Bank for International Settlements, www.bis.org/publ/bcbs128.htm).
[154] www.sbp.org.pk/bprd/2014/c4-annexure-1.pdf
[155] M. J. Zamorski, "Joint Supervisory Guidance on Operational Risk Advanced Measurement Approaches for Regulatory Capital--Board Memorandum", FDIC, Division of Supervision and Consumer Protection, July 2003, www.fdic.gov/regulations/laws/publiccomments/basel/boardmem-oprisk.pdf.
[156] R. M. Mark, "Operational and Infrastructure Risk", Presentation at a symposium in preparation for the conference The Information Technology Revolution--Implications for Financial Services and Public Policy (March 6-8, 2002), Black Diamond Risk Enterprises, Toronto

The Basel II capital rules stipulated by the Operational Risk Subgroup (AIGOR) of the Basel Committee Accord Implementation Group[157] define different quantitative measurement approaches for operational risk_eight BLs are: (i) corporate finance, (ii) trading and sales, (iii) retail banking, (iv) payment and settlement, (vi) agency services, (vi) commercial banking, (vii) asset management, and (viii) retail brokerage. The eight event (or loss) types are: (i) internal fraud, (ii) external fraud, (iii) employment practices and workplace safety, (iv) clients, products, and The business practices, (v) damage to physical assets, (vi) business disruption and system failures, and (vii) execution, delivery, and process management.[158]

Systematic risk is another area that deals with the risk of the failure of a participant to meet its contractual obligations which may in turn cause other participants to default with a chain reaction leading to broader financial difficulties. Systemic risk refers to the risk or probability of breakdowns in an entire system, as opposed to breakdowns in individual parts or components, and is evidenced by co movements (correlation) among most or all the parts. [159]

Systemic risk is the risk that financial instability becomes so widespread that it impairs the functioning of a financial system to the point where economic growth and welfare suffer materially.[160] Mokal suggests that "the whole financial system is sound if and only if each institution is sound'. This is based on a "domino" conception of systemic crises, where the failure of one financial institution spreads to others through payment and settlement systems.[161]

In 2008 Schwarcz developed a detailed overview of the various elements of the definition of systemic risk and concluded that "a common factor in the various definitions of systemic risk is that a trigger event, such as an economic shock or institutional failure, causes a chain of bad economic consequences sometimes referred to as the domino effect. These consequences could include (a chain of) financial institutions and/or market failures. Less dramatically, these consequences might include (a chain of) significant losses to financial institutions or substantial

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[157] A. Seivold, S. Leifer, and S. Ulman, "Operational Risk Management: An Evolving Discipline", Supervisory Insights, Federal Deposit Insurance Corporation (FDIC), 2006
www.fdic.gov/regulations/examinations/supervisory/insights/sisum06/article01 risk.html
[158] Basel Committee on Banking Supervision, Operational Risk Transfer Across Financial Sectors (August 2003a, Joint Forum Paper, Bank for International Settlements, www.bis.org/publ/joint06.htm)
[159] Kaufman and Scott, "What is systemic risk, and do bank regulators retard or contribute to it?" (2003) VII (3) The Independent Review 371
[160] European Central Bank, "The Concept of Systemic Risk' [2009] Financial Stability Review 134, 134.
[161] Mokal (n 57) 21; Claudio Borio, "Rediscovering the Macroeconomic Roots of Financial Stability Policy: Journey, Challenges, and a Way Forward' (2011) 3 Ann Rev Fin Econ 87, 88

financial-market price volatility. In either case, the consequences impact financial institutions, markets, or both."[162]

The IMF, Basel Committee on Banking Supervision (BSCB) and Financial Stability Board (FSB) in the October 2009 report, Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments, Initial Considerations [22] described systematic risk as disruption to the flow of financial services that is (i) caused by an impairment of all or parts of the financial system; and (ii) has the potential to have serious negative consequences for the real economy. The Co-ordinating Group of the Committee on the Global Financial System of the BIS emphasise the importance of identifying and effectively dealing with systematic risk stating that the purpose of macroprudential policy is to reduce systemic risk, strengthening the financial system against shocks and helping it to continue functioning stably without emergency support on the scale that was extended in the crisis. Preventative in its orientation, macroprudential policy is distinct from financial crisis management policy. Views vary on how macroprudential policy should be defined and implemented. Questions also surround the choice of available instruments and the ways in which they might operate. Central banks have a stake in macroprudential policy. First, they are seen as bearing important responsibilities for financial stability, if sometimes only implicitly so. Second, the objectives, instruments and conduct of macroprudential policy are part of an overall economic and financial stabilisation function that includes monetary policy. Successful macroprudential policy and monetary policy can reinforce each other to stabilise the economy.[163]

1.3.6 Reserve Money and Expansion

A sound banking system must have reserve monies in a separate account to meet the demands of depositors should any emergency arise. Even though the money in the reserve is idle money and investing the same could yield higher returns than keeping the money in reserve, an effective banking system cannot afford to risk losing customers' trust and confidence by

[162] Steven L. Schwarcz, "Systemic Risk" (2008) 97 The Georgetown Law Journal 193
[163] Macro-prudential instruments and frameworks: a stock taking of issues and experiences, CGFS papers no.38 (May 2010), http://www.bis.org [Accessed October 2022]

keeping a smaller amount for meeting emergencies. This could be disastrous should an emergency occur for instance over withdrawing by depositors.[164]

Even if minimum limits for reserves are set, the amount which a bank should reserve is determined by operations of the bank only since it is the institutions which have the knowledge and wisdom on risks. Expansion is used to denote not only physical expansion and increase in capital and depositor base, but also cover the spread of the banking system all over the country concerned. Klause and another[165] argued that for a banking system to be sustainable the concentration should not be in big towns only, but it should cover rural areas and less developed locations too. A banking system can only be widespread and expansive if the deposits can be mobilized and its credit facilities can easily be advanced to various industries like agriculture, insurance, trade, real estate, etc. This is crucial and essential particularly for developing countries' banking systems owing to the reason that there is over reliance on the system to provide these Banking facilities when expanding in various areas and ensuring that there is economic growth and capital formation.[166]

1.3.7 Market Discipline

In order to achieve sound banking system market discipline, could be used as an effective tool in constraining harmful risk-taking. Market discipline has long been a core principle of financial regulation and was relied upon extensively before the crisis.[167] Market discipline is the mechanism via which market participants monitor and discipline excessive risk-taking behaviour by banks.[168]

Market discipline was initially utilised by Basel II, which provides recommendations on regulating the capital adequacy of banks. U The third pillar mandated extensive disclosure

[164] Philipp Härle a Andras Havas, and Hamid Samandari, 'The Future of Bank Risk Management'[December 2015] McKinsey Working Papers on Risk <www.mckinsey.it/idee/the-future-of-bank-risk-management> & <https://www.europeanbusinessreview.eu/page.asp?pid=1480> accessed 04 January 2020.
[165] Andreas Krause and Simone Giansante 'Interbank Lending and the Spread of Bank Failures: A Network Model of Systemic Risk' (May 2012) 83(3) Journal of Economic Behaviour & Organization Rev Nov 2012 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2069734> & http://www.elsevier.com/wps/find/journaldescription.cws_home/505559/description#descriptio accessed 03 January 2020
[166] Muhammad Ayub Siddiqui, 'Towards Determination of Interest Spread of Commercial Banks: Empirical Evidences from Pakistan'(2012)6(5) African Journal of Business Management February 185,1862 ISSN 1993-8233 ©2012 Academic Journals <http://www.academicjournals.org/AJBM> accessed 04 January 2020.
[167] David Min, "Understanding the Failures of Market Discipline' (2015) 92 Wash U L Rev 1421, 1423
[168] Constantinos Stephanou, "Rethinking Market Discipline In Banking: Lessons From The Financial Crisis' [2010] World Bank Policy Research Working Paper Series 5227

requirements for, inter alia, banks' capital structure, capital adequacy, risk exposure, and credit, market, and operational risk. The rationale was that market discipline imposes strong incentives on banks to conduct their business in a safe, sound, and efficient manner, including an incentive to maintain a strong capital base.[169]

1.3.8 Other Essentials at a Sector Level

At a sectoral level, it is very difficult to separate sound banking practices from requirements of banking regulations. There is an inherent connection between the two as regulation of the banking sector plays an important role in maintaining the other sectors like employment, capital markets and insurance in an economy.

The criteria for the determination of the key standards for a sound banking system, at a sector level, have been outlined by the Banking Stability Board: [170]

1. Critical and relevant for a robust, stable, and properly functioning banking system which covers implemented policies and lessons from all previous banking crisis, so that a sense of prioritization in policy implementation is imparted;
2. Be universal in their applicability, thus can cover areas which are very crucial and are equally important in all parts of the country;
3. Be flexible in implementation, through being general enough to consider the different county and the circumstances in that country;
4. Should be broadly endorsed, that such essential practices and standards should be provided by an internationally recognised body in the banking sector and done with extensive consultation with all the stakeholders.
5. Lastly, the standards and practices have to be made assessable by third parties such as International Banking Institutions and national authorities.

A sound banking system can also be considered in the context of corporate governance; the theory of agency holds that shareholders are principals, and that the management of the firm

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[169] BCBS, "Working Paper on Pillar 3 - Market Discipline' (2001)
[170] Banking Stability Board, 'Key Standards for Sound Banking Systems' <http://www.fsb.org/what-we-do/about-the-compendium-of-standards/key_standards/> accessed 04 January 2020

plays the role of an agent.[171] Thus, working of modern company law separates ownership and control and hence the professionals who could be running the banking system may not account properly to the shareholders. It is argued that accountability and disclosure, which are ingredients of sound banking, warrants empowerment of the shareholders.[172] In the case of banks, in addition to shareholders, depositors are also stakeholders and therefore, principals. Due to systematic risk, even other banks and the public at large are also stakeholders.

A democratic corporate governance system is essential for banks for the detailed reasons explored in chapter five of this thesis. However, it may be argued that the classic shareholder-centric corporate governance paradigm could have adverse effects on achieving the objective of maintaining the safety and soundness of financial institutions. It has also been argued that the shareholder-centric corporate governance paradigm contributes to higher risk-taking tendencies in banks and financial institutions. Excessive levels of risk-taking[173] coupled with poor risk management[174] at banks have been opined to be a key factor in the failure of a number of financial institutions.[175]

The existence of a cohesive relationship is, therefore, required between stakeholders in the banking sector and ones who not only complement each other but also have the will, capacity, and good faith for a successful implementation of banking regulations. Other stakeholders such as the government through the Ministries and the central bank also play their role in establishing a sound banking system. These stakeholders' connection is a key factor in sound banking and how they interact between each other, how they propose to resolve conflict within their misunderstandings, for instance, between the central bank and the Ministries concerned. Therefore, the existing stakeholder framework must create independence and at the same time allow collaboration and cooperation.[176]

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[171] Thomas Donaldson & Lee E. Preston, 'The Stakeholder Theory of the Corporation, Concepts, Evidence and Implications'(January1995) vol 20(1) The Academy of Management Review 65-91 < http://www.circles-of-confusion.com/fall-business-ethics/donaldson-stakholder.pdf > accessed 15 September 2019

[172] Charles W. L. Hill& Thomas M. Jones, 'Stakeholder-agency theory' (March1992) vol 29 Issue 2 Journal of management studies, Willy Online Library 131-154< https://onlinelibrary.wiley.com/doi/abs/10.1111/j.1467-6486.1992.tb00657> accessed 15 September 2019

[173] D. H. Erkens, M. Hung, and P. Matos, "Corporate Governance in the 2007–2008 Financial Crisis: Evidence from Financial Institutions Worldwide" (2012) 18 Journal of Corporate Finance 389

[174] M. K. Brunnermeier, A. Crockett, C. Goodhart, A.D. Persaud and H. Shin, The Fundamental Principles of Financial Regulation, Geneva Reports on the World Economy (London: Centre for Economic Policy Research, 2009)

[175] Brunnermeier et al., The Fundamental Principles of Financial Regulation (2009); G. Sabato, "Financial Crisis: Where Did Risk Management Fall?" (August 24, 2009), SSRN, at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1460762

[176] Achua Joseph K, 'Corporate social responsibility in Nigerian banking system'[February 2008,vol 3(1)] Society and Business Review,'57ff'
.<www.researchgate.net/publication/235260935_Corporate_social_responsibility_in_Nigerian_banking_system> 'accessed 03 January 2020'

The core standards that come out from this discussion are that of corporate governance, supervision standards, security regulations, effective deposits and deposit insurance schemes, sound banking reporting and disclosures standards, etc. Nevertheless, it would be a mistake to conclude that there are specific sets of sound operation standards even though the requirements of the minimum standards are well recognised and well established which could be categorised as sets of practices considered as sound practices and can mutatis mutandis be applied depending on the banking sector, regulation, and supervisions.[177] Whereas other essentials of a sound banking system such as improvement and innovation[178] are as crucial as stability and risk management.[179]

1.4 ROLE OF A GOOD BANKING INSTITUTION IN SOUND BANKING SYSTEM

The majority of the banking institutions are operating as public listed companies. This implies that corporate law can treat these institutions just like non-banking institutions. However, much of the recent research done on corporate governance has primarily made use of performance and governance measurements based on value maximization.[180] It is argued[181] that this may be a better and reasonable approach believing that the 2007- 2009 banking crisis triggered a powerful occurrence to remind us that banking institutions and the financial sector require different metrics for performance. Of course, from the surface one can argue that sound practices would mean safety, liquidity, stability, etc. Mehran and Mollineaux suggests that a better approach is for the analysts to look at these banking institutions by referring to conflicting demands i.e., soundness and safety of the banking institutions against improvement

[177] Abraham Mwenda and Noah Mutoti, 'Banking Sector Reforms, Bank Performance and Economic Growth: Evidence from Zambia' (2011)23(1) African Development Rev 60,74 <https://onlinelibrary.wiley.com/doi/pdf/10.1111/j.1467-8268.2010.00272.x > accessed 04 January 2020. Zsofia Arvai, Ananthakrishnan Prasad and Kentaro Katayama, 'Macroprudential policy in the GCC countries' [2014] MAPP GCC PAPER March 2014 SDN /14 /01 <https://www.imf.org/external/pubs/ft/sdn/2014/sdn1401.pdf> accessed 04 January 2020.
[178] Anthony M Santomero and Jeffrey J Trester, 'Banking Innovation and Bank Risk Taking' (1998)35(1) Journal of Economic Behavior & Organization 25-37, University of Pennsylvania Rev August 1997<https://kundoc.com/pdf-Banking-innovation-and-bank-risk-taking-.html> accessed 08 January 2020
[179] Johannes M Pennings and Farid Harianto, 'The Diffusion of Technological Innovation in the Commercial Banking Industry' (1992)13(1) Strategic management journal 29,46
< https://onlinelibrary.wiley.com/doi/abs/10.1002/smj.4250130104> accessed 08 January 2020
[180] Michael C Jensen, 'Value Maximization, Stakeholder Theory, and the Corporate Objective Function' Business Ethics Quarterly(April 2002)12(2) CPU 235,256 <https://www.jstor.org/stable/3857812?seq=1> accessed 04 January 2020.
[181] Jörg Andriof, Unfolding Stakeholder Thinking: Theory, Responsibility and Engagement: Theory, Responsibility and Engagement (Routledge 1st edn October 2002)
ISBN-13: 978-1874719526

and innovation. If one starts considering this antagonising perspective, the understanding of sound banking will surely change.[182]

Banks are private-sector institutions whose healthy or sound functioning is in the public interest.[183] There is very little consensus on the question: what is a sound banking institution? It should be noted that much research[184] on corporate governance theory has referred to non-banking institutions until recently; and further research has been focused on the standpoint of a potential investor. How can an investor potentially believe that their money in terms of investments would ever be given back? This principal-agent problem is resolved in the banking system by creating the fact that the corporate governance makes responsibilities explicitly for value maximization of banking firms. This creates one possible ingredient for a sound banking system. There is equity-based compensation and shareholders are given control to hold to account the practices of directors. There are checks and balances whereby corporate control ensures that there is alignment of interests of the banking institution with those of the shareholders. Another ingredient that can hold and show sound banking is the use of stakeholders' theory of corporate governance.[185] Having in mind that the banking system is of great importance and its collapse can cripple the banking sector and send ripples all the way to economic stability and growth, the involvement of the supervisor who is independent of political interference[186] should be synchronized in a streamlined manner to have a sound banking system. An indication of the balance is that the banking system considers both the agency theory and the stakeholders' theory and balancing the shareholders' rights of returns, and the public expectation of a sound and stable banking structure.[187]

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[182] Hamid Mehran and Lindsay Mollineaux, 'Corporate Governance of Financial Institutions'(Rev February 2012) 539, p6 Federal Reserve Bank of New York January Staff Report <https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr539.pdf> accessed 04 January 2020

[183] Robyn McLaughlin and Hamid Mehran, 'Regulation and the Market for Corporate Control: Hostile Tender Offers for Electric and Gas Utilities' (September1995) 8(2) 181,204 Journal of Regulatory Economics <https://link.springer.com/article/10.1007%2FBF01072589> accessed 04 January 2020

[184] Mclaughlin and Mehran (n.183)

[185] Richard A Johnson and Daniel W Greening, 'The Effects of Corporate Governance and Institutional Ownership Types on Corporate Social Performance'(1999) 42(5) 564, 576 Academy of Management Journal <www.jstor.org/stable/256977>.accessed 04 January 2020

[186] Alberto Alesina and Lawrence H Summers, 'Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence' (1993) 25(2) 151,162 Ohio State University Press,Journal of Money, Credit & Banking <http://debis.deu.edu.tr/userweb/yesim.kustepeli/dosyalar/alesinasummers1993.pdf> accessed 04January 2020 ; Simone Polillo and Mauro F Guillén, 'Globalization pressures and the state: the worldwide spread of central bank independence' (2005) 110(6) 1764,1802 American Journal of Sociology < https://www.journals.uchicago.edu/doi/abs/10.1086/428685?mobileUi=0&journalCode=ajs> accessed January 2020. Alberto Alesina and Lawrence H Summers, 'Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence' Journal of Money, Credit and Banking (May 1993) 25(2)151,162 Ohio State University Press <www.jstor.org/stable/2077833?seq=1> accessed 04 January 2020.

[187] Luc Laeven and Ross Levine, 'Bank governance, regulation and risk taking' (August 2009)93(2) 259,275 Journal of Banking Economics ELSEVIER <www.sciencedirect.com/science/article/pii/S0304405X09000816> accessed January 2020.

Therefore, it is safe to presume that in the world where there is absence of market failure and there is no misleading information, the interests of the society at large be aligned with the interest of the shareholders. A compromise between the two interests should be struck in such a manner that the shareholders can reap the benefits of investment in the banking sector and the public sector is maintained at a stable condition. Banks can then easily increase their profitability to achieve maximum value and through pursuing productive incentives which improve the general quality of the banking sector and banking intermediation.[188] The creditors and shareholders of banking institutions have traditionally favoured a high level of risk taking as compared to what the regulator and the public anticipates. Let us not forget investors always wish for higher returns.[189] It should also be noted that most existing banks and banking sectors suffer from the challenge of moral hazards[190] and misleading information. What seems principally to have caused the banking collapse of otherwise solvent banks in 2008 appears to have been a combination of opacity of information about counterparties' exposures, the true value of illiquid assets and therefore creditworthiness of borrowers, together with a run on the wholesale lending markets (principally, on repo-style transactions, in many cases provided by hedge funds acting rationally to minimise potential losses). Such runs were certainly the proximate cause of the failure of Northern Rock (it was the wholesale run, and not the televised depositor run, that resulted in the significant majority of liquidity losses at Northern Rock, and retail deposits proved the most sticky source of funding to the stricken bank), Bear Stearns, Lehman Brothers and AIG (where the run took the form of margin calls on credit default swaps written by AIG Financial Products as AIG's credit-worthiness deteriorated). However, as a similar run had been the proximate—if not ultimate—cause of Enron's collapses this risk is not confined to financial institutions.[191]

The definition of a sound banking system has always been considered through the eyes of a regulator. A regulator has to set standards which become core elements in determination of sound banking. Value maximization is not usually the main concern of the regulator because

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188 Joseph E Stiglitz and members of a UN Commission of Banking Experts, 'THE STIGLITZ REPORT: Reforming the International Monetary and Banking System in the Wake of the Global Crisis' (UN Conference on the World Banking and Economic Crisis, The New Press New York 2010) ISBN 978-1-59558-520-2 < www.library.fa.ru/files/Stiglitz-Report.pdf> accessed 04 January 2020

189 Meir Statman, What do investors want: Know What Drives Investor Behaviour and Make Smarter Banking Decisions (McGraw-Hill Education 16 Dec. 2010) 1,304 IBSN 978007174165. ' Jay Ritter R, 'Investment banking and securities issuance' (2003)30 Chp5 254ff The Journal of Portfolio Management <https://site.warrington.ufl.edu/ritter/files/2016/09/InvestmentChapter5.pdf> accessed 04 January 2020

190 A term originated in insurance sector: change of behaviour of a person after getting insured.

191 J. Tirole and M. Dewatripont, The Prudential Regulation of Banks (Cambridge: MIT Press, 1995) p. 454

many regulators are more inclined to follow the law and maintain stability in the market, the view of a social planner and those of an economist are usually different. There is a conflict of interfering with market forces through the use of legislation, directives, and rules. Even if it is argued that sound banking elements are in compliance with corporate governance, there remains an inherent challenge of balancing the legislation, proper risk management, deposit insurance availability, accountability, etc. Risk management should not inhibit innovation, legislation should not be too rigid, and small banks should not face large costs of compliance. These are some of the conflicts within the banking sector which make it hard if not impossible to pinpoint the essential ingredients of a sound banking system.

The need for stability and risk management in the banking sector is one which runs in the mind of every regulator,[192] It is one of the main roles of central banks and banking regulators. The understanding of failures and the repercussions which can be caused owing to instability in the banking sector haunted many after the 2007-2008 banking crisis. It is in that understanding that the regulators' role in maintaining stability really kicked in. Therefore, stability is a key element in determining a sound banking system.[193]

There is a large body of research which has proved that good banking institutions establish development in banking sector of developed and developing economies[194] leading to establishing a sound banking system. This is because a good banking institution ensures a sound system of payment, disciplining and supervision of borrowers, the management of uncertainties and risks, identification of viable investments and opportunities, and the aggregation of the public savings for the banking investments.[195]

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[192] Roger W Ferguson and Jr Vice Chairman, 'Should Banking Stability be an Explicit Central Bank Objective; Challenges to Central Banking from Globalized Banking Systems 2002)<https://www.imf.org/exteral/pubs/ft/seminar/2002/gfs/eng/ferguson.pdf> accessed 04 January 2020.
[193] Miguel A Segoviano and Charles Albert Eric Goodhart, 'Banking stability measures' (January 2009) International Monetary Fund working paper ISSN 0956-8549-627 & <https://www.imf.org/external/pubs/ft/wp/2009/wp0904.pdf> accessed 04 January 2020; 0
[194] Raghuram G Rajan and Luigi Zingales, 'Banking Dependence and Growth' (1998) 88(3) American Economic Review 559,86 <www.isid.ac.in/~tridip/Teaching/DevEco/Readings/07Finance/07Rajan&Zingales-AER1998.pdf> accessed 08 January 2020 ; Robert G King and Ross Levine, 'Finance and Growth: Schumpeter Might Be Right' (August 1993)108 (3)The Quarterly Journal of Economics MIT Press717,737< https://academic.oup.com/qje/article abstract/108/3/717/1881857?redirectedFrom=PDF> accessed 08 January 2020. The Quarterly Journal of Economics is currently published by The MIT Press.
[195] Ross Levine, 'Banking Development and Economic Growth: Views and Agenda' (1997) 35(2) Journal of Economic Literature American Economic Association 688,726 <http://faculty.haas.berkeley.edu/ross_levine/Papers/1997_JEL_ViewsAgenda.pdf> accessed 08 January 2020.

The question is the determination of whether these two positions, i.e., shareholders' centric theory and regulatory objectives, are reconcilable because there are no specific developed standards and methods of measuring and evaluating performance of governance in the banking sector, hence the need for determining which core elements are essential and which trade-offs are necessary. The response is both negative and positive. Some banking policies which are considered to be sound policies and the presence of which cannot be disregarded in a banking sector – such as those laws and policies either through corporate governance measures or otherwise, such as those geared to weeding out predatory lending in commercial banks, have the chance of increasing efficiency and stability. While other policies may need re-evaluation and a further normative choice made between a safer banking system and an innovative one and further a choice between the trade-off between the two.[196]

The determination of liquidity is one example; it has been constantly argued that in banking, the liquidity can best be determined by the banking institutions themselves as compared to a rigid value set by regulators. This kind of interplay makes it hard to pinpoint any element as being absolute in sound banking. Of course, they have a purpose.[197] but it comes at a detriment of other elements such as flexibility in banking practices and innovation.[198] Researchers have argued that free markets always create a balance and liquidity and as many researchers have favoured free market liquidity rather than liquidity determined by regulations.[199]

The banking system, as a whole, is itself susceptible to shocks by its various individual institutions. Thus, the element of overall stability must go hand in hand with the stability of constituent institutions. It follows that corporate governance should also be operational in these institutions making up the banking system and no banks should be left behind. Small, medium, and large banking institutions must all be made subject to sound practices and supervision accordingly. Smaller banks must not suffer higher costs which may adversely affect their

[196] Richard S Grossman, 'The Shoe That Didn't Drop: Explaining Banking Stability During The Great Depression' (September 1994)54(3) The Journal of Economic 654,682 <https://www.cambridge.org/core/journals/journal-of-economic-history/article/shoe-that-didnt-drop-explaining-banking-stability-during-the-great-depression/AC892E7CE045D50866F0> accessed 08 January 2020

[197] Douglas W Diamond and Raghuram G Rajan, 'Liquidity Shortages and Banking Crises' (April 2005) LX(2) The Journal of Finance 615,647<https://faculty.chicagobooth.edu/douglas.diamond/research/papers/liquidshort.pdf>accessed 08 January 2020.

[198] Douglas W Diamond and Raghuram G Rajan, 'Liquidity Risk, Liquidity Creation, and Banking Fragility: A Theory of Banking' (2001)109(2) Journal of political Economy 287,327 <https://faculty.chicagobooth.edu/raghuram.rajan/research/papers/doug1.pdf> accessed 08 January 2020.

[199] Anders Ögren, 'Free or Central Banking? Liquidity and Banking Deepening in Sweden,1834–19136 (Januray2006) 43(1) Explorations in Economic History Elsevier 64,93<https://www.sciencedirect.com/science/article/abs/pii/S0014498305000811> accessed 08 January 2020

profitability due to high and stringent supervision. Even the very desirable corporate governance reforms which ideally make up a crucial percentage of essential sound banking practices may not be fully appropriate for the banking sector, and if appropriate, then care must be taken to implement such corporate governance principles in a manner which considers the special nature of the banking sector.[200] Any single best banking practice element or corporate governance element can never be appropriate and effective for all banking sectors and application for governance models with best practice elements, should consider the dynamics of a particular banking system.[201] It follows that each banking sector requires specific elements of corporate governance and hence making each maintaining specific elements which make sound banking.[202]

1.5 The limits of law to strengthen a sound banking system in an economy

1.5.1 Selective Application of Procedural Law

In order for a banking system to function properly, it requires, apart from the law, a good and an effective supervision system with power of enforcement. In many developing countries, although laws exist, they are not effectively enforced, or they are selectively enforced. Law itself may be used as a means of perpetuating insecurity, stagnation, and inequality.[203] From the practical point of view the Law is categorised under the heads of substantive law and procedural law. The substantive law generally provides the set of rules and procedural law sets the mechanism for the enforcement of these rules. The lack of applying or discriminately applying procedural law is a major problem in developing countries such as Pakistan; we would see in the next chapters particularly in chapter 2 and in chapter 6 that Pakistan has very robust Money Laundering Law and regulations however these are selectively applied. The prime example of it is the ex-premier and head of one of three major political parties had been named in Panama Documents and mainstream media[204] for laundering money and building a real

[200] Renée Adams and Hamid Mehran, 'Is Corporate Governance Different for Bank Holding Companies?' (April 2003) 9(1) Federal Reserve Bank of N.Y. Econ Policy Rev 142 <www.newyorkfed.org/research/epr/03v09n1/0304adam.html>accessed 08 January 2020

[201] Kern Alexander, 'Corporate Governance and Banks: The Role of Regulation in Reducing the Principal-agent Problem'(2006) 7(1/2) Journal of Banking Regulation 17,40<www.rwi.uzh.ch/dam/jcr:a8903a5c-238a-4431-9a4f-d9293da4f3c2/Alexander_Corporate%20Governance%20and%20Bank_JBR%202006.pdf>

[202] Alexander (n.201)

[203] https://openknowledge.worldbank.org/bitstream/handle/10986/25880/9781464809507_Ch03.pdf?sequence=35

[204] https://www.icij.org/investigations/panama-papers/former-pakistan-pm-nawaz-sharif-family-members-indicted/

estate empire in the UK. This particular case also begs to question the effectiveness of the UK money laundering regulations.[205]

1.5.2 Over Regulations

There is some truth in saying that through regulation sound banking can be achieved and there is evidence to show this in the case of the US where Congress intervened to save the US Banking market and the banking crisis.[206] The problem with the regulations is that with law, there is always that inherent danger of over-regulation. This would dismantle the idea of any effective regulation and make the condition too rigid for banks to operate as they otherwise will be constrained by regulations.[207] This is well recognised by the banking profession internationally. In the US, for instance, Admati argued that "The current and proposed regulations are complex but on some of the most important pieces, they only tweak previous regulations that failed to provide banking stability."[208]

The problem with over regulation is that it has the impact of short-changing a bank. The bank investment hugely depends on debt, which encompasses the deposits taken by the bank, and that these institutions rely very little on money or equity from the shareholders or owners. Admati further argues that the laws in themselves are not sufficient tools in regulating the banking sector because it is hard to establish the best equity requirement in the absence of crucial data and models. This cannot be achieved by laws and regulations alone but should be undertaken by banks which are in a better position to determine their liquidity including equity and security. Given that the law cannot legislate on every tiny detail it becomes hard and over-prescriptive which has the impact of restricting the same best practices which the law seeks to develop and maintain. Admati also states that the numbers and the details in determining the capital requirement and equity are hard to state, since the ratios of equity are highly dependable on enormous amounts of data and assets which have to be calculated, this entails what to exclude and what to include in addition to other information. Therefore, even though laws are

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[205] https://www.dailymail.co.uk/news/article-5878097/Former-prime-minister-Pakistan-sons-ploughed-millions-Londons-swankiest-addresses.html

[206] John B Taylor, 'The Banking Crisis and the Policy Responses: An Empirical Analysis of what Went Wrong' (January 2009)14631 National Bureau of Economic Research NBER working paper<www.nber.org/papers/w14631.pdf>accessed 08 January 2020

[207] Joshua Aizenman, 'Banking Crisis and the Paradox of Under-and Over-regulation (May 2009) National Bureau of Economic Research Working Paper NBER 15018 <www.nber.org/papers/w15018>accessed 08 January 2020

[208] Anat R Admati, 'The Compelling Case for Stronger and More Effective Leverage Regulation in Banking'(October 2013) 43(2)Forthcoming Journal of Legal Studies S35,S61 <www.gsb.stanford.edu/sites/gsb/files/compelling_case_september_30.pdf> accessed 08 January 2020.

geared to allowing sound practices in the banking sector, they are not sufficient in doing so alone. It has been argued that many banking laws are misplaced and have been influenced by the absence of data and irrelevant trade-offs: "They are based on very flawed analyses of the relevant trade-offs."[209]

It must be noted that regulations go hand in hand with regulators and supervisors and as such the effectiveness of any piece of regulation is essential in the quest for sound banking practices.[210] The theoretical basis for regulatory supervision is based on the idea that the private sector itself cannot effectively guarantee sound banking practices as the banking institutions are profit driven just like any businesses, and that if left unmonitored it will cause an element of sub-optimal stability and performance.[211] Thus, it is revealed that a powerful supervisor backed by sound regulations would help ameliorate any market failure in such a system.[212] This view sees banking regulations and the governments' intervention as a "helping hand" in ensuring that their banks are not prone to be socially costly and contagious.[213] The downside as outlined herein is that too powerful supervision and excessive regulations lead to exertion of negative influence on the banking system negating sound practices. It has been noted that those governments with powerful supervisory bodies can easily use the influence and power of the bodies to favour some specific constituents, extract bribes and bring in campaigns to Countries.[214]

1.5.3 Restrictive Nature

Banking regulations and law have emanated from the demands of both depositors and creditors which are concerned with the ability of these banking institutions' ability to monitor risks. These cover the lending areas which would provide stability of the banking structure in cases

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[209] Admati (fn 209)
[210] Daesik Kim and Anthony M Santomero. Risk in Banking and Capital Regulation' The Journal of Finance' (December 1988) 43(5) XLIII, The Journal of Finance American Finance Association 1219,1233 < https://onlinelibrary.wiley.com/doi/abs/10.1111/j.1540-6261.1988.tb03966.x> accessed 09 January 2020
[211] Honohan Patrick and others, 'The Irish Banking Crisis: Regulatory and Banking Stability Policy' (2010) Central Bank of Ireland MPRA Paper 24896, 1,184<https://core.ac.uk/download/pdf/6493912.pdf> accessed 09 January 2020.
[212] Charles Albert Eric Goodhart, 'The Changing Role of Central Banks' (2011) 18(2) Banking History Rev Banking Markets Group 35 <www.bis.org/events/conf100624/goodhartpaper.pdf> accessed 09 January 2020.
[213] James Barth ,Gerard Caprio Jr and Ross Levine, 'Bank Regulation and Supervision: What Works Best?' (April 2004)13(2) NBER Working Paper 9323 205,248 <www.sciencedirect.com/science/article/pii/S1042957303000603> accessed 09 January 2020.
[214] Marco Arnone and others, 'Central Bank Autonomy: Lessons From Global Trends' (June 2009) 56(2) International Monetary Fund Staff Papers IMF working paper WP/07/88 263,296 <www.researchgate.net/publication/46526574_Central_Bank_Autonomy_Lessons_From_Global_Trends> accessed 09 January 2020

of banking crises. Thus, adding to administrative and statutory regulatory provisions, the banking sector has been overshadowed with widespread formal and informal regulations; in one form or another. Banks have been made subject to a list of non-exhaustive regulations including: restrictions on new entry and branching; interest rate control and control over fees and prices; ownership regulation and regulation of linkages with other banking institutions; line of business restrictions; the limitation of the portfolio of the assets which a bank is required to hold like the limitations to have certain securities or not to hold certain securities; deposit insurance requirements; bank reserve requirements to hold a given quantity of liability in central banks.[215]

Another aspect of limitation is the scope that regulations might cover to include every aspect of sound banking. The regulations and statutory prescriptions are geared to providing the framework and skeleton for sound banking in a sector, the rest of the day-to-day practice has to be fitted into that skeleton. This rationale on its own means that laws alone cannot guarantee that sound banking practices will prevail in all jurisdictions. Even so, the law does not operate in a vacuum, and it is made for people, the compliance with the law is not a matter of choice and sound practice established by the various ethical and governance principles. Saying that the only law will guarantee good practice in banking is like saying that the penal code guarantees crime free state; that's not the case, thus compliance with good banking practice is not only determined by the laws and regulations but also by the management, the corporate culture, and practices.[216]

1.5.4 Undue Complexity

The complexity in law and regulations feeds on itself and may bring the system into disrepute. According to King, not many individuals can understand the totality of current financial regulation, and "those who try are not left with the impression that it is common sense. For example: the Prudential Regulation Authority and the Financial Conduct Authority, in the UK, have combined rulebooks exceeding ten thousand pages. Efforts to comply with financial regulation are a barrier to new small firms trying to enter the financial sector, and, in advanced

[215] Olivier De Jonghe, 'Back to The Basics in Banking? A Micro-analysis of Banking System Stability' (January 2010)19(3) Journal of Banking intermediation Elsevier 387,417<http://isiarticles.com/bundles/Article/pre/pdf/18304.pdf> accessed 08 January 2020

[216] Anthony M Santomero and Jeffrey J Trester, 'Banking Innovation and Bank Risk Taking' (1998)35(1) Journal of Economic Behavior & Organization 25-37, University of Pennsylvania Rev August 1997<https://kundoc.com/pdf-Banking-innovation-and-bank-risk-taking-.html> accessed 08 January 2020

countries, result in the employment of several hundred thousand people. To employ such a large number of talented people to cope with complex regulation constitutes a large 'dead-weight' cost to society."[217]

1.5.5 Enforceability and Sanctions

The other shortcoming in terms of law is that it has failed to hold to account those who caused the Banking crisis in 2008, the fact that the law does not fully ensure that those responsible for the crisis have learnt all the lessons is dangerous. This reveals that at times the law cannot address all the concerns of sound banking practices. It is arguable that the US law, the Dodd-Frank Act,[218] failed in tightening the bank and banking industry regulations but could not truly resolve all the problems in relation to sound banking practices. This cements the idea that even though the laws are effective in ensuring some aspects of sound banking practices are instilled, they are not a guarantee that there will be full sound practice because of certain challenges. For instance, Admati argued that: "More effective regulation of the mix of funding, so-called leverage, used in banking is highly cost effective relative to alternatives, and might reduce the need for costlier interventions.[219] Yet the opportunity for major reform to improve the system has been missed so far."[220]

The regulatory discretion also suffers from many vulnerabilities including "dynamic inconsistency" or "time-inconsistency" which explains decision-makers' relative changing preferences over time to the point where the preferences are inconsistent.[221] For financial regulators, it can explain the loss of consistency in the application of a regulatory policy or tool when it is most needed because regulators cannot be trusted to credibly commit, to "stick to their guns in the midst of war."[222]

1.5.6 Inadequacy

[217] M. King, The End of Alchemy (London: Little, Brown, 2016

[218] Frank 'The Dodd–Frank Wall Street Reform and Consumer Protection Act' (111th Congress H. Rept. 111-517 Conference Report 21 July 2010) <www.congress.gov/111/plaws/publ203/PLAW-111publ203.pdf>accessed 08 January 2020.

[219] Admati (fn 209)

[220] Clifton B Parker, 'The Banking Industry Needs More Effective Regulatory reforms, Says Stanford Expert' (November 3, 2014) Stanford Report < https://news.stanford.edu/news/2014/november/banking-regulation-admati-110314.html>accessed 08 January 2020.

[221] F. Kydland and E. Prescott, "Rules Rather than Discretion" (1977) 85(3) J.P.E. 473–492

[222] A. G. Haldane, "Control rights (and wrongs)" Wincott Annual Memorial Lecture, (London, October 24, 2011)

Blinder[223] explores the Banking Entropy Theorem: the inadequacy of the laws in fully regulating the industry cannot fully guarantee the sound banking; banking regulations and their effectiveness tend to get weakened over time by (a) industry workarounds, (b) regulatory changes, and (c) legislative changes. The main exceptions come during and after banking crises, when public revulsion against banking excesses enables, perhaps even forces, a tightening of regulation.[224]

The justification for this entropy theorem is premised on the following ideas as outlined by Parker:[225] Firstly, its reason is that the monetary rewards for any successful producer in the banking sector are enormous, especially in the US and the UK. Secondly it is premised on the fact that due to the high potential payoffs in the industry, the banking industry tends to attract a country's top brainpower and most of the innovative talents in the country. Thus, people pursuing finance and banking careers tend to be smarter than the average person, making them more creative, less risk-averse and more avaricious and maybe even risk-loving. Third premise, banking regulation reduces; the potential or actual; profitability of a banking institution in one way or another, thus the need of finding ways through innovation to go around regulatory boundaries rewards very handsomely. This means that banking commerce is in the rarest of circumstances affected by bribery and, even though some regulations are tough, banking regulators have always favoured the perspective of a system that is highly regulated, even when everything is going on well or in good times. Another premise that is relied on by Parker is the fact that in politics there is the syndrome of "money talks" and as such financiers and bankers have a lot of money which they spend on lobbying both the executive and the legislative arms of government. The obvious result of this is that regulators will be more inclined in implementing regulations influenced by politics which may prejudice banking practices. Therefore, this brings out the second view which shows regulations can be applied in an unsustainable way, that of a "grabbing hand" implying that too powerful regulations and supervision will be positively related to corruption and conversely not to the improvement of banking stability and performance.[226]

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[223] Alan S Blinder, 'Banking Entropy and the Optimality of Over-Regulation' (November 2014) 17th Annual International Banking Conference Working Paper 242, 40 <https://www.princeton.edu/ceps/workingpapers/242blinder.pdf> accessed 09 January 2020

[224] Douglas D Evanoff, Andrew G Haldane and George G Kaufman, The New International Banking System: Analysing the Cumulative Impact of Regulatory Reform(48 World Scientific Publishing Company 2015) ISBN-13: 978-9814678322

[225] Parker (n.215)

[226]James Barth ,Gerard Caprio Jr and Ross Levine, 'Bank Regulation and Supervision: What Works Best?' (April 2004)13(2) NBER Working Paper 9323 205,248 <www.sciencedirect.com/science/article/pii/S1042957303000603> accessed 09 January 2020.

1.5.7 Legislative Process

The regulator is a creation of a legislation, and its regulatory powers are also governed normally by the same legislation. One may argue that new legislation could be passed considering the changed economic scenario and banking needs, but it is very difficult to pass legislation that is not influenced by the practice of lobbying by the bankers particularly in a developing country like Pakistan where political instability, as discussed in chapter 2 and chapter 6, is at an unprecedented level and no democratically elected parliament could until recently complete its tenure and was overthrown on the allegations of corruption.

Given that many financial laws take a longer time to be enacted due to policy issues and industry wide consultation and statute law tend to remain unchanged for a long period, the law takes time in catching up with modern industry trends in finance. It makes it hard for the law to effectively ensure that there is sound banking practice in a system. Even if regulations and laws are passed to manage a banking sector, politicians and regulators become influenced by third parties and hence the veracity of the law may not be expected.

1.5.8 Stakeholder's Influence

Financial regulation and company law are often not "givens", but a basis for negotiation for some major players such as professional groups; established institutional and social structures; interdependent relationships between different markets; and national political priorities. Certainly, these forces have been present in the regulatory changes that have accompanied recent trends in globalisation.[227] Like company law, financial services regulation is a social and political process, not a value-neutral and automatic system. A great deal of financial services regulation is expressed in broad standards and its mobilisation depends upon: "a vast interorganizational network of stock issuers, brokers, independent gatekeepers (lawyers, accountants, and the like), regulators, and investors who transcend the form and content of their constituent agencies to create a shared, albeit temporary and contingent, "regulatory

[227] Y. Dezelay, "Professional Competition and the Social Construction of Transnational Regulatory Expertise", in McCahery, Picciotto and Scott, pp. 203-216 at p. 207

authority."[228]

These disparate yet interdependent agents actually give shape and effect to these broad standards, thereby in effect manufacturing regulatory law. Of course, major players such as the London Stock Exchange possess greater regulatory authority, and therefore more capacity to set the rules or change the parameters of the regulation game than smaller players.[229] It is not a static phenomenon, but rather a process of continuing political adaptation within a regulatory setting, in which actors can erode existing regulation, lobby for change, and take advantage of competition between different regulatory regimes.

Historically, it is the legal realist theory of corporate personality which has shaped the responses of both civil and criminal justice systems to companies, and this realist approach has had a specific effect on company law: it has been used to explain how corporations act, and in particular how they commit wrongs … "the judges drew upon the realist theory to enable the state of mind of those who direct the company to be attributed to the company itself … The realist theory finds the essence of personality in will: the capability of deciding on and initiating action."[230] However, corporations obviously do not possess emotions, but they can generate an organisational culture, the characteristics, and routines of which may be "transmitted from one generation of role incumbents to the next."[231]

1.5.9 Proportionality

Proportionality is another issue that makes it hard for banks to fully install sound practices. In the EU it is recognised that banking regulations have to adhere to the core principles of the European legal system. Therefore, any banking law that does not adhere to necessity, sustainability and proportionality is ineffective as it may harm other aspects of the banking system. The reason that a banking regulation is out of the boundaries set by the Treaty of the European Union[232] will mean that the law has failed to be justifiable and hence ineffective. Such a prescription cannot help to engrave sound banking practices.

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[228] N. Reichman, "Moving Backstage, Uncovering the Role of Compliance Practices in Shaping Regulatory Policy", in K. Schlegel and D. Weisburd (eds), White Collar Crime Reconsidered (Northeastern University Press, Boston, 1992), pp. 244-268 at p. 246
[229] E. Meidinger, "Regulatory Culture: A Theoretical Outline" (1987) 9 Law and Policy 357
[230] Wood (n 10)
[231] B. Fisse and J. Braithwaite, "The Allocation of Responsibility for Corporate Crime: Individualism, Collectivism and Accountability" (1988) 11 Sydney Law Review 468-513 at 489
[232] Article 5, Treaty of the European Union

According to the European Banking Authority (EBA) provides that the following aspects will be followed and defined this aspect to be: "The principle of proportionality means that small and non-complex institutions can comply with the principles by implementing less complex, but still appropriate, [...] policies, while large and complex institutions have to implement more sophisticated [...] policies."[233] It is also noted[234] that disproportional regulations may hurt the smaller and less risky banks. Sometimes regulators have the power to distort the market results and cause inflated costs of the banking systems, these arbitrary regulations are not suitable for ensuring that there is compliance with good practice.

1.5.10 Banking Practices & Trade Usage

Many times, the law prescribes general provisions of good governance, corporate governance, banking disclosures, capital requirements, accounting standards, board, and leadership, etc. However, these laws are not applied in a vacuum and their compliance is heavily dependable on the quality of the banking institutions' internal compliance processes.[235] Regulatory requirements like unreasonable risk-based capital requirements have the impact of increasing the banking system credit rationing which can easily affect the banking system negatively. This will not amount to sound banking practices.[236] It is therefore arguable that the impact of regulation and its effectiveness, especially capital requirements, in a banking system highly depends on institutional features and specific policies. Thus, it would not only be wrong but also misleading to rule that these requirements are undesirable altogether.[237]

Regulations and supervisions go hand in hand; even though regulations can be promulgated in a manner which would allow sound banking practices, the regulators have to be aware of the intricacies that surround the banking business. For instance, the practice of capital requirement

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[233] Andreas Schenkel, 'Proportionality of Banking Regulation-Evidence from Germany' [March 2017] University of Muenster Institute for Cooperative Research <www.ifg-muenster.de/forschen/veroeffentlichungen/2017/material/v_20170127.pdf> accessed 09 January 2020
[234] Schenkel (n 233)
[235] Katarzyna Sum, The Factors Influencing the EU Banking Regulatory Framework: Impediments for the New Regulations Post-Crisis Banking Regulation in the European Union Springer International Publishing 2016) Chap1169,207 ISBN 978-3-319-41378-5
[236] Anjan V Thakor, 'The Design of Banking Systems: An Overview' (1996) 20(5) Journal of Banking & Finance ELSEVIER917,948 <https://www.sciencedirect.com/science/article/abs/pii/037842669500033X?via%3Dihub> accessed 09 January 2020
[237] William B Francis and Matthew Osborne. 'On the Behaviour and Determinants of Risk-Based Capital Ratios: Revisiting the Evidence from UK Banking Institutions' (17 Nov 2010)10(4) Bank of England International Review of Finance SSRN485,518 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1733365> accessed 09 January 2020;

is a good example. It is true that capital requirements are crucial to ensuring that banks meet their obligation with ease.[238] This is because net reserve and capital act as a buffer for losses and hence failure and thus capital adequacy regulations help maintain sound banking practices. However, it is a contentious matter and researchers have disagreed on whether regulators and regulation requirements practically reduce and narrow down banking systemic risk.[239] Scholars also argue that it is very hard, and perhaps impossible, for any supervisor or regulator to set a cap on capital standards which mimic the conditions that are suitable and required by a properly informed and undistorted banking sector or private-market participants. For example, Alexander and Baptiste[240] have revealed that these regulators setting capital requirements may cause an increment in risk-taking behaviour; this is against the sound banking practices which should be the main goal of the regulators, supervisors, and regulations.

It goes without saying that banking laws are proper at ensuring that soundness is maintained, however other tools are also as important in this role. The pre-crisis regulatory belief that markets are self-correcting caused regulators and policymakers to focus on ensuring the safety and soundness of individual institutions, rather than the financial system as a whole. This invidious position was long acknowledged by the courts, observing that banks are in a most unenviable position. They are at risk of criminal prosecution if they entertain suspicions but do

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[238] Mathias Dewatripont and Jean Tirole, The Prudential Regulation of Banks (The MIT Press UK edn 20 December 1994)1-282 ISBN-13: 978-0262513869

[239] Dr Nout Wellink, 'The importance of banking supervision in Banking stability' [November 2008] BIS Review 138/2008 <https://www.bis.org/review/r081117a.pdf> accessed 08 January 2020.

[240] Gordon J Alexander and Alexandre M Baptista, 'A Var-Constrained Mean-Variance Model: Implications for Portfolio Selection and the Basle Capital Accord' (2001) EFA 2001 Barcelona Meetings SSRN 45,16< https://papers.ssrn.com/sol3/papers.cfm?abstract_id=275894> accessed 09 January 2020 ; Jürg Blum,'Do capital adequacy requirements reduce risks in banking?' (1999)23(5) Journal of Banking & Finance Elsevier Science B.V 755,771< https://www.sciencedirect.com/science/article/pii/S0378426698001137> accessed 09 January 2020 ; David Besanko and George Kanatas, 'The regulation of bank capital: Do capital standards promote bank safety?' (1996)5(2) Journal of Banking Intermediation 160,183< https://econpapers.repec.org/article/eeejfinin/v_3a5_3ay_3a1996_3ai_3a2_3ap_3a160-183.htm> accessed 09 January 2020; Jean-Charles Rochet,'Capital Requirements and The Behaviour of Commercial Banks' (1992)36(5) European Economic Review1137,1170 <https://econpapers.repec.org/article/eeeeecrev/v_3a36_3ay_3a1992_3ai_3a5_3ap_3a1137-1170.htm> accessed 09 January 2020; Gerard Gennotte and David Pyle, 'Capital controls and bank risk' (1991)15(4-5) Journal of Banking & Finance 805,824< https://www.sciencedirect.com/science/article/abs/pii/037842669190101Q> accessed 09 January 2020 ; Mark J Flannery, 'Capital Regulation and Insured Banks Choice of Individual Ioan Default Risks' (1989)24(2) Journal of Monetary Economics ELSVIER235,258 <https://www.sciencedirect.com/science/article/abs/pii/0304393289900056> accessed 09 January 2020; Daesik Kim and Anthony Santomero, 'Risk in Banking and Capital Regulation' (1988)43(5) The Journal of Finance 1219,1233< https://onlinelibrary.wiley.com/doi/abs/10.1111/j.1540-6261.1988.tb03966.x> accessed 09 January 2020
; Lam Chun and Andrew Chen, 'Joint Effects of Interest Rate Deregulation and Capital Requirements on Optimal Bank Portfolio Adjustments'(1985) 40(2)The Journal of Finance 563,575 <https://onlinelibrary.wiley.com/doi/abs/10.1111/j.1540-6261.1985.tb04973.x> accessed 09 January 2020
; Michael Koehn and Anthony M Santomero, 'Regulation of Bank Capital and Portfolio Risk' (1980)35(5) The journal of finance 1235,1244 > & <https://onlinelibrary.wiley.com/doi/abs/10.1111/j.1540-6261.1980.tb02206.x> ; Kahane Yehuda, 'Capital adequacy and the regulation of Banking intermediaries' (1977)1(2) Journal of Banking & Finance ELSEVIER 207,218 who have all argued that regulators don't have what it takes to set capital requirements effectively.< https://www.sciencedirect.com/science/article/abs/pii/0378426677900073> accessed 09 January 2020.

not report them or, if they report them, and then nevertheless carry out their customer's instructions without authorisation. If they do not act as instructed, their customers are likely to become incensed and some of those so incensed may begin litigation."[241]

Market discipline is a very effective mode for the supervision and governance of banking institutions whether the goal is to increase stability, innovation, value maximization or even combined desired goals. Policies which tend to up the banking market discipline use either one of the following models: the encouragement of the bank to consider the behaviour of the market or encouraging the market to pay attention to the banking sector. Either of the two can only be made possible if the market has access to information which the banking institutions hold and if the banking institutions have access to the information in the market. Even though there were regulations which required banks to share information in the major banking hubs like Europe and US, this did not prevent the banking crisis of 2007/08.

The regulatory framework shields banks, to some extent, from these conflicting obligations. The potential focus on appearances rather than substance is particularly acute in the suspicious activity reports that banks are required to produce in order to tackle money laundering and, at times, avoid legal liability and corresponding costs. While banks often communicate to their customers messages of trust, loyalty, long-term relationship, and confidentiality, in their rhetoric to the public and regulators, "they also utilise the gatekeeper narrative and endorse their important contributing role to society.[242]

1.5.11 Disclosure and Information sharing

Collection of information and data is crucial in the banking sector, it is this information which makes the backbone of macro prudential policies and monetary policy in an economy.[243] Most of the time banking legislations give a blanket power to the regulators to collect information from banking institutions. The methodology and framework are entirely based on the supervisors and regulators. It has been suggested that, for a better working of the banking

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[241] Longmore LJ in Shah v HSBC Private Bank (UK) Ltd [2010] EWCA Civ 31; [2010] Bus. L.R. 1514 at [32].
[242] A. Hoffmann and C. Birnbrich, "The Impact of Fraud Prevention on Bank-customer Relationships an Empirical Investigation in Retail Banking" (2012) 30(5) International Journal of Bank Marketing 390, 394.
[243] Erlend W Nier, 'Towards Effective Macroprudential Policy Frameworks: An Assessment of Stylized Institutional Models'(November 2011) IMF Working Paper 11/250< https://www.imf.org/external/pubs/ft/wp/2011/wp11250.pdf> accessed 09 January 2020.

sectors, a common and joint model should be adopted by the supervisors[244] where other statistical bodies play their part; this is because the regulator needs all the help it needs from the private sector and other stakeholders in coming up with a sound macro prudential policy. The importance of information sharing in any sector is that it involves a holistic approach to a problem and the expertise of various stakeholders is not disregarded.[245]

Another way in which the law could be seen as being not an absolute consideration in ensuring sound banking is through the perspective in which information plays in the banking sector. It has been proved that market discipline and information are very closely related. Even with proper law and lack of information, the regulators and supervisors may not be able to properly understand the circumstances and situation of the banking system. Critically speaking, market incentives of the regulators to monitor banking institutions can remain untampered by the mandated information disclosure. The extent and level of information disclosure can therefore be of lesser importance than the original and the original motivation to produce the information. It has, historically, been proven that transparency in the banking sector increases sound banking practices.[246]

The practice in banking sectors where banks are constantly sharing quality information with their regulators and supervisors have helped make the work of the banking sector regulation much easier. Banks have been filing at a constant and increasing flow of information pertaining to quarterly reports, balance sheets, income statements, and other information which the regulators require from these institutions. In fact, it can be argued that the regulatory framework has been evolving to cope with the prevailing level of information sharing. As much as regulations and laws provide the supply of data and information to the supervisors, the law is limited in the manner in which this information can be put to use to ensure that there are proper banking practices and that these are analysed in comparison to the pre-existing monetary policy and macro-economic policy. The banking regulators have expanded the range of information that they collect to include off-balance sheet exposures and formation which is collected on derivatives.[247] It has been argued that policies which seek to highlight the significance of the

[244] Katia D'hulster, 'Cross Border Banking Supervision: Incentive Conflicts in Supervisory Information Sharing between Home and Host Supervisors' (2012) 13(4) World Bank Policy Research WP 5871 SSRN 300,319< https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1955108> accessed 09 January 2020
[245] Jing Fan, Pengzhu Zhang and David C Yen, 'G2G Information Sharing Among Government Agencies'(2014)51(1) Information & Management ELSEVIER120,128 < https://www.sciencedirect.com/science/article/abs/pii/S0378720613001146> accessed 09 January 2020
[246] Alexanders and others (n.240)
[247]Alexanders and others (n.240)

information are important because the sharing of information can be used to boost discipline in the banking sector.[248]

The need for establishing a proper communication framework with banking stakeholders and a framework is emphasised by the Bank for International Settlement (BIS) in detail.[249] BIS has argued that this framework should address the need for and importance of establishing data-sharing between banking institutions, banking institutions with the supervisor, the stakeholders in the banking sector, and must be able to cater for both top-down and bottom-up models of information sharing. Cooperation and data sharing are mandatory by legislation,[250] but the central bank has the discretion to create and facilitate a coherent and comprehensive picture for all the policy makers. It is also crucial that the benefits of data and information sharing are well entrenched in the banking system so that statutory compliance is made without hindrances. This shows that well modelled information sharing can be useful for creating sound banking as it allows proper compliance mechanisms and verification of banking information.

The second point which the BIS considered important is that it is proper to ensure that the legal, regulatory, and legislative framework is clear and supports data and information-sharing. Communication and sharing of data and information is of utmost importance in any banking sector and since the stability of markets are based on information and perceptions,[251] the need to encourage dialogue between banking stakeholders becomes a matter of importance. Information sharing should be fostered within the banking institutions, in the regulators and supervisors alike, across the banking agencies and with all banking reporting agencies such as credit information sharing bureaus, anti-money laundering, relevant ministry and policy-making bodies.

International Finance Corporation (IFC) surveys have found out that even though the G20 members have some of the very comprehensive legislations on banking, the reports by IFC have shown that most central banks consider information sharing and cooperation as real

[248] Mark J Flannery, 'Using Market Information in Prudential Bank Supervision: A Review of The US Empirical Evidence'(August 1998)30(3) Part 1Journal of Money, Credit and Banking Ohio State University Press OSUP
[249] Bank for International Settlement, Data-sharing: Issues and Good Practices (Report to BIS Governors Prepared by the Task Force on Data Sharing (January 2015) ISBN 978-92-9259-169-4
[250] S. 246 Banking Act 2009; Part 7 & others Proceeds of Crime Act 2002, S. 25A & others the Banking Companies Ordinance 1962 and other laws
[251] Thorsten Beck, Asli Demirgüç-Kunt, and Vojislav Maksimovic, 'Bank Competition and Access to Finance: International Evidence' (2004)36(3) Journal of Money, Credit and Banking OSUP JSTOR627-648< https://www.jstor.org/stable/3838958?seq=1>

challenging.[252] This is despite understanding of risk by statistics experts is made easier by use of increased information sharing on a granular level, this also makes it possible for supervisors to properly grasp the cross border, intra-institutional and inter-institutional linkages of risk in banking.[253]

The regulatory framework can easily allow data sharing but in a limited way on a specific condition. The working of the relevant bodies will be affected in a number of ways: First the recipient authority will be under obligations and subject to effective sanctions in the event of any breach of confidentiality occurring. As stated above, regulations may act as an impediment to proper information and data sharing.[254]

1.5.12 Failure of Corporate Governance

Hannigan observed quoting as HM Treasury that failure of banks "was widespread corporate governance failures by these boards, particularly in understanding and probing their firms' risk management processes:"[255] Hannington concluded that "United Kingdom banking defaulters and failures, such as Northern Rock, HBOS, and Royal Bank of Scotland, was corporate governance failure despite, looking at on papers all had boards with the obligatory mix of executive and non-executive directors, all had remuneration, audit, and nomination committees, all operated in compliance with respected codes of corporate governance, as their annual reports confirmed".

Banks however continue to fail in complying with their obligations, and even in developed countries banks fail to take proper actions to prevent the execution of illicit financial transactions. For example, the Association of Certified Financial Crime Specialist (CFCS) reports that in 2019 fines for breaches of AML regulation amounted to over $8 billion globally.[256] In 2013, the Financial Conduct Authority[257] disclosed that the vast majority of

[252] Bank of International Settlement, The Sharing of Micro Data – a Central Bank Perspective (Irving Fisher Committee on Central Bank Statistics IFC Report December 2016) ISBN 978-92-9259-011-6

[253] Bank of International Settlement, Data-Sharing: Issues and Good Practices (Prepared by the Task Force on Data Sharing IFC Report January 2015) ISBN 978-92-9259-169-4

[254] ibid

[255] Hannigan, "Board failure in the financial crisis—Tinkering with Codes and the need for wider Corporate Governance Reforms: Part 1" (2011) 32 Company Lawyer (12) 363, 363

[256] https://www.acfcs.org/fincrime-briefing-aml-fines-in-2019-breach-8-billion-treasury-official-pleads-guilty-to-leaking-2020-crypto-compliance-outlook-and-more/ [Accessed 27 July 2020]

[257] FCA, "Banks' control of financial crime risks in trade finance", Financial Conduct Authority, Thematic Review, TR13/3 (2013).

banks operating in the UK had not taken adequate actions to make sure that they should not be involved in financial transactions with sanctioned individuals or business firms. Below are some examples that illustrate that law alone could not strengthen soundness of a banking system which would require good corporate governance, indiscriminate enforcement by regulator even in developed country like the UK:

Co-operative Bank (2013)

In July 2013, the UK Prudential Regulation Authority determined that the UK Co-operative Bank had a £1.5 billion shortfall in its capital adequacy. The Co-operative Bank had been suffering losses from its bad loan book, largely inherited from the Britannia Building Society, which it had taken over in 2009. After applying the more stringent Basel III capital adequacy rules to the Co-operative Bank, the regulator determined a massive capital shortfall in the Co-operative Bank's capital position and while the Co-operative group as sole shareholder would inject £1 billion into the bank to recapitalise it, the rest of the shortfall was to be made up for by bailing in the preference shareholders and subordinated debt holders of the Co-operative Bank. The Co-op Bank episode ultimately resolved in the Co-op Group absorbing a significant amount of loss as major shareholders and bondholders converted into equity holders having a majority stake.

Co-operative Bank (August 2015)

Following a joint investigation with the PRA, the FCA issued a public censure against the Co-operative Bank Plc (" Co-op Bank") in 2015. Between March 2013 and 17 June 2013, Co-op breached FCA Listing Rule 1.3.3R (misleading information not to be published) by making statements about its capital position in its annual report that were false and misleading. The Co-op also did not disclose to the regulator changes to two senior positions and the reasons behind those changes. The FCA considered that there was no reasonable basis for Co-op stating that it had adequate capital in the most severe stress scenarios. The FCA also considered that it should have been notified about proposed changes to management so as to properly consider and assess the management of the firm.[258]

[258] https://www.fca.org.uk/publication/final-notices/the-co-operative-bank-plc-2015.pdf

Aviva Investor Global Services Ltd (February 2015)

In February 2015, the FCA found conflicts of interest in the management of funds paying differing levels of performance fees on the same desk within the fixed income business (known as side-by-side management). The lack of adequate and effective control over its side-by-side management of funds led to a breach of Principle 3. The FCA also found that the Internal Audit function identified weaknesses in systems and controls, but these were not adequately addressed by the firm. The FCA published a Final Notice addressed to Aviva Investor Global Services Ltd and had imposed a fine of over £17 million for breaching FCA Principles for Businesses, namely Principle 3 (Management and control) and Principle 8 (Conflicts of interest).[259]

The examples quoted above are randomly chosen from banking and non-banking institutions; simple browsing of the regulator's website demonstrates that many banks are penalised every year with significant fines.[260]

Another limitation of law or more specifically corporate and company law in strengthening a sound banking system is shareholder-centric ideology that affects the business practices of banks and financial institutions as for-profit corporations.[261] It is arguable that shareholder-centric corporate governance paradigm could be adverse to the objective of maintaining the safety and soundness of financial institutions because it contributes to higher risk-taking tendencies in banks and financial institutions. Management could take advantage of the conflicts and act according to its preferences, resulting in a completely contrary consequence from what is envisaged. One could argue that the United Kingdom may have found a middle way by maintaining the shareholder-centric model of conventional corporate governance for all corporates, in re-characterising shareholders as "stewards".[262]

We have discussed and explored earlier in this chapter "essentials of a sound banking system other than law." These other essentials, such as corporate governance and appropriate

[259] https://www.fca.org.uk/publication/final-notices/aviva-investors.pdf

[260] https://www.fca.org.uk/search-results?search_term=fines%20and%20penalties; www.sbp.org.pk/BS/2019/DSEA-Aug-19.pdf

[261] D. Bholat and J. Gray, "Organizational Form as a Source of Systemic Risk" (July 24, 2012), SSRN, http://ssrn.com/abstract=2121649

[262] D. Walker, "A Review of Corporate Governance in UK Banks and other Financial Industry Entities: Final Recommendations" (November 26, 2009); UK Stewardship Code 2010, 2012;

accountings, limit the role of law in strengthening a sound banking system because these are outside the scope of law and regulations. Following examples illustrate such limitations:

1.5.13 Misleading Account and Audit

Accounting is an important element in the Corporate Governance Code. It has featured prominently as one of the main corporate governance principles going back to the Cadbury Report. Unfortunately, inaccurate accounting, lack of internal controls and misleading audit caused by a limited remit of auditors have often been cited as major reasons for the collapse of many banking companies.

Misleading audit appears to play a lead role as an accurate audit will pick up deficiencies in accounting and internal control systems. At a launch of a new inquiry examining the future of audit in November 2018, the Chair of the Business, Energy and Industrial Service Committee, Honourable Rachel Reeves said the audit market is broken:

> "Misleading audits have been at the heart of corporate failures over recent decades. Recent accounting scandals at BHS, Carillion, and at Patisserie Valerie have shown accounts bearing closer resemblance to works of fiction than an accurate reflection of the true financial performance of the business. Repeated accounting failures have contributed to the collapse of major businesses and undermined public and investor confidence." [263]

A common example of accounting failures is where the company's account is signed off prior to it going into insolvency. EY, the new auditors for Thomas Cook, signed off the company's last set of accounts for 2018 prior to it becoming insolvent in September 2019. Such practices commonly arise where the company uses the same firm of auditors for many years. In addition to giving rise to feelings of loyalty, this practice can gradually compromise the independence and objectivity of the firm and could eventually lead to the auditors being found complicit with the failed company. The accusation of auditors' complicity in Thomas Cook's downfall was levied against PwC, auditors of Thomas Cook and EY the firm which replaced PwC in 2017.[264]

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[263] "BEIS Committee Examine the Future of Audit", Parliament, 12 November 2018, https://www.parliament.uk/business/committees/committees-a-z/commons-select/business-energy-industrial-strategy/news-parliament-2017/future-of-audit-inquiry-launch-17-19/ [Accessed August 2022]

[264] Riggins, "Top Corporate Scandals in 2018" (19 March 2019) https://www.financialdirector.co.uk/2019/03/19/top-corporate-scandals-in-2018/ [Accessed August 2022]

A parliamentary inquiry into the collapse of the company found that Thomas Cook paid PwC up to £21 million in consultancy fees between 2007 and 2016.[265]

According to another parliamentary report on the collapse of Carillion, the FRC first raised concerns about the company's future in 2015 while conducting a regular review of the company's account.[266] "The FRC highlighted 12 potential problems with Carillion's books, ranging from a lack of clarity in goodwill assumptions to a non-existent explanation on the major decline in Carillion's book-to-bill ratio" and gave warnings of a potential profit shortfall. Yet the company's account continued to be signed off until March 2017, when Carillion itself issued profits warnings. The company went into liquidation less than a year later in January 2018 with debts of £1.5 billion. The board's insufficient handling of annual reporting and accounts was seen as a major reason for the company's collapse. The parliamentary report raised questions about the independence and objectivity of KPMG, Carillion's auditor, given that they were the company's auditors for all 19 years of its existence from 1999, although it noted that this was within the 20-year statutory maximum period within which companies must change their auditors. In a critical statement, the report stated that KPMG audited Carillion for 19 years, pocketing £29 million in the process. Not once during that time did they qualify their audit opinion on the financial statements, instead signing off the figures put in front of them by the company's directors. Yet, had KPMG been prepared to challenge management, the warning signs were there in highly questionable assumptions about construction contract revenue and the intangible asset of goodwill accumulated in historic acquisitions. These assumptions were fundamental to the picture of corporate health presented in audited annual accounts.[267]

1.6 CONCLUSION

The operation of law requires a legal system composed of actors and processes to make, interpret, advocate, and enforce the law. This system includes legislatures, judicial and law enforcement institutions, administrative agencies, as well as the legal profession, advocates, and civil society groups. In all societies, state law is but one of many rule systems that order

[265] Wale Azeez, "Auditors 'Complicit' in UK Corporate Failures" Sky News, 23 October 2019, https://news.sky.com/story/auditors-complicit-in-uk-corporate-failures-mps-say-11842171 [Accessed August 2022]
[266] https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/76906.htm#_idTextAnchor110
[267] Parliament, https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/76906.htm#_idTextAnchor110. [Accessed October 2022].

behaviour and authority. These rule systems include customary and religious law, cultural and social norms, functional normative systems, and economic transactional normative systems.[268]

As pointed out by Crowther, "The secret of successful banking is to distribute resources between the various forms of assets in such a way as to get a sound balance between liquidity and profitability, so that their possession of cash, on hand or quickly realisable, to meet every claim, and at the same time enough income for the bank to pay it way and earn profits for its shareholders." But modern bankers also consider a few other essentials.[269] One of the essentials of a sound banking system is to have a higher degree of liquidity. The bank holds a small proportion of its assets in cash. Therefore, its other assets must possess the criterion of liquidity so that they may be converted into cash easily. Another essential of a sound banking system is that it must maintain prudent and secure lending policies.

Since the bank keeps the deposits of the people, it must ensure the safety of their money. Therefore, it should have stringent policies for loans and investments to avoid unnecessary risks. If the debtors of the banks do not repay the loans in time and it loses on its investments, the bank shall become insolvent. As a result, its depositors lose money and suffer. Thirdly**,** a sound banking system must have rational operational and lending policies ensuring its stability. There should neither be any undue contraction or expansion of credit. If a bank restricts the creation of credit when trade and industry need it the most, it will harm the interests of the business community. On the other hand, if it expands credit when the economic conditions do not permit it, it will lead to an inflationary spiral.

The regulator can ensure compliance with stability in the banking operations of the commercial banks by a judicious credit control policy. Furthermore, the banking system should have sufficient elasticity in its lending operations. It should be able to expand and contract the supply of loanable funds with ease in accordance with the directives of the regulator. A sound banking system should not be concentrated only in big towns and cities but in rural areas and backward regions too. It is only by widespread expansion of the banking system that the deposits can be mobilised, and credit facilities can be made available to trade, industry, agriculture, etc. This is especially the case in a developing country where the banking system must provide these

[268] Tamanaha, Brian Z 2008. "Understanding Legal Pluralism: Past to Present, Local to Global." Sydney Law Review 30 (3) 375–411

[269] Smiriti Chand,'7 Essentials of a Sound Banking System' http://www.yourarticlelibrary.com/banking/7-essentials-of-a-sound-banking-system-banking/11001/ accessed 09 January 2020.

facilities through its expansion in all areas. Lastly, a sound banking system must have competent regulators that enforce a number of best practices upon the supervised banks such as ensuring banks' numbers reflect the current reality health of their finances; banks must monitor their activities, liquidity, and solvency daily; regulators must ensure that banks hold enough capital to absorb potential losses as per the Basel regulation; banks must manage risk exposures proactively.

Banks are private-sector institutions whose healthy or sound functioning is in the public interest.[270] There is very little consensus on the question: what is a sound banking institution? It should be noted that research[271] on corporate governance theory has mostly referred to non-banking institutions until recently; and further research has been focused on the standpoint of a potential investor. How can an investor potentially believe that their money in terms of investments would ever be given back? This principal-agent problem is resolved in the banking system by creating the fact that the corporate governance makes responsibilities explicitly for value maximization of banking firms. There is equity-based compensation and shareholders are given control to hold to account the practices of directors. There are checks and balances whereby corporate control ensures that there is aligning of interests of the banking institution with those of the shareholders. Another ingredient that can hold and show sound banking is the use of stakeholders' theory of corporate governance.[272] An indication of the balance is that the banking system considers both the agency theory and the stakeholders' theory and balancing the shareholders' rights of returns, and the public expectation of a sound and stable banking structure.[273]
Collection of information and data is crucial in the banking sector, it is this information which makes the backbone of macro prudential policies and monetary policy in an economy.[274]

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[270] Robyn McLaughlin and Hamid Mehran, 'Regulation and the Market for Corporate Control: Hostile Tender Offers for Electric and Gas Utilities' (September1995) 8(2) 181,204 Journal of Regulatory Economics <https://link.springer.com/article/10.1007%2FBF01072589> accessed 04 January 2020
[271] *Simon Lowe, "How Will the Revised UK Corporate Governance Code Affect You?" (25 July 2018) Grant Thornton*, https://www.grantthornton.co.uk/insights/how-will-the-revised-uk-corporate-governance-Code-affect-you/ [Accessed August 2022]; *Report of the Committee on The Financial Aspects of Corporate Governance (1 December 1992)* https://ecgi.global/sites/default/files/codes/documents/cadbury.pdf, para.1.3 [Accessed August 2022]; *Nash Riggins, "10 Reasons for Corporate Failure" (29 March 2019) Financial Director*, https://www.financialdirector.co.uk/2019/03/29/10-reasons-for-corporate-failure/ [Accessed August 2022].
[272] Richard A Johnson and Daniel W Greening, 'The Effects of Corporate Governance and Institutional Ownership Types on Corporate Social Performance'(1999) 42(5) 564, 576 Academy of Management Journal <www.jstor.org/stable/256977>.accessed 04 January 2020
[273] Luc Laeven and Ross Levine, 'Bank governance, regulation and risk taking' (August 2009)93(2) 259,275 Journal of Banking Economics ELSEVIER <www.sciencedirect.com/science/article/pii/S0304405X09000816> accessed January 2020.
[274] Erlend W Nier, 'Towards Effective Macroprudential Policy Frameworks: An Assessment of Stylized Institutional Models'(November 2011) IMF Working Paper 11/250< https://www.imf.org/external/pubs/ft/wp/2011/wp11250.pdf> accessed 09 January 2020.

International Finance Corporation surveys have found out that even though the G20 members have some of the very comprehensive legislations on banking, most central banks consider information sharing and cooperation as real challenging.[275] This is despite understanding of risk identified by statistics because use of increased information sharing on a granular level enables the supervisors to properly grasp the cross border, intra-institutional and inter-institutional linkages of risk in banking.[276] It has been proved that market discipline and information are very closely related. Even with proper law and lack of information, the regulators and supervisors may not be able to properly understand the circumstances and situation of the banking system.

In many developing countries, although laws exist, they are not effectively enforced, or they are selectively enforced. Law itself may be used as a means of perpetuating insecurity, stagnation, and inequality.[277] The lack of applying or discriminately applying procedural law is a major problem in developing countries such as Pakistan; as we will see in subsequent chapters that Pakistan has very robust Money Laundering Law and regulations however these are selectively applied.

The US Congress intervention, on three occasions, to save the US Banking market and the banking crisis[278] demonstrated that sound banking system can be achieved by regulations: in 1933, Congress passed the Glass-Steagall Act of 1933[279] to restore confidence and order to the United States banking system after the crash of the stock market, runs on banks and the subsequent closing of over 5,000 banks between the crash and March 1933.[280] Secondly the Gramm-Leach-Bliley Act of 1999 (GLBA)[281] repealing Glass-Steagall was enacted to end the separation of banking, investment, and insurance activities in the banking industry when deregulated savings and loan institutions nicknamed “thrifts” resulting in a push by the thrifts into risky investments which investments collapsed in the mid 1980s, failing almost 300 thrifts

[275] Bank of International Settlement, The Sharing of Micro Data – a Central Bank Perspective (Irving Fisher Committee on Central Bank Statistics IFC Report December 2016) ISBN 978-92-9259-011-6
[276] Bank of International Settlement, Data-Sharing: Issues and Good Practices (Prepared by the Task Force on Data Sharing IFC Report January 2015) ISBN 978-92-9259-169-4
[277] https://openknowledge.worldbank.org/bitstream/handle/10986/25880/9781464809507_Ch03.pdf?sequence=35
[278] John B Taylor, ‘The Banking Crisis and the Policy Responses: An Empirical Analysis of what Went Wrong’ (January 2009)14631 National Bureau of Economic Research NBER working paper<www.nber.org/papers/w14631.pdf>accessed 08 January 2020
[279] Banking Act of 1933 (also known as the Glass-Steagall Act of 1933), (Pub.L. 73-66, 48 Stat. 162,
[280] David M. Kennedy, Freedom from Fear, The American People in Depression and War, 1929–1945 (1999), pp.162–163
[281] Financial Services Modernization Act of 1999 (also known as Gramm-Leach-Bliley Act of 1999), (Pub.L. 106–102, 113.1338, enacted November 12, 1999).

and costing to the taxpayers USD $125 billion.[282] The most recent financial crisis then led to a new round of banking regulation the Dodd-Frank Act[283] which is intended to ensure prevention of the return of the banking crisis by introducing regulatory reforms and new laws.

In addition to national authorities, international soft law institutions including FSB Basel Committee, the Committee on the Global Financial System, Committee on Payment and Settlement Systems, Financial Action Task Force on Money Laundering, International Association of Deposit Insurers, IAIS, International Accounting Standards Board, International Auditing and Assurance Standards Board, IMF, IOSCO, OECD and World Bank are key players of setting standards to be followed by national authorities.[284] Transnational Regulatory Networks "TRNs" is another source giving national authorities to legislate corresponding regulatory laws. The soft law law-making institutions such as the Basel Committee, the FSB and, to some extent, even the IMF all play a substantial role in influencing domestic legislation policy.[285] Basel adoption in Pakistan was also a result of IMF and World Bank conditionality; over the course of the late 1980s and 2000s, Pakistani politicians, whether civilian or military, increasingly shifted away from prioritizing state-led industrial development, to embrace a more international orientation and championing financial services exports in particular.

[282] Paul Krugman, The Return of Depression Economics, and the Crisis of 2008 (2009), pp.158–162.
[283] Dodd-Frank Wall Street Reform and Consumer Protection Act Pub.L., 111–203, H.R. 4173, enacted July 21, 2010
[284] Financial Stability Board, "Who Are the Standard-Setting Bodies" https://www.financialstabilityboard.org/cos/wssb.htm [Accessed July 2020]
[285] Lawrence G. Baxter, "Capture Nuances in Financial Regulation" (2012) 47(3) Wake Forest Law Review 537, 543, 558

CHAPTER 2

PAKISTAN: BANKING SYSTEM, GROWTH AND FINANCIAL STABILITY

2.1 INTRODUCTION

It is discussed in the first chapter that the Banking system in Pakistan was inherited from pre-partition India. The first chapter also describes that banks in Pakistan are mandated, by the IMF and World Bank, to comply with international banking standards. In this chapter a brief outline of the structure of the Banking system in Pakistan, its growth, and the role, is discussed. This chapter also examines the factors impacting the growth of the banking sector of Pakistan as well as factors that affect its soundness.

The financial system plays a critical role in the smooth and efficient functioning of every economy. The most fundamental contribution that any financial system makes is the channelling of resources from individuals and companies with surplus resources to those with resource deficits. In doing so the financial system not only satisfies the savings needs of the economy, but it also facilitates the accumulation of investment capital that is critical to growth and development.[286]

Banks provide an attractive bundle of most of these core financial services. By enabling depositors to write cheques and other negotiable instruments on their deposits, banks offer payments services and liquidity equal to that of currency. Banks also resolve the information conflict faced by borrowers, and generally enjoy substantial economies of scale in processing and analysing information. Finally, bank risk-pools borrowers' promises into a single promise by acting as an intermediary. For these reasons banks invariably form the centrepiece of the financial system. Even though banks offer a bundle of financial services, it is their roles as the centre of the payments system and a safe store of value to unsophisticated lenders that generate the intense regulatory oversight that banks receive in every country. The fact that banks are highly geared and vulnerable to swings in confidence makes the regulatory imperative even greater. Therefore, banks are regulated more intensively than any other group of financial institutions and their safety and soundness is closely protected by banking regulators.[287]

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[286] www.sbp.org.pk/fsr/2008/PDF/Chapter%206%20Framework%20for%20Consolidated%20Supervision.pdf
[287] www.sbp.org.pk/fsr/2008/PDF/Chapter%206%20Framework%20for%20Consolidated%20Supervision.pdf

Banks are therefore an important pillar of the economy owing to their key role in facilitating economic activity and smooth functioning of the payments system. Banking has gone well beyond its traditional function of channelling funds from the surplus sector of the economy (households/savers) towards the deficit sector (firms/investors). In the modern world, maturity transformation, risk management, monitoring, funds transfer, securitization, and facilitation of trading in financial assets, have emerged as main banking services.[288]

Banks, without financial stability, are inhibited to perform their role as a financial intermediary. Over the past two decades, computing and communication-related technologies, and techniques of financial analysis have changed banks' overall conditions: advancement and reduced costs in computing, telecommunications, data collection and storage, and the Internet have made it practically possible for banks and their customers to understand and follow regulatory requirements and financial risk management techniques. This has benefitted the banks in setting up branches in different countries with the assistance of technological and analytical advances that has improved banks' abilities to measure and manage their risks. It would not be wrong to suggest that Pakistani banking is the fastest sector of the economy. As per a World Bank report, Pakistan has been ranked second on the basis of performance among south Asian countries. The competition in the banking industry is growing day by day. Higher pressure on Pakistan's economy, political instability and continuing changing monetary policies has increased the importance and challenges of this sector.[289]

The financial sector of Pakistan constitutes banks, Development Finance Institutions (DFIs), Microfinance Banks (MFBs), Non-banking Finance Companies (NBFCs), insurance companies, Modarabas and other financial intermediaries. Latest asset structure of the financial sector is given below. The financial sector of Pakistan predominantly is composed of banks, as they hold the largest share of financial assets as a percentage of GDP. The State Bank of Pakistan regulates Banks, DFIs, Exchange Companies and MFBs, while Securities and Exchange Commission of Pakistan (SECP) regulate NBFCs, Insurance Companies and Modaraba Companies.[290]

[288] https://www.sbp.org.pk/publications/wpapers/2017/wp91.pdf
[289] Raza, S. A., & Hanif, N. (2013). Factors affecting internet banking adoption among internal and external customers: a case of Pakistan. International Journal of Electronic Finance, 7(1), 82-96
[290] https://www.sbp.org.pk/FS/SFS.asp

Institution	Regulatory Body	Licensed under
Banks	SBP	Section 27 of BCO, 1962
of which: Islamic Banking Institutions	SBP	Section 27 of BCO, 1962
Microfinance Banks	SBP	Microfinance Institutions Ordinance 2001
Exchange Companies	SBP	Foreign Exchange Regulation Act, 1947
DFIs	SBP	
Nonbank financial institutions:	SECP	
Investment companies	SECP	Companies Ordinance, 1984
Asset Management Companies	SECP	Companies Ordinance, 1984
Mutual Funds and Plans	SECP	Companies Ordinance, 1984
Pension Funds	SECP	Companies Ordinance, 1984
Discretionary & Non-Discretionary Portfolios	SECP	Companies Ordinance, 1984
Real Estate Investment Trust	SECP	Companies Ordinance, 1984
Leasing Companies	SECP	Companies Ordinance, 1984
Modarabas	SECP	Companies Ordinance, 1984
Insurance companies	SECP	Companies Ordinance, 1984

In a bank-dominated financial sector, the role of an efficient and competitive banking system can hardly be overemphasized for a developing country like Pakistan. The banking sector in Pakistan has witnessed significant transformation in its structure and business activities following the financial sector reforms initiated in early 1990s, with an objective to transform the repressed financial sector into a competitive, efficient, and sound one, owned and managed largely by the private sector.[291]

2.2 Pakistan Banking System

[291] https://www.sbp.org.pk/publications/wpapers/2017/wp91.pdf

2.2.1 Historical Background

The Banking System of Pakistan has been evolving under the influence of political instability along with the influence of religious institutions. Pakistan came into existence when the freedom of India movement, from the British Raj, took an interesting turn; a good number of people were moved to claim separation along with freedom on the basis of a two-nation theory. This theory basically motivated the Muslims in the subcontinent to divide the subcontinent on the basis of religious ideology; which strongly constructed the beliefs in Muslims that they could not live alongside the Hindu population of the region, even though they had lived together for over seven centuries, because their beliefs and lifestyles were different. Some however argue that the real reasons included the pursuit of economic freedoms that Muslims were seeking from the Hindus living in the subcontinent. The majority of Muslims were under-qualified and less educated compared to their counterparts due to the fact that they were denied equal opportunities and were discriminated against, by the British, in accessing education and employment for almost two centuries. Great Britain defeated Muslims' rulers i.e., Moguls to take control of India and it were Muslims who revolted against British Raj in its early years therefore the Muslims were seen as a threat to the existence of the British Raj for over a century until they were weakened by implementation of such discriminatory policies. This had led the Muslims to believe that they would become subservient to Hindus and would not attain economic and social independence even after the independence of India.

The lack of qualifications and educational background and experience to handle the country's machinery had been evident by the long bumpy ride that the country had to face before developing its own institutions. The first constitution of the country was agreed in 1956, i.e., nine years after its formation; this constitution could not last more than six years, and the new constitution was formed in 1962. This constitution was itself replaced by the constitution of 1973 which was agreed after three years of constitutional crises as the 1962 constitution was discontinued under the Legal Framework Order of 1970. The Country has always been in political turmoil; democratic governments had been overthrown for the reasons principally on the allegations of corruption and the country, since independence, had been governed by the Military commanders for most of the time.

The above background is narrated to give information as to the elements affecting the legislative process and that the features of Banking Laws in Pakistan had not been immune from political instability and religious factors. The legislative authority is vested with the parliamentary power however the president can also promulgate the laws[292] when parliament is suspended for some reasons e.g., by operation of emergency government formed by an Army chief commonly known as Martial Law. The laws legislated by parliament normally end with "the Act" and promulgated by a president or a chief executive are called "Ordinance".

2.2.2. Overview of the Banking Sector

The banking sector in Pakistan has evolved and expanded since 1947. In 1948, The State Bank was established and became operational. The Banks in Pakistan are divided into four major segments: public sector banks, private banks, Islamic Banks, and foreign banks. The public-sector banks are further classified into two categories i.e., banks set up exclusively for specialist services such as Industrial or Agricultural Developments and the banks providing general banking services. The public-sector bank can only be set up by the legislation i.e., by way of passing an Act or an Ordinance; such Act or Ordinance contains the name of the bank, and its contents include share capital, shareholders and their qualification, scope of operation, accounts, and audits etc. The Government, national or provincial, is a major shareholder of these banks. There are 14 public sector banks that are constituted and operative under this mechanism.

The Pakistani banking sector has gone through different phases of growth. The sector was directed by the government of Pakistan to implement the development strategies till 1980's. From the early 1970s to 1990, the banking business in Pakistan was subject to credit ceilings, directed and subsidized credit, control on deposit and lending rates, etc. These policies together with weak control on management rendered the banking services inefficient and resulted in lack of healthy competition among the banks.[293] Financial sector reforms initiated in early 1990s aimed at developing a market oriented, efficient, and sound banking system under the private sector management.[294] The banking sector of Pakistan has gone through three phases which are pre-nationalization, nationalization, and post nationalization.

[292] Article 89 of the Constitution of Pakistan 1973

[293] Mehmood, A., Hidthiir, M. H. B., & Nor, A. M. (2019). A conceptual paper for macroeconomic determinants of non-performing loans (NPLs) In banking sector of Pakistan. Asian Journal of Multidisciplinary Studies, 7(3), 6-15

[294] https://www.sbp.org.pk/publications/wpapers/2017/wp92.pdf

2.2.2.1 Pre-nationalisation

In the pre-nationalisation phase, Australian Bank Ltd. and Habib Bank Ltd. were the only two banks after the partition of Pakistan and India on August 14, 1947. For both the newly established countries, the Reserve Bank of India was performing as the central bank. A need was felt to establish the banking sector in Pakistan because the Reserve Bank of India was not performing its functions fairly for the Pakistani banking industry. The Pakistani government founded The State Bank of Pakistan in1948 and National Bank of Pakistan in 1949[295]. The Government then launched The State Bank of Pakistan Act in 1956 and introduced Banking Companies Ordinance in 1962 for the development of the banking sector of Pakistan.

2.2.2.2 Nationalisation

In early 1970s, the Pakistan government introduced reforms to promote economic growth by equitable distribution of credit to increase the efficiency and soundness of banks along with social accountability. But banks failed to follow the directions because credit was given to big accounts and urban areas which resulted in shortage of credit in agricultural, small businesses and emerging exports and housing. The second phase began in 1974. The government decided to nationalize the banking sector by merging all the banks and established five banks.

The Government of Pakistan decided to give the regulator i.e., The State Bank of Pakistan wider powers of enforcement. If a director could not fulfil his obligation the State Bank could fire him. Moreover, it was laid down that no person could serve as director of a bank for more than six years continuously. Meanwhile The State Bank of Pakistan introduced reforms for the establishment of new institutions. More importantly, the People's Finance Corporation was set up to encourage small business while the National Development Finance Corporation was established for public and managed industries and enterprises. In 1974, under this nationalization program, all the private banks were brought into public control. This was partly due to the fact that merit was not followed by the banks while forwarding loans, and only political clout was the required criterion. Consequently, economic growth was declining because these loans were never paid back to the financial institutions. The Banks

[295] http://tribune.com.pk/story/286458/history-of-banking-in-pakistan--of-humble-origins-and-vast-potential

Nationalization Act 1974 provided a wide range of powers to the government, including power to appoint Chairman, Directors, and Executives of banks, setting up Pakistan Banking Council as a body to then 14 commercial banks with 3323 offices all over Pakistan and 74 offices in foreign countries.

2.2.2.3 Denationalisation

The last phase which is titled post nationalization began in 1990 when the government of Pakistan privatized the banks and denationalized two financial institutions by making amendments in the Banks Nationalisation Act of 1974. In the early 1990s, the government started to denationalise banks. This was due to the realisation that nationalised banks' role in the economy was adversely affecting the growth and efficiency of the financial sector for the reasons of government ownership, political intervention into credit allocation and recovery.

The Banks had huge numbers of nonperforming loans with consequential heavy losses. To respond to this issue several policy reforms were undertaken to motivate the private sector in this industry.[296] The successive governments not only sold the share capital of state-owned banks but also welcomed entry of the new banks to strengthen the competition in the market and to maintain the market-based banking. The government relaxed the policy of opening up of private banks which encouraged the private sector to grow. All these changes were designed to instil healthy competition and create a sound and an efficient banking system capable of supporting the growing economic activity.[297] Understanding the degree and evolution of banks' competition is also important as it has strong implications for the way changes in monetary policy stance impact the ultimate underlying objectives.[298]

The reforms introduced in the 1990s included:

2.2.2.4 Removal of Restriction on Consumer Finance

[296] Akhtar, Muhammad, Ali, Khizer., &Sadaqat, Shama (2010). Performance Efficiency of Commercial Banks of Pakistan: Non-Parametric Technique Data Envelopment Analysis (DEA). Asian Journal of Business and Management Sciences, 1(2), 150-156

[297] Bonaccorsi Di Patti, E., & Hardy, D. C. (2005). Financial Sector Liberalization, Bank Privatization, and Efficiency: Evidence from Pakistan. Journal of Banking & Finance, 29 (8-9), 2381–2406

[298] Ibid fn. 5 at pg.5

The restrictions which were imposed by The State Bank of Pakistan were removed, and banks were given more liberty to offer a variety of consumer finance products.

2.2.2.5 Micro financing

The State Bank of Pakistan brought microfinance under its regulation and supervision so the facility of rural finance and micro credit could be provided to a large population of Pakistan. The regulatory and licensing requirements were made easy. The micro credit institutions were opened at provincial and national level.

2.2.2.6 Establishment of Small and Medium Enterprise Banks

Small and Medium Enterprise (SME) Banks were established by The State Bank of Pakistan to empower the entrepreneurs of the country by providing credit on easy terms. The loans were approved on the basis of asset conversion cycles and cash flow generation without any collateral. The SME establishment played a major role in the growth of the banking sector of Pakistan.

2.2.2.7 Reduction of Corporate Tax

The Government of Pakistan played an important role in the growth of the banking sector by reducing the corporate tax from 58% to 35%. This encouraged the banking sector to become more profitable.

2.2.2.8 Introduction of Islamic Banking

Islamic banking was introduced in Pakistan because it supports the idea of interest free banking which was proven to be a very popular idea. Since Pakistan was founded as an Islamic State, most of the population of Pakistan tends to avoid conventional banking due to the strong beliefs that it is based on interest. Therefore, Islamic Banking was introduced in order to encourage people to start using banks.

2.2.2.9 Mortgage Financing

The banks of Pakistan started to provide a wide variety of banking services in mortgage financing and some steps were taken to encourage the mortgage financing in Pakistan. The upper ceiling was raised, and tax was reduced on the interest payment of the mortgage. The long-term funds were raised through rated and listed instruments so the long-term assets and liabilities could be matched with them.

2.2.2.10 Introduction of Agriculture Credit Schemes

The commercial banks of Pakistan played an important role in lending credit to the agriculture sector through different schemes. The previous schemes were limited to only production loans but after the liberalization of the banking sector, the whole agriculture sector was provided loans through different schemes.

2.3 PAKISTAN BANKING SYSTEM TODAY

This process of privatization streamlined the banking system. The government overcame the legal obstructions and setbacks in the recovery of bad loans in 2001. However, despite the tremendous efforts of the State Bank for the improvement of the economy, the confluence of factors such as massive non-performing loans (NPLs) and a weak economy heightened risk and led the banking sector towards financial malaise. In spite of these challenges, Pakistan has faced tremendous expansion in the banking sector since its creation. Therefore, it is vital to understand the arduous and formidable evolution of the banking sector in Pakistan.[299]

Pakistan's banking system is very diverse in its composition and nature of operations. The entire banking industry has two main sectors, namely domestic (97%) and foreign banks (3%). The Pakistani banking industry encompasses nationalized commercial banks, private banks, public sector banks, foreign banks, Islamic banks, specialized banks, and microfinance banks. There are some companies in Pakistan which are also working as banks so the financial sector can develop along with economic growth. In 1993, 33 commercial banks were functioning out of which 19 were foreign and 14 were local banks. By the end of 2001, the number of

[299] http://tribune.com.pk/story/286458/history-of-banking-in-pakistan--of-humble-origins-and-vast-potential

commercial banks increased to 43, out of which 19 were foreign banks and 24 were local banks. At the same time, the expansion of international business has attracted foreign banks to invest and has started operations in Pakistan over the past several decades. At present, Pakistan commercial banking industry consists of 33 Banks, including 5 state-owned public banks, 15 domestic private banks, 5 Islamic banks, and 4 foreign banks.[300] Developments have led to significant changes in the structure of the banking sector in Pakistan: the share of big 5 banks has declined from over 90 percent in early 1990s to 51.5 percent by end 2015; the ownership structure has changed from the public to the private sector as the latter controls over 80 percent of banking assets. Islamic banks also emerged in the banking arena, which control more than 10 percent of banking assets. Furthermore, a number of foreign banks have switched their operations from a branch mode to full-fledged locally incorporated subsidiaries to expand their businesses.[301]

The foremost market share of the banking sector is controlled by six major banks, which account for 57% of the country's deposits and 53% of the country's CB industry's advances. In 2017, total assets of commercial banking rose by Rs 1.52 trillion compared to the previous year, a 16% increase. In addition, there was a 17% surge in total liabilities and a 3% increase in equity compared to the previous year. The balance sheet reveals that local banking witnessed an increase of 15.25% while foreign banks recorded an increase of 42.31% in asset value in 2017.[302]

Local private commercial banks account for approximately 77 percent of total banking assets, of which 67 percent belong to private sector conventional banks and 10 percent to Islamic Banks. Private commercial banks are the largest providers of credit, with an estimated total loan value of more than PKR 6.53 trillion in December 2020 (with conventional banks' lending PKR 5.5 trillion and Islamic banking institutions lending PKR 1.02 trillion). Based on total banking assets, the five public sector banks have a market share of 19 percent (lending approximately PKR 1.6 trillion in advances), while foreign banks (licensed branches of foreign banks) and specialized banks have a total share of 3 percent and 1 percent respectively. These specialized banks only have a credit portfolio of PKR 185 billion out of the total of PKR 8.2 trillion.[303]

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[300] https://www.sbp.org.pk/f_links/f-links.asp
[301] Ibid fn. 5 at pg.5
[302] Qayyum, Abdul (2007). Financial Sector Reforms and the Efficiency of Banking in Pakistan. South Asian Network of Economic research Institutes
[303] www.ifc.org/wps/wcm/connect/ba48a17c-ff43-4f4a-9c7b-1a6d7c8d44a0/NPL-Market-Assessment-Pakistan.pdf?MOD=AJPERES&CVID=o5fg6VH at p. 32 [accessed 05 January 2023]

The following tables demonstrate the variables of growth by these banks in last three years:[304]

Public Sector Commercial Banks

PKR million

	Dec-19	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22
Total Assets	4,551,798	4,761,786	5,111,814	5,544,082	5,684,145	5,736,075	5,909,488	7,200,776	7,244,043
Investments (net of Provisions)	2,045,796	2,338,293	2,722,091	2,880,768	3,091,525	2,867,108	3,160,226	4,278,355	4,381,486
Advances (net of Provision)	1,574,357	1,575,708	1,566,129	1,610,094	1,656,159	1,779,667	1,884,394	1,889,876	1,952,682
Borrowings	664,337	426,841	920,261	748,159	1,062,421	522,018	1,040,938	1,665,911	1,907,842
Deposits	3,222,625	3,664,602	3,539,538	4,091,128	3,919,608	4,479,198	4,130,190	4,665,030	4,495,010
Liabilities	4,234,910	4,399,716	4,757,477	5,171,464	5,302,773	5,346,605	5,517,921	6,815,705	6,841,639
Paid up Capital	81,419	81,419	87,733	87,733	87,733	87,733	88,258	91,563	91,563
Equity	316,887	362,070	354,337	372,618	381,372	389,470	391,567	385,071	402,404
Profit before tax	34,654	57,975	13,079	38,085	51,223	70,919	18,750	41,192	60,249
Profit after tax	19,841	37,241	9,021	17,941	31,865	43,116	11,332	16,673	25,505
Provisioning Charges (ytd)	21,151	40,030	5,967	6,536	15,565	17,923	2,687	1,632	1,708
Non-Performing Loans	234,621	267,740	284,306	286,668	306,145	299,818	307,028	305,372	312,590
Provisions Held Against NPLs	208,144	250,851	258,418	260,881	272,516	275,909	280,533	280,365	283,921
Non-Performing Loans (net)	26,477	16,890	25,888	25,786	33,629	23,909	26,495	25,007	28,669

Local Private Banks

PKR million

	Dec-19	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22
Total Assets	16,478,214	19,383,674	19,659,482	21,606,031	22,001,323	23,165,685	23,688,934	26,221,076	25,902,466
Investments (net of Provisions)	6,574,479	9,203,542	9,678,409	10,707,939	10,871,320	10,996,596	11,516,206	12,617,780	12,728,794
Advances (net of Provision)	6,445,645	6,529,880	6,620,924	7,016,159	7,342,112	8,149,695	8,246,085	8,795,490	8,897,577
Borrowings	1,826,455	2,359,741	2,510,376	3,048,107	3,174,856	3,674,166	4,111,469	4,670,456	3,997,368
Deposits	12,427,568	14,518,078	14,642,782	16,004,507	16,197,346	16,823,869	16,772,051	18,650,485	18,864,342
Liabilities	15,283,736	18,025,794	18,342,857	20,241,380	20,616,328	21,757,508	22,270,551	24,814,737	24,448,353
Paid up Capital	365,309	366,674	366,674	366,674	368,796	368,796	368,796	372,796	374,423
Equity	1,194,478	1,357,880	1,316,626	1,364,652	1,384,995	1,408,178	1,418,383	1,406,339	1,454,113
Profit before tax	254,536	329,275	84,427	175,101	269,225	365,518	114,176	245,631	401,522
Profit after tax	143,980	193,353	51,140	104,074	158,295	216,584	68,687	103,863	178,036
Provisioning Charges (ytd)	37,015	79,308	5,177	13,004	22,404	25,161	801	13,578	27,261
Non-Performing Loans	469,366	491,476	506,723	505,405	520,321	510,025	515,448	526,542	542,087
Provisions Held Against NPLs	387,081	444,333	450,269	459,102	474,786	476,226	482,013	496,405	514,578
Non-Performing Loans (net)	82,285	47,143	56,454	46,303	45,535	33,799	33,435	30,137	27,509

Foreign Banks

PKR million

	Dec-19	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22
Total Assets	716,351	733,826	726,538	756,141	829,489	870,473	846,198	964,822	1,131,206
Investments (net of Provisions)	287,315	344,572	461,685	494,943	505,489	600,085	602,450	652,456	799,814
Advances (net of Provision)	91,089	72,368	72,277	77,125	73,081	90,340	112,706	106,564	107,287
Borrowings	365,133	344,992	311,811	356,215	386,457	406,290	422,362	479,930	542,026
Deposits	245,181	274,380	277,120	282,610	341,053	360,846	312,026	364,305	424,653
Liabilities	648,439	657,285	649,616	676,197	752,055	790,854	761,124	873,229	1,029,301
Paid up Capital	47,202	45,082	43,115	44,324	47,293	48,514	50,071	54,635	59,700
Equity	67,912	76,541	76,922	79,943	77,434	79,619	85,074	91,593	101,904
Profit before tax	25,290	28,654	3,207	5,637	9,955	14,557	6,280	10,328	22,380
Profit after tax	14,415	17,254	1,816	3,136	5,030	7,691	3,710	5,371	9,428
Provisioning Charges (ytd)	6	56	(19)	(3)	(21)	120	40	(23)	64
Non-Performing Loans	2,772	2,478	2,440	2,443	1,832	1,837	1,844	1,853	1,876
Provisions Held Against NPLs	3,074	2,823	2,805	2,817	2,193	2,341	2,389	2,350	2,465
Non-Performing Loans (net)	(303)	(346)	(365)	(374)	(361)	(504)	(544)	(497)	(589)

Specialized Banks

PKR million

	Dec-19	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22
Total Assets	244,974	244,569	252,504	270,700	274,711	286,070	272,435	474,066	271,496
Investments (net of Provisions)	31,848	48,227	62,149	78,844	81,333	90,650	90,405	280,866	79,626
Advances (net of Provision)	137,882	113,617	105,514	104,769	101,671	100,807	98,362	97,934	98,194
Borrowings	76,157	85,291	99,914	112,712	124,063	135,563	134,566	327,612	120,719
Deposits	58,115	61,466	61,191	63,070	57,572	55,972	43,686	50,405	44,927
Liabilities	166,003	178,626	188,339	205,078	210,448	221,797	207,768	409,403	196,850
Paid up Capital	62,956	62,956	62,956	62,956	62,956	62,956	62,956	62,956	62,956
Equity	78,971	65,942	64,165	65,622	64,262	64,273	64,667	64,663	74,646
Profit before tax	(10,075)	(4,549)	(4,286)	(1,484)	(2,817)	98	652	2,701	3,334
Profit after tax	(7,488)	(3,809)	(3,542)	(2,247)	(3,619)	(3,168)	384	284	1,500
Provisioning Charges (ytd)	9,682	3,644	5,882	5,584	7,576	7,201	1,102	2,317	3,640
Non-Performing Loans	54,360	67,208	56,839	56,272	49,066	48,525	39,342	44,754	41,269
Provisions Held Against NPLs	21,472	34,159	33,112	32,585	30,758	30,383	25,171	25,547	24,578
Non-Performing Loans (net)	32,888	33,049	23,726	23,687	18,309	18,143	14,171	19,207	16,692

[304] www.sbp.org.pk/ecodata/fsi/qc/2022/Sep.pdf [accessed 06 January 2023]

The latest accounts, containing income statement and balance sheet, filed by these banks also demonstrate that growth of the banking sector of Pakistan would continue in the same velocity in coming years.[305]

Financial Position	PSCB	LPB	FB	CB	SB	All Banks	Absolute change	
							QoQ	YoY
ASSETS								
Cash & Balances With Treasury Banks	332,549	1,728,013	89,830	2,150,392	3,305	2,153,697	(176,741)	254,809
Balances With Other Banks	31,422	211,633	33,215	276,270	27,093	303,363	(26,258)	64,512
Lending To Financial Institutions	125,406	441,105	12,798	579,309	8,988	588,297	(712,532)	(682,762)
Investments - Net	4,381,486	12,728,794	799,814	17,910,094	79,626	17,989,720	160,263	3,440,054
Advances - Net	1,952,682	8,897,577	107,287	10,957,546	98,194	11,055,740	165,876	1,882,718
Operating Fixed Assets	98,201	655,847	2,017	756,065	18,405	774,471	23,479	106,828
Deferred Tax Assets	44,006	134,980	562	179,549	15,840	195,389	16,421	82,055
Other Assets	278,291	1,104,518	85,682	1,468,491	20,044	1,488,535	237,962	611,330
TOTAL ASSETS	**7,244,043**	**25,902,466**	**1,131,206**	**34,277,715**	**271,496**	**34,549,210**	**(311,530)**	**5,759,542**
LIABILITIES	-	-	-	-	-	-	-	
Bills Payable	23,975	273,977	4,923	302,876	426	303,302	(64,661)	(12,789)
Borrowings From Financial Institution	1,907,842	3,997,368	542,026	6,447,235	120,719	6,567,955	(575,955)	1,820,158
Deposits And Other Accounts	4,495,010	18,864,342	424,653	23,784,004	44,927	23,828,932	98,707	3,313,353
Sub-ordinated Loans	14,805	122,019	-	136,824	-	136,824	(3)	19,237
Liabilities Against Assets Subject To Finance Lease	8,610	-	-	8,610	-	8,610	501	439
Deferred Tax Liabilities	10,403	9,944	99	20,446	549	20,995	310	(16,427)
Other Liabilities	380,994	1,180,702	57,601	1,619,297	30,228	1,649,525	144,170	510,566
TOTAL LIABILITIES	**6,841,639**	**24,448,353**	**1,029,301**	**32,319,293**	**196,850**	**32,516,142**	**(396,932)**	**5,634,538**
NET ASSETS	**402,404**	**1,454,113**	**101,904**	**1,958,422**	**74,646**	**2,033,068**	**85,402**	**125,005**
NET ASSETS REPRESENTED BY:	-	-	-	-	-	-	-	-
Share Capital	91,563	374,423	59,700	525,686	62,956	588,642	6,692	21,863
Reserves	83,562	415,612	197	499,371	7,982	507,353	35,382	80,742
Unappropriated Profit	173,863	595,318	42,489	811,670	(12,938)	798,732	36,885	123,769
Share Holders' Equity	**348,988**	**1,385,353**	**102,386**	**1,836,727**	**58,000**	**1,894,727**	**78,958**	**226,374**
Surplus/Deficit On Revaluation Of Assets	53,416	68,761	(482)	121,695	16,646	138,341	6,444	(101,369)
TOTAL	**402,404**	**1,454,113**	**101,904**	**1,958,422**	**74,646**	**2,033,068**	**85,402**	**125,005**

PROFIT AND LOSS STATEMENT	PSCB	LPB	FB	CB	SB	All Banks	Change (YoY)
Mark-Up/ Return/Interest Earned	485,707	1,747,510	71,326	2,304,543	29,858	2,334,401	1,005,444
Mark-Up/ Return/Interest Expenses	372,518	1,104,717	27,633	1,504,869	19,424	1,524,293	815,238
Net Mark-Up / Interest Income	**113,189**	**642,793**	**43,692**	**799,674**	**10,434**	**810,108**	**190,206**
Provisions & Bad Debts Written Off Directly/(Reversals)	1,708	27,261	64	29,033	3,640	32,672	(12,851)
Net Mark-Up / Interest Income After Provision	**111,480**	**615,532**	**43,629**	**770,641**	**6,794**	**777,436**	**203,057**
Fees, Commission & Brokerage Income	20,179	101,859	2,085	124,123	764	124,887	21,994
Dividend Income	4,017	10,065	-	14,082	107	14,188	2,176
Income From Dealing In Foreign currencies	7,823	82,535	(17,949)	72,409	-	72,409	53,127
Other Income	1,785	5,356	(39)	7,102	5,328	12,430	(23,246)
Total Non - Markup / Interest Income	**33,805**	**199,814**	**(15,903)**	**217,716**	**6,198**	**223,915**	**54,052**
	145,286	815,346	27,726	988,358	12,993	1,001,351	257,109
Administrative Expenses	85,192	406,450	5,125	496,768	9,638	506,406	95,074
Other Expenses	(156)	7,373	221	7,439	21	7,460	2,136
Total Non-Markup/Interest Expenses	**85,037**	**413,824**	**5,346**	**504,207**	**9,659**	**513,866**	**97,210**
Profit before Tax and Extra ordinary Items	60,249	401,522	22,380	484,151	3,334	487,485	159,899
Extra ordinary/unusual Items - Gain/(Loss)	-	-	-	-	-	-	-
PROFIT/ (LOSS) BEFORE TAXATION	**60,249**	**401,522**	**22,380**	**484,151**	**3,334**	**487,485**	**159,899**
Less: Taxation	34,744	223,486	12,952	271,182	1,835	273,016	137,001
PROFIT/ (LOSS) AFTER TAX	**25,505**	**178,036**	**9,428**	**212,969**	**1,500**	**214,469**	**22,898**

[305] www.sbp.org.pk/ecodata/fsi/qc/2022/Sep.pdf [accessed 06 January 2023]

Source: The State Bank of Pakistan [PKR Billions][306]

The above tables also demonstrate that specialised banks had reduced their losses to zero in the first quarter of 2021 and continue to make profit.

The positive outcome of banking reforms adopting Basel have shown considerable progress in banking in Pakistan. The five-year performance, between 2016 and 2020,[307] of the Banking Industry had been very strong:

- Total banking assets increased from PKR 15.8 trillion to PKR 25.1 trillion (cumulative growth of 59 percent)
- Deposits rose from PKR 11.7 trillion to PKR 18.5 trillion, growing by 57 percent
- Net advances increased from PKR 5.5 trillion to PKR 8.3 trillion, a growth of 51 percent
- Investments jumped from PKR 7.5 trillion to PKR 11.9 trillion, growing by 59 percent
- Equity rose from PKR 1.4 trillion to PKR 1.8 trillion, growth of 38 percent
- Profit after Tax increased from PKR 0.19 trillion to PKR 0.24 trillion, growth of 29 percent
- Non-Performing Loans rose from PKR 0.6 trillion to PKR 0.83 trillion, an increase of 37 percent

The following paragraphs briefly discuss how these reforms, and their continuing implementation were basis to attain the above results:

Electronic banking was introduced in Pakistan in 1987, the first automated machine (ATM) installed in Pakistan by Habib Bank Limited. Nearly a decade ago, ATMs were not familiar with the general public and developed use of ATM cards that grew very slowly. It was not until 2002 when National Bank of Pakistan, after the formation of the national exchange and instructions by the State Bank, through all banks to their account holders and connected to any one of the two switches (1link and MNET), adopted the issuance of electronic banking and ATM issuance, National bank contacted its account cardholder and encouraged them to connect to both switches 1 LINK and MNET (electronic Media Network) (an interbank connection platform for online financial transaction processing and management services).

306 www.sbp.org.pk/ecodata/fsi/qc/2022/Sep.pdf [accessed 06 January 2023]

307 www.ifc.org/wps/wcm/connect/ba48a17c-ff43-4f4a-9c7b-1a6d7c8d44a0/NPL-Market-Assessment-Pakistan.pdf? at p. 37 [accessed 05 January 2023]

After the 2002 elections, the newly established government formulated policies which supported the growth of the banking sector that turned the banking sector profitable.[308] The banking sector generated revenue of $1.1 billion in 2006. The world saw the Global Financial Crisis which was difficult on all sectors of the economy. Despite all the difficulties, the banking sector of Pakistan showed stiffness and it was able to handle the pressures of the Global Financial Crisis. During the crisis, the large banks maintained a very healthy position and the smaller banks started to offer their services to niche markets so they could survive the crisis.

	2007	2008	2009	2010	03/2011	06/2011	09/2011	12/2011	03/2012
Growth Rates	YoY	YoY	YoY	YoY	YoY	YoY	YoY	YoY	YoY
Assets	18.8	8.8	15.8	9.3	11.7	13.7	17.2	15.0	16.6
Loans (Net)	10.7	18.3	2.1	3.1	5.2	4.7	3.0	(0.2)	2.8
Deposits	18.4	9.4	13.5	13.9	13.5	16.3	14.9	14.5	16.5
Investments	53.1	15.4	59.9	22.2	27.9	38.4	51.9	42.5	39.5
Equity	35.3	3.4	17.3	5.9	5.6	8.1	14.9	12.4	12.9

Table Financial Soundness Indicators [The State Bank of Pakistan]

The financial soundness indicators provided by the State Bank of Pakistan show how the banking sector survived through the Global Financial Crisis from 2007 to 2012. The assets of the banking sector declined from 18.8 percent in 2007 to 8.8 percent in 2008. But as the banking sector slowly recovered from the crisis, the assets started to grow and, by March 2012 which was 16.6 percent.

The loans (net) which were 10.7 percent in 2007 showed growth to 18.3 percent in 2008. This growth is because the government borrowed money from the banking sector to fund its economic budget. After 2009, the banking sector did not perform well in lending loans because of high interest rates until March 2012. The deposits which were 18.4 percent in 2007 reduced to only 9.4 percent in 2008 but with the passage of time, the deposits of the banking sector

[308] Hardy, C.D., & Emilia Bonaccorsi Di Patti (2001). Bank Reform and Bank Efficiency in Pakistan. IMF Working Paper, 01/138: Washington DC

grew and reached 16.5 percent in March 2012. The investments (net) were 53.1 percent in 2007 which got negative in 2008 because of the Global Financial Crisis as every investor wanted to save their investment. After the Global Financial Crisis, the investments (net) grew to 39.5 percent in March 2012. The banking sector equity was 35.5 percent in 2007 which was reduced to only 3.4 percent in 2008 but with time, the equity was regained by the banking sector to 12.9 percent in March 2012.

Classification of Advances by Borrowers

	CY08	**CY(**	**YoY growth (%)**	
			CY08	**CY09**
Government	150.5	333.4	93.6	121.6
Non-financial PSEs	186.9	225.4	49.0	20.6
Private Sector	2,240.8	2,221.5	18.9	-0.9
o/w manufacturing	1,299.4	1,282.4	19.0	-1.3
All others	478.3	411.5	-8.9	-14.0

Amount in billion Rupees Source: Statistical Bulletin, SBP

These reforms required all banks or financial institutions to commence consolidation to meet the regulatory requirement i.e., capital adequacy forced by the State Bank. Large banks were well positioned to comply with these regulatory requirements of the State Bank at that time, but newly formed small banks were not expected to meet these requirements from the State Bank. Therefore, small banks gave birth to the mergers and acquisition in the banking sector of Pakistan. The first mergers and acquisition case took place in Pakistan in 2002.

After the mergers and acquisition in 2002 the Pakistani banking sector changed from a government domain to a more competitive and profitable industry. With the passage of time numerous new reforms developed which increased the efficiency of the banking sector of Pakistan that brought economic growth as well as baking industry survival. Another cause of Merger and acquisitions was the execution of Basel accord II by The State Bank.

In 2005, the State Bank by notice required all banks to preserve their capital gradually to the level of 23 billion Pakistani rupees till 31 December 2013. After some period, this requirement decreased and remains only 10 billion rupees according to the market situations, but banks were found unable to use capital through injecting owner equity and reinvestment of profit, so only the one way available was Mergers and Acquisition.

During 2002 to 2011 Mergers and Acquisition list is following.

Before M&A	After M&A	Years
Al-Faysal Investment Bank	Faysal Bank Limited	10/1/2002
Crescent Investment Bank Limited	Mashreq Bank Pakistan	9/7/2003
Trust Commercial Bank Limited Limited	Crescent Commercial Bank	18/10/2004
Trust Investment Bank Limited Limited	Trust Commercial Bank	30/04/2004
Fidelity Investment Bank Limited Limited	Trust Commercial Bank	30/04/2004
Union Bank Limited	Standard Chartered Bank Ltd.	29/12/2006
First Allied Bank Mudaraba	Allied Bank Limited	25/08/2006
Atlas Investment Bank Limited	Atlas Bank Limited	26/07/2006
Crescent Standard Investment Bank Ltd.	Innovative Housing Finance ltd	20/07/2007
Pakistan Industrial Credit & Investment Corp.Ltd	NIB Bank Limited	1/1/2008
PICIC Commercial Bank Limited	NIB Bank Limited	1/1/2008
Network Leasing	KASB Bank Limited	17/02/2009
Askari Leasing Limited	Askari Bank Limited	10/3/2010
Al-Zamin Leasing Mudaraba Limited	Invest Capital Investment Bank Limited	11/1/2010
MyBank Limited	Summit Bank Limited	6/7/2011
Atlas Bank Limited	Summit Bank Limited	11/1/2011
Royal Bank of Scotland Ltd.	Faysal Bank Ltd	3/1/2011
Al-Zamin Leasing Corporation Limited	Invest Capital Investment Bank Limited	11/1/2010

Source: competition commission of Pakistan, Pakistani Banks Descriptive Statistics

The banking industry of Pakistan is more diverse than that of many other countries because it exercises two different banking systems: one is the conventional banking system that works on interest rates. However, the other banking system is known as Islamic banking, which is based on Shariah laws. Before appraising the banking regime of Pakistan, it is important to elucidate the concepts of the conventional and the Islamic banking systems.[309]

[309] Muhammad Mahmood Shah Khan, Bushra Shafiq and Farrukh Ijaz, "An Empirical Analysis of Banking Sector in Pakistan: Islamic Versus Conventional Banks" https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2930470 [Accessed December 2022]

The conventional banks' operations are based on the rules set by the board of directors of such banks subject to the regulations and guidelines set by the State Bank. The conventional banks have a fixed interest rate according to which they receive money from the depositors and lend to the borrowers. The core responsibility of the banking industry is to play the role of intermediary between the depositors and debtors.[310] On the other hand, the Islamic banking sector claims to follow the injunctions of Shariah law. Therefore, Islamic banks do not operate on a fixed rate for the depositors and debtors. The main source of earning for this sector is service charges, consultancy, and a share in profits. The risk is jointly shared between the lenders, debtors, and the bank. Islamic banks receive a share in the business of the debtors and then, on the basis of that share, they offer the percentage to the lenders. The Islamic banking industry has rapidly emerged during the last decade and half. Many economists argue that the Islamic banking industry could perform better if there were a separate legal framework that could address its operational challenges.[311]

Pakistani banking is a fully diverse sector with significant foreign banks, domestic private banks, and state-owned banks. The findings regarding the Pakistani banking sector reveal, it is enjoying intense competition not only with the domestic players but with the international players in the sector. For more details the information set out below is the descriptive statistics of the Pakistani banking sector.

Variables	N	Mean	Std	Min.	Max
Deposits (Rupee Million)	68	96348	125512	127.7	591907
Total Assets (RMB Million)	68	1.086e+08	1.447e+08	567,131	7.622e+08
Net Interest	68	6.791e+06	9.385e+06	30,801	5.075e+07

[310] Ashfaq Ahmad, Muhammad Imran Malik and Asad Afzal Humayoun, "Banking Developments in Pakistan: A Journey from Conventional to Islamic Banking" (2010) 17 European Journal of Social Sciences 12

[311] Muhammad Mahmood Shah Khan, Bushra Shafiq and Farrukh Ijaz, "An Empirical Analysis of Banking Sector in Pakistan: Islamic Versus Conventional Banks" https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2930470 [Accessed December 2022]

Income (RMB Million)					
ROE (%)	68	0.00278	0.0047	-0.0251	0.0322
ROA (%)	68	0.0167	0.0415	-0.276	0.108
NPL (%)	68	0.132	0.171	1.58e-05	0.803
GDP (%)	68	0.0383	0.00651	0.0258	0.0554

Table: Descriptive Statistics of the Pakistani banking[312]

This table discloses that the size of the Pakistani banking is quite rich and makes smooth performance on average if we have a look at the Return on Assets and Return on Equity. In a few years they do have abnormal losses which are due to the financial crisis. It is a fact that Pakistan was not affected strongly by the financial crisis of 2008. The most common challenge is the issue of non-performing loans.

2.4 Challenges faced by Banking System of Pakistan

The challenges that are faced by banks in Pakistan include rural market penetration, training and technology, legal infrastructure, fiscal deficits, limited products, interest rate, Non-performing loans, lack of good governance, public awareness, Investment opportunity Specific Issues, terrorism, political instability, corruption, and energy crisis. Some of these challenges are briefly discussed hereunder.

2.4.1 Financial Inclusion

Pakistan still has a large number of people who do not have access to banking services due to scattered and fragmented locations. But if we talk about those people who are availing banking

[312] https://www.sbp.org.pk/

services, their expectations are rising as the level of services are increasing due to the emergence of Information Technology and competition. The converging forces of technology have tremendously altered manual systems of delivering banking services and have subsequently paved the way for electronic delivery platforms in recent times.[313]

It was acknowledged by then Governor of Central Bank of Pakistan:

> "The truth of the matter is that dysfunctional institutions will take time to turn around, investment – output relationship is always lagged and change in investor sentiment and confidence requires more than just economic considerations. The structural reforms underway have themselves displaced the existing equilibrium, generated tensions and uncertainties associated with the ongoing transition, and forced economic agents to adopt a wait-and-see attitude. Moreover, the external environment has not been particularly conducive either. This disconnects between popular expectations and ground realities poses the greatest risk to the continuation of the reform agenda. It is quite conceivable that a more populist regime could adopt policies that might provide a short-term boost to the economy but put the country back on an unsustainable path."[314]

2.4.2 Fiscal Deficit

Pakistan's persistent fiscal deficits had been a major issue in establishing and maintaining a sound banking system. Public sector corporations have been a constant source of burden on the budget as well as quasi-fiscal accounts. As much as one third of the fiscal deficit can be directly attributed to the losses of public corporations. In addition, nationalized commercial banks had been carrying a large exposure to these corporations. The denationalized commercial banks have undertaken major restructuring by downsizing their staff and closing down unprofitable branches. As a result of restructuring, at least 50 percent of the surplus staff was eliminated, while more than half of non-profitable branches were closed.[315]

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[313] Kamran, H.W., Mohamed-Arshad, S.B. & Omran, A. (2019). Country Governance, Market Concentration and Financial Market Dynamics for Banks Stability in Pakistan. Research in World Economy, 10 (2), 136-146
[314] ishrathusain.iba.edu.pk
[315] Husain I, 'Financial Sector Reforms and Pro-Poor Growth: Case study of Pakistan'(2004)< https://ishrathusain.iba.edu.pk/speeches/financialSector/2004/Financial_Sector_Reform.pdf>accessed 14 January 2020

2.4.3 Poor Tax Mechanism

Pakistan's said persistent fiscal deficits can be harnessed if a robust and buoyant tax base can be developed. This requires deep rooted reforms to widen the tax base, strengthen tax administration, promote self-assessment, eliminate whitener schemes, reduce multiplicity of taxes, and tackle the culture of tax evasion and corruption. As part of reforms, a task force was formed to examine these issues; this task force recommended to simplify assessment processes, promote intensive use of technology, eliminate contact between taxpayer and tax collector, reorganize the Central Board of Revenue and restructure the service terms and conditions of revenue officials.

2.4.4 Training and Technology

Dr Nanik Ram et al[316] Explored the unethical issues in the banking sector of Pakistan. Nanik identified issues including lack of staff training, influencing the customer to divert loans in other purposes, delays in sanctioning the loans, sending legal notice after the due date and fixing up payment schedule without considering the generation capacity of the borrower. Khalid and Masood,[317] exploring the issues regarding agriculture credit problems in Pakistan, revealed that loan application procedures are lengthy and cumbersome, interest rate is too high, the behaviour of the bank staff is not good with the farmers, delay in sanctioning loans and releasing funds, the repayment procedures is rigid, and the loans are misused by the farmers.

2.4.5 Non-Performing Loans (NPLs)

The importance of financial institutions, as one of the main pillars of an economy, cannot be denied.[318] The main source of credit in developing countries is banking.[319] Major earnings of the banking sector are advances.[320] Thus, most banks generate their funds through advances

[316] Dr. Nanik, Dr. Khoso, M Bachal and Faiz M. Shaikh, Ethicalnissues in commercial banks in Pakistan: Australian Journal of Business and management research Vol. 1

[317] M. Khalid Bashir and M. Masood Azeem, agriculture credit in Pakistan: constraints and options, Pakistan Journal of life and sciences, Pak.j.lifesos.sci. (2008), 6(1): 47-49

[318] Waqas, M., Fatima, N., Khan, A., & Arif, M. (2017). Credit Risk Determinants in Banking Sector: A Comparative Analysis of the PIB (Pakistan, India, and Bangladesh). International Journal of Finance & Banking Studies, 6(1), 51–68

[319] Mirza, A., Malek, M., & Abdul-Hamid, M. A. (2020). Value relevance of earnings and book value of equity: Evidence from Malaysia. Global Business Management Review, 10(2), 19-40

[320] Niu, J. (2016). Loan growth and bank valuations. The Quarterly Review of Economics and Finance, 61, 185-191

and some of the advances turn into NPLs.[321] In the balance sheet, credit risk is represented through NPLs.[322] Credit risk includes both partial and total risk of default.[323] NPLs are responsible for decreasing the growth in lending, failure to invest in good projects, shaking customer's confidence and decreasing the development of the economy of a country. Hence, economic activity is minimized and usage of funds in productive projects is blocked.[324]

NPLs become the main reason for the failure of a bank.[325] The most common risk experienced by the banks is stated to be occurring in NPLs.[326] NPLs matter is a serious threat to the strength of banking institutions.[327] NPLs are one of the main indicators and represent credit as well as operational risks. NPLs also explain the efficient provision of resources. Therefore, it becomes vital to determine the factors that affect NPLs in the context of the monetary environment of the emerging countries, in general and precisely the overall circumstances of Pakistan.

The study of Badar & Javid[328] indicates that in the last 10 years NPLs had grown rapidly in Pakistan. The NPLs issue is a serious concern in Pakistan as the ratio was 15.74% in 2011 and in 2016 it was calculated as 10.06% which remained beyond the threshold of 10% of the NPL ratio. Economic crises are caused by the high level of NPLs.[329] Besides, high NPLs give way to an occurrence of agony to be classified as a full-fledged crisis which occurs when the share of non-performing advances in the financial context exceeds 10. As far as the NPLs ratio is concerned, Pakistan was ranked in the 25th spot out of 32 nations that have an NPL percentage more than 10%[330] while its NPLs ratio in 2016 is still over 10%.[331] Consequently, the current situation shows that NPLs can set off a banking, fiscal or economic crisis.

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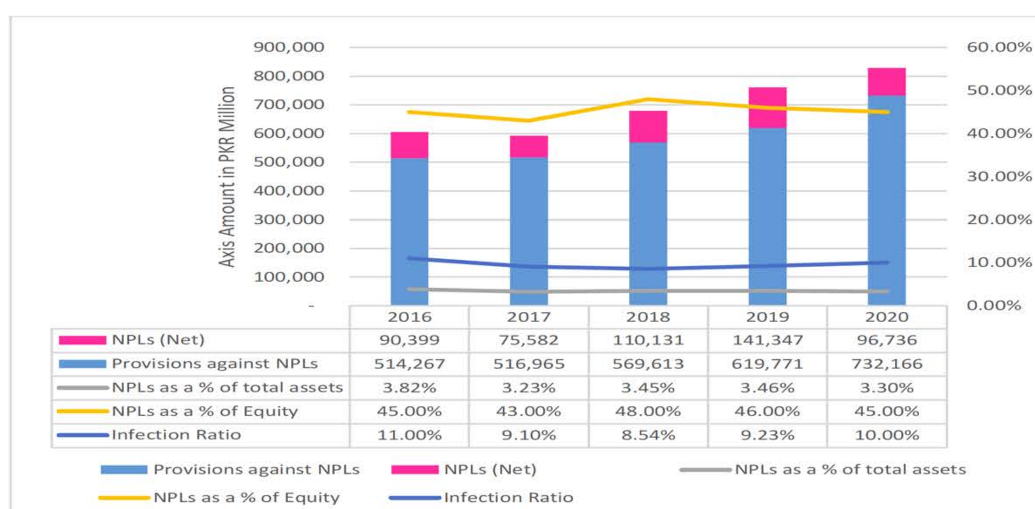
[321] Malimi, K. The influence of capital adequacy, profitability, and loan growth on non-performing loans a case of Tanzanian banking sector. International Journal of Economics, Business and Management Studies, (2017) 4(1), 38-49
[322] Malimi (n. 321) 43
[323] Basel Committee (2000)
[324] Nikolopoulos, K. I., & Tsalas, A. I. (2017). Non-performing loans: A review of the literature and the international experience. Non-performing loans and resolving private sector insolvency, 47-68
[325] Campbell, A. Bank insolvency and the problem of nonperforming loans. Journal of Banking Regulation, (2007) 9(1), 25-45
[326] Fraser, D. R., Gup, B. E., & Kolari, J. W. (2001). Commercial Banking: The Management of Risk (Second). South-Western College Publishing
[327] Saba, I., Kouser, R., & Azeem, M. Determinants of non-performing loans: Case of US banking sector. The Romanian Economic Journal, (2012) 44(6), 125-136
[328] Badar, M., Javid, A. Y., & Zulfiquar, S. Impact of macroeconomic forces on nonperforming loans: An empirical study of commercial banks in Pakistan. wseas Transactions on Business and Economics, (2013) 10(1), 40-48
[329] Lleshanaku, A. From the perspectives of macroeconomic factors: The past and future of problematic loans in Albania. Academic Journal of Interdisciplinary Studies, (2015) 4(1), 35
[330] Balgova, M., Nies, M., & Plekhanov, A. (2016). The economic impact of reducing non-performing loans
[331] Najaf, R., Najaf, K., & Pasowal, B. A. (2015). E-Banking in Pakistan. American Scientific Research Journal for Engineering, Technology, and Sciences (ASRJETS), 10(1), 74-84 Pakistan, S. B. o. (2017).

The net NPLs of conventional banks in Pakistan reduced from PKR 90.4 billion in 2016 to PKR 75.6 billion in 2017 but increased to PKR 110 billion in 2018 and PKR 141.3 billion in 2019. In 2020, net NPLs decreased to PKR 96.7 billion, after loan deferral facilities were implemented by the central bank, which has resulted in delayed NPL recognition.[332]

Annual trend analysis, as in figure below, of the industry shows that between 2016 and 2020, NPLs of the commercial banks in Pakistan have shown a steady increase from 2017 to 2020. However, in 2020, when compared with gross NPLs, net NPLs reduced considerably, by 32 percent, from PKR 141,347 million in 2019 to PKR 96,736 million in 2020, without a decrease in the gross NPL. This can be explained by the increase in loan provisioning (18 percent) from the previous year.[333]

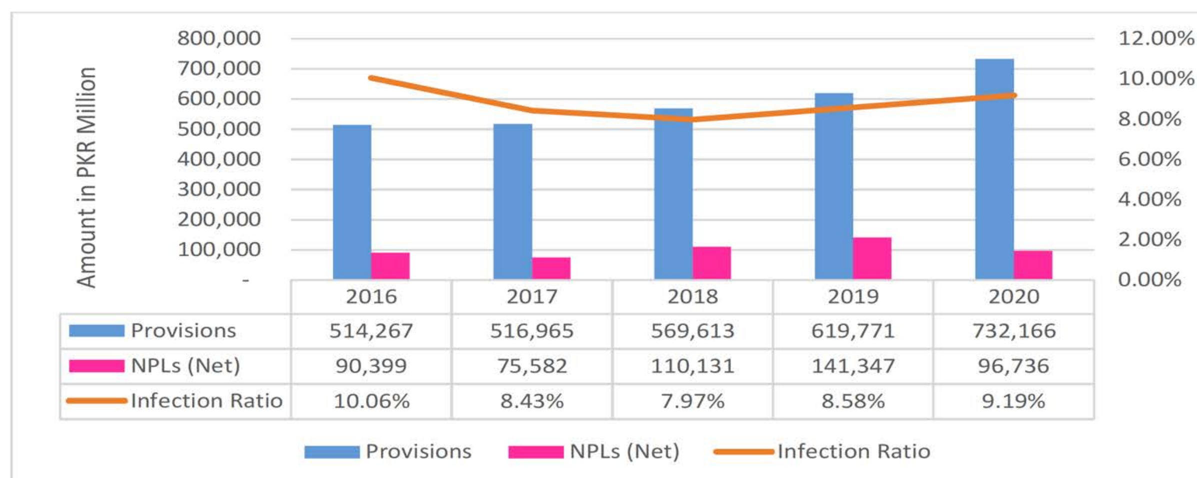


Source: Quarterly Compendium: Statistics of the Banking System, Financial Stability Department SBP, 2020

The net NPLs of conventional banks, as shown in chart below, in Pakistan reduced from PKR 90.4 billion in 2016 to PKR 75.6 billion in 2017 but increased to PKR 110 billion in 2018 and PKR 141.3 billion in 2019. In 2020, net NPLs decreased to PKR 96.7 billion, after loan deferral facilities were implemented by the central bank, which has resulted in delayed NPL recognition. In absolute terms, the NBP is the second largest bank in terms of total assets, but it has the largest portfolio of NPLs, accounting for 21 percent of all NPLs in the country, as shown in the chart below. This is primarily because it is a public sector commercial bank, which tends to have a higher risk of loan defaults than private commercial banks or foreign

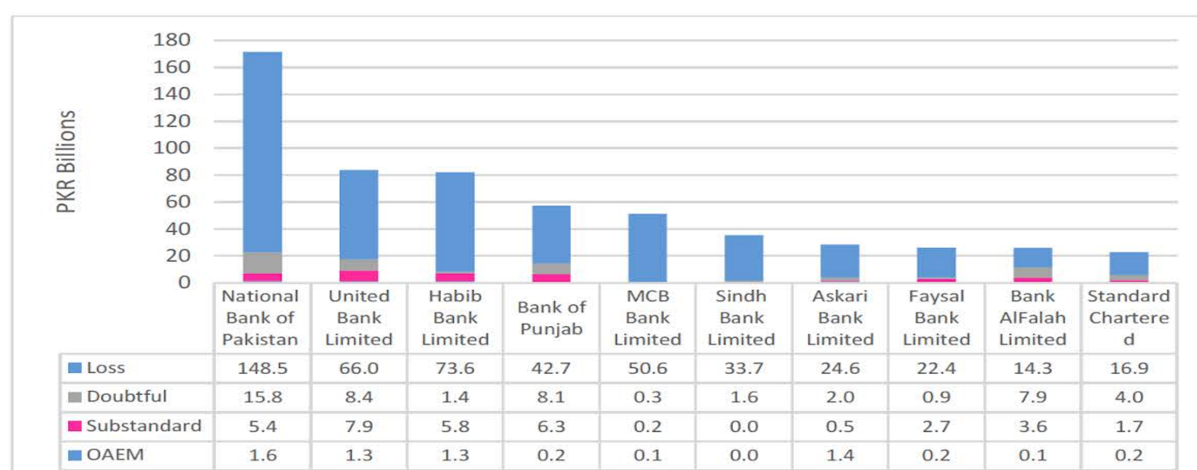
[332] www.ifc.org/wps/wcm/connect/ba48a17c-ff43-4f4a-9c7b-1a6d7c8d44a0/NPL-Market-Assessment-Pakistan.pdf?MOD=AJPERES&CVID=o5fg6VH at p. 45 [accessed 05 January 2023]
[333] Ibid (n.332) p. 43

banks. Similarly, the Bank of Punjab, also a public sector commercial bank, ranks fourth for the highest percentage of NPLs. It owns about 7 percent of the total share of NPLs in the market although it holds only 4 percent of the industry's total assets.[334]



	2016	2017	2018	2019	2020
Provisions	514,267	516,965	569,613	619,771	732,166
NPLs (Net)	90,399	75,582	110,131	141,347	96,736
Infection Ratio	10.06%	8.43%	7.97%	8.58%	9.19%

Source: Quarterly Compendium: Statistics of the Banking System, Financial Stability Department SBP, 2020



	National Bank of Pakistan	United Bank Limited	Habib Bank Limited	Bank of Punjab	MCB Bank Limited	Sindh Bank Limited	Askari Bank Limited	Faysal Bank Limited	Bank AlFalah Limited	Standard Chartere d
Loss	148.5	66.0	73.6	42.7	50.6	33.7	24.6	22.4	14.3	16.9
Doubtful	15.8	8.4	1.4	8.1	0.3	1.6	2.0	0.9	7.9	4.0
Substandard	5.4	7.9	5.8	6.3	0.2	0.0	0.5	2.7	3.6	1.7
OAEM	1.6	1.3	1.3	0.2	0.1	0.0	1.4	0.2	0.1	0.2

Source: Annual Reports 2020 for Top 10 Banks

2.4.6 Legal infrastructure, Political instability & Corruption

Political instability and corruption demoralize progress and create more frustration in society. It eats vital resources and weakens its economic growth, national unity, and social peace. Lawlessness becomes an order of the day due to corruption, poverty, violence, and indiscipline. Quickly the whole judicial, moral, and economic fabric of a country will collapse.[335] Pakistan is a developing country and has the capability for enhancing the economic situation; but the barriers i.e., political instability, governance issues, and crimes hinder economic growth in

[334] Ibid (n.332) p.48
[335] Ismail, A., Rashid, K., 2014. Time series analysis of the nexus among corruption, political instability and judicial inefficiency in Pakistan. Qual. Quantity 48 (5), 2757–

several ways.[336] The inconsistency in the consensus of various political parties, the ineffectiveness of local governments that organizing a legal and clear voting (election) for good control & corruption at the government level are the key root causes of political instability in Pakistan.[337]

Pakistan's judicial history is full of ups and downs. In 1949 Federal Court of Pakistan was established and Mian Abdul Rashid was appointed to be succeeded by the controversial period of Justice Muhammad Munir who introduced the "theory of necessity" to validate the dissolution of constituent Assembly in 1954.[338]

Professor Uzma Zahoor has encapsulated 50 years history of judicial role in failing to prevent both corruption and political instability arguing and relating corruption with respect to political instability in the following words:

> "Corruption has become a relative phenomenon in Pakistan's society and constitutional history.[339] Corrupt was the status of the first constituent assembly when it prolonged with duration for nine years after independence by not framing the constitution for the country. The reformer was the governor general whose extra constitutional act of dissolving that assembly and setting aside of interim constitution was validated on the basis of doctrine of necessity applied for the first time in the constitutional history of Pakistan. Exploiting was a legal order set under the first constitution of Pakistan of 1956 when it was abrogated, and army took over the reigns of the country in 1958 judiciary applauded[340] This extra constitutional act by pronouncing that "a successful revolution in its own justification." The then Martial law regime constitutionalised itself by presenting the constitution of 1962."[341]

[336] Tabassum, T., 2019. Causal relationship of economic factors with GDP growth of two emerging markets of South Asia: Bangladesh and India. Global Bus. Econ. Rev. 21 (6), 798–813.
[337] https://www.researchgate.net/publication/363681428_An_Event_Based_Analysis_of_Stock_Return_and_Political_Uncertainty_in_Pakistan_Revisited [accessed Dec 29 2022].
[338] Federation of Pakistan Vs Molvi Tamizuddin Khan PLD 1955 FC 240
[339] https://leappakistan.com/wp-content/uploads/2019/04/A-Comment-on-Zafar-Ali-Shah-V-General-Pervaiz-Musharraf-Uzma-Zahoor-PLR-Vol-I.pdf
[340] State vs. Dosso PLD 1958 SC 533
[341] Zahoor (n.339)

"…The 1973 constitution with all its sublime cum majestic doctrinal approach content in itself a command of directory nature for the preservation of constitutionalism in the form of Article 6 which expressly declared that any act of abrogation of constitution as high treason. Along with Article 6, Article 270 was also placed in the constitution to validate the laws passed and actions taken by Martial Law. Hence it was first to express constitutional confession as being an unfaithful disciple of rule of law."[342]"…The Supreme Court in its famous judgement in Begum Nusrat Bhutto v The Chief of Army Staff[343] again declared the ultra vires an unconstitutional election of Chief Martial Law Administrator as valid for a temporary period on the basis of doctrine of necessity and adjusted the constitutional regime as corrupt. Thus Article 6 was given a judicial explanation."[344]

"…. Between 1990 and 1995, three successive governments were dissolved on the allegations of corruption. On 12th October 1999, the army resurrected itself as a reformer and put an end to ever stumbling legal order in the country. The allegation was again corruption, maladministration, uncertainty of rule of law and ridiculing the honour of judiciary.[345] Even the judicial pronouncement did not create any shocking waves; it was the same old fairy tale and reincarnation of doctrine of necessity on the basis of which, once again, the Supreme Court declared General Musharaf government de jure."[346] "From the armed forces to judicial tycoon's and from the people's representatives to the electorate, ours is the legal system, which has been ripped apart and molested by every possible component of our state.[347] Our judges should have at least tried to explore the destructive practical consequences of the surgeries committed on our society by our institutions and individuals. This has resulted into side effects of a different kind of surveillance in our legal order: the severance of the link between the political order and legal order affected by precedents set by judiciary itself."[348]

[342] Zahoor (n.339)
[343] PLD 1977 SC 657
[344] Zahoor (n.339) p. 216
[345] Zahoor (n.339) p.218
[346] Syed Zafar Ali Shah v General Pervaiz Musharaf PLD 2000 SC 869
[347] Zahoor (n.339) p.222
[348] Zahoor (n.339) p.222

From June 2005 onwards, by appointment of new Chief Justice of Pakistan,[349] his suspension in March 2007 followed by restoration with the help of Lawyer's movement in 2009, was considered as an era of rebirth of "judicial activism.[350] The superior judiciary had taken a lot of Suo moto cases in the name of public interest litigation. After 2009, the Supreme Court exceptionally expanded the scope of Article 184 (3) and took cognizance of the matters ranging from the highest to the pettiest nature of cases, which helped it earn the title of people's judiciary.

The Court invalidated the National Reconciliation Ordinance 2007 "NRO"[351] and directed corruption cases against then President Asif Ali Zardari to be pursued. The Court, later, dismissed an elected Prime Minister on the basis of contempt of Court. The Court, while claiming its moral uprightness, cultivated the judiciary's image as a guardian of the exploited people's interest. Consequently, the frustrated society, which remained vulnerable to discrimination, injustice, and political exploitation, appreciated, and earned a good name for the judiciary, and the same turned out as a legal tool for the judiciary's populist stance. The Court not only asserted autonomy from the government, but also affirmed its role as an arbiter for deciding core political issues. The successor Chief Justice[352] continued to frequently exercise these discretionary powers, alluding to the excessive use of the Suo motu unnecessarily and sometimes without jurisdiction, took cognizance of matters reserved for executives and parliament.

In Panama Papers case,[353] The Court set another precedent by constituting the Joint Investigation Team (JIT). The Court disqualified the elected Prime Minister, on the basis of the inquiry report submitted by the JIT. The report declared three of Sharif's children as owners of the offshore companies[354] suspected of money laundering. Based on the evidence collected by the JIT, the court directed the NAB to file corruption cases against Sharif and his family. Previously, Sharif has been ousted twice, on corruption charges, from holding the Prime Minister's office: in 1993 through a Presidential Order and in 1999 through Musharraf's coup.

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[349] Iftikhar Muhammad Chaudry

[350] Black's Law Dictionary: "A Philosophy of judicial law making whereby judges allow their personal views about public policy, among other factors to guide their decisions; usually with the suggestion that adherents of this philosophy tend to find constitutional violations and are willing to ignore precedent."

[351] NRO 2007 is further discussed with respect to NPLs in this chapter and in Chapter 6.

[352] Mian Saqib Nisar was appointed between December 2016 and January 2019

[353] Imran Khan Niazi v Mian Muhammad Nawaz Sharif, [2017] Petition. No. 29 and 30 of 2016 and 03 of 2017

[354] Daily Mail reported this In the UK (n.210)

In the instance case, turning an inquiry into an investigation about Sharif's moral character depicts the Court's intervention in political matters.

The Suo Moto actions by judges of the Supreme Court and of High Courts has added unnecessary and controversial case load in the court's diary. Whereas no effort was made by the same judges to resolve huge caseload pending for years and some for decades in the courts including Banking Courts.[355] This is despite fully knowing that the judiciary works under heavy workload due to the bulging population and surge in litigation.

In 2009, the National Judicial Policy[356] was formulated to reduce the backlog of cases. The data collected by the Law and Justice Commission of Pakistan revealed as follows:

- 46,695 cases were pending before the Supreme Court;
- The five high courts had pending 389,549 cases; and
- 1,783,826 cases were pending trial at before the district judiciary of the country.

It was reported that a staggering amount of over PKRs3 trillion of Federal Bureau of Revenue was pending adjudications:[357]

- 2,959 cases were pending in the Supreme Court involving PKRs72.2 billion tax revenue;
- 8,986 cases were pending in the Supreme Court involving PKRs738.9 billion tax revenue; and
- 58,937 cases involving PKRs950 billion were pending in appellate tribunals.

Additionally, further cases involving PKRs2.5 trillion were pending with tax commissioners.

There are around 4200 judges (combined strength of judges of Superior Courts, Subordinate Courts and Special Courts/Administrative Tribunals) for a population of 180 million in Pakistan. It means that there is one judge for 42857 persons, which is far below the international standards. Around 90% of litigation in Pakistan is conducted at the level of Subordinate Courts and the rest at the level of High Courts and Supreme Court. There exists a shortage of courtrooms, judicial officers, ministerial staff, and office equipment. The strength of the Subordinate Judiciary has not kept pace with the rise in litigation due to which a huge backlog

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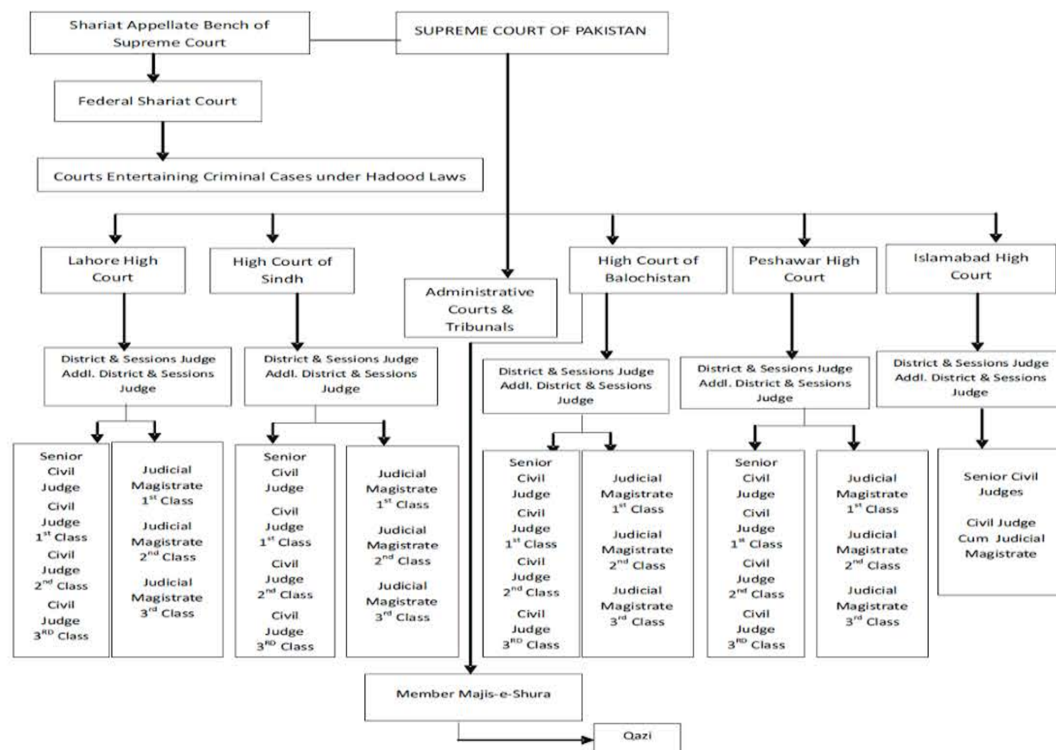
[355] https://www.nation.com.pk/08-Feb-2016/10-000-cases-pending-with-banking-courts
[356] https://www.dawn.com/news/1699337 published on 13 July 2022
[357] https://www.dawn.com/news/1678348/reports-about-cases-worth-rs3tr-pending-with-courts-irk-cjp published 05/03/2022

of pending cases is accumulated, and there are enormous delays in deciding cases. The civil and session judges deal with an excessive number of cases even though limits set by reforms limit 500 cases, at one time, to be dealt by Civil and 450 cases, at one time, to be handled by District & Sessions Judge.[358] The court's structure is in shown in the chart below:



Source: Federal Judicial Academy Pakistan[359]

The banks' loan recovery cases were under the jurisdiction of ordinary civil courts until 1978[360] when banking courts were established to have exclusive jurisdiction. The Financial Institutions (Recovery of Finances) (Amendment) Act 2016 and The Financial Institutions (Recovery of Finances) Rules, 2018 (the 'Recovery Rules') is current law. The s. 7(4), (5). Recovery Ordinance gives banking courts exclusive jurisdiction for all disputes in relation to any financial facilities availed by the customers from any financial institution to the exclusion of banking offences courts, criminal courts and the Federal Investigation Agency. The time limitation for a suit for recovery is three years from the date of default or 12 years in case of mortgaged property. The defendant is required to file an application for leave to defend "PLA" to first obtain leave of the Court to defend the suit. PLA shall contain a summary of the

[358]www.supremecourt.gov.pk/downloads_judgements/all_downloads/Judicial_System_of_Pakistan/thejudicialsystemofPakistan.pdf p.18
[359] Judicial System (n 359) p.21
[360] On promulgation of Banking Companies (Recovery of Loans) Ordinance of 1978

substantial questions of law as well as fact in respect of which, in the opinion of the defendant, evidence needs to be recorded. A PLA has to be filed within 30 days from the date of service of a notice. The Court could grant decree if Defendant failed to file PLA or if the court is not satisfied with the grounds taken in the PLA. The Court also has discretion to grant interim decree, even where leave to defend is granted, to the extent that the court might be of the view that the claim was, prima facie, established. This decree may be modified on passing of final decree.

The decree, once granted, can be executed through the process of the Court or by the financial institution itself without intervention of the Court. In case of private execution, accounts have to be filed in the Court. The assets secured by way of mortgage, pledge and hypothecation can be put to public auction through intervention of the banking court. Section 15 of the Recovery Ordinance gave powers to financial institutions to sell out the mortgaged properties privately without intervention of the court after duly serving notices to the defaulted customer. Another way of enforcement is by attachments of Personal Assets judgement-debtors. A bank can also seek to get the judgement debtor arrested where such assets are not traceable. The procedure devised to dispose of proceedings in banking court is expeditious. But banking courts had been unable to resolve the case for years for multiple reasons that are discussed in chapter 6 of this thesis.

2.5 Essentials of a Good Banking System in a Country's economy

The banking industry is not merely an essential part of a financial system; the banks are also embedded in our lives. The collapse of the banking industry can cause a recession that will affect all the inhabitants of the state, no matter whether they are engaged with banks through any means or not at all. The stability of the banking industry is nonetheless backed by trust: if the public loses its confidence in the banking system, this will indeed increase the demand for liquidity, which could cause a financial crisis. Hence, an efficient banking system has become the mainstay for the sustainability of the financial system.[361]

[361] Kelvin Mkwawa, "Importance of Banking Industry", (3 May 2018), The Citizen, https://www.thecitizen.co.tz/magazine/businessweek/Importance-of-banking-industry/1843772-4543558-b68977/index.html [Accessed October 2022]

It is for the central bank of a country to develop policies which the commercial banks must implement. This system entails two stages: (a) formulation of wider policies; and (b) implementation of those policies in actual situations. Any major crisis in the banking industry has been found to be catastrophic for not only the banking sectors in a specific country but can also adversely affect the banking systems of other countries. The performance of retail banking at domestic level is crucial and ideal for the analysis of the soundness, competitiveness, and sustainability of a banking sector. It is important to stimulate good banking practices which would ensure that the banking sector is stable. Therefore, the central bank must also make a judgement about the taking of most appropriate steps for targeting inflation to minimize the economic and banking volatility.[362]

Evidence of the impact of policies of sound banking practice is enshrined in the EU Regulations. This creates a top-down cascading effect of policies which are set at a higher level allowing the EU countries' central banks some level of flexibility for implementation. The European System of Central Banks (ESCB) is mandated to implement and define monetary policies, and also to ensure that there is promotion of smooth operation of payment systems. Further, the body is tasked with maintaining a well-coordinated and smooth conduct in terms of policies that are pursued by the relevant authorities which are responsible for supervising and regulating the stability of Banking system and credit institutions.[363] This kind of regional Banking policy has enabled the EU to practise sound financial and banking system.[364]

It is for the commercial banks to monitor the market by keeping an eye on consumers' behaviour by keeping track of elasticity in consumers' demand and by ensuring that there are sufficient resources of supply chains to meet such demand. This monitoring and timely actions ensure maintaining of healthy competition as opposed to development of risky monopolistic competition which might result in the concentration of money with the minority turning the majority of the people into economic chaos and non-ending struggle to meet the basic necessities for the subsistence.[365] Otherwise, it would give birth to unwanted destructive factors such as inflation, unemployment and budget deficits inviting experts to develop policies, on an

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[362] Bank of Canada, 'Monetary Policy Report' (2012) <www.bankofcanada.ca/wp-content/uploads/2010/11/monetary_policy.pdf> accessed 09 January 2020
[363] Article 127 The EU Treaty
[364] Erlend W Nier, 'Towards Effective Macroprudential Policy Frameworks: An Assessment of Stylized Institutional Models'(2011) Monetary and Capital Markets Department IMF Working Paper 11/250 <https://www.imf.org/external/pubs/ft/wp/2011/wp11250.pdf> accessed 09 January 2020
[365] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2018/ss118 [accessed on 16 February 2021]

emergency basis, to save the economy from total destruction and bring stability by way of drafting stabilisation policies to improve the situation in budgets deficits and controlling inflation and unemployment. The policies of both micro and macroeconomics would be proven futile without an effective system of banking regulations that would ensure that the banks are keeping the minimum reserves to meet its liquidity requirements and there are responsible policies in place for prudential investment and the secured credit arrangements are offered on flexible terms at low interest.[366]

In March 2009, the "Turner Report" (Turner Review) was published. The United Kingdom's Financial Conduct Authority (FCA) recognised that the most important systemic risks in liquidity management are the regulations surrounding the global banking industry. Such regulations require banks to have a good value of liquid assets as a buffer.[367] The Financial Conduct Authority emphasised that the institutions should be immediately based on the risk impact to regulate the Banking systems. The Financial Conduct Authority regulates mortgages, credit derivatives and other Banking products that need to be particularly under the spotlight given the fallout from the Banking crisis.[368]

The systematic risk regulations also require that the regulatory authorities need to have sufficient knowledge of markets, institutions, and economic policies in order to perform an accurate analysis to achieve the ability of handling large amounts of information. The UK Government has had centuries of a diverse sub-sector regulatory structure within the banking services sector which has had to be adjusted. After the banking crisis, the authorities in the UK had to strengthen the corporate governance within the Banking world.[369]

Another example of rescuing the failing economic policies through regulations is the Banking plans, in March 2009, announced by the US government. This programme was designed as a protection mechanism which required a certain size of hedge funds to be in place in private equity funds and venture capital funds. These funds were made compulsory to be registered with the US Securities and Exchange Commission registration, and it was made necessary to disclose more and detailed information about their assets and respective leverage.[370] This

[366] https://www.bis.org/bcbs/publ/d439.pdf [accessed on 16 February 2021]
[367] Shkelqim Fortuzi and Sanie Doda (2015) III (6) International Journal of Economics, Commerce and Management ISSN 2348 0386 <http://ijecm.co.uk/wp-content/uploads/2015/06/3640.pdf> accessed 10 January 2020
[368] https://www.fca.org.uk/news/speeches/our-supervision-overview [accessed on 16 February 2021]
[369] https://www.cfainstitute.org/en/research/foundation/2009/regulating-systemic-risk [accessed on 16 February 2021]
[370] https://www.thebalance.com/what-was-the-bank-bailout-bill-3305675 [16 February 2021]

information was then used by the regulatory agencies as a protection mechanism because the regulatory scene was seriously lagging behind the rapid advancement of innovative Banking derivatives. The protection and disclosure framework, in June 2009, meant that the United States' government proposed the banking stability of enterprise regulation which was implemented and is still in force.[371] This was in order to prevent companies acting inappropriately by manipulating their own legal structure to avoid regulation.

Economic stability is a fragile phenomenon and can always be shaken by unpredictable national, regional, or global banking crises that strike from time to time; law and legal institutions perform an irreplaceable role to tackle the occurrences of such crises and rescue the economy of a country, region, and Continent. The regulatory regime of the banks plays the role of a key player when it comes to safeguarding the commercial banking system. The reason that "the Bank must also make a judgement about the most appropriate horizon for returning inflation to target, so as to minimize the economic and Banking volatility that these actions may cause[372]" reveals that banking institutions have a key role to play in the economic sector of a country. The developing and developed Countries have often joined together to figure out solutions to prevent the triggers causing the banking instability despite the existence of banking custom and banking regulations. This issue of economic development has always been under some discussions; people have been searching for the factors for developing improvements to the economy.

The law, banking stability and economic development are interrelated. A stable banking market is crucial for the constant development of an economy however banking crises gave rise to adoption and development of new legislation to prevent and resolve issues causing systematic Banking instability. Legislation formulates the rules to regulate varieties of banking activities from market entry, information disclosure, elimination of misconducts and retention of the invaluable market confidence. Cieslik and Goczek find that, in the absence of good governance, corruption negatively affects a country's growth. Because of the lack of control over corruption, investors withdraw their investments and move to countries with good governance.[373]

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[371] https://corpgov.law.harvard.edu/2010/11/20/the-financial-panic-of-2008-and-financial-regulatory-reform/ [accessed on 16 February 2021]
[372] Bank of Canada, 'Monetary Policy Report' (2012) <www.bankofcanada.ca/wp-content/uploads/2010/11/monetary_policy.pdf> accessed 09 January 2020
[373] Cie slik, A., & Goczek, Ł. (2018). Control of corruption, international investment, and economic growth Evidence from panel data. World Development, 103, 323e335

Evidence of the impact of policies of sound banking practice is enshrined in the EU Regulations. This creates a top-down cascading effect of policies which are set at a higher level allowing the EU countries' central banks some level of flexibility for implementation. The European System of Central Banks (ESCB) is mandated to implement and define monetary policies, and also ensure that there is promotion of smooth operation of payment systems. Further, the body is tasked with maintaining that there is a well-coordinated and smooth conduct in terms of policies that are pursued by the relevant authorities which are responsible for supervising and regulating the stability of Banking system and credit institutions.[374] This kind of regional Banking policy has enabled the EU to practise sound Banking and banking system.[375]

Low-income people having access to a diverse set of financial tools have far higher capacity to improve or stabilize their income, acquire assets and strengthen their resilience to economic shocks.[376] In addition, by investing funds properly, managing risks and efficient allocation of resources, these financial policies have a significant impact on the economic growth of a country.[377] Besides economic growth, previous finance literature suggests that improved access to finance has benefited different socioeconomic variables. Better access to finance, in particular, boosts savings; increases economic growth; decreases income inequality, poverty and gender inequities; and improves general human development. [378]

Flaschel[379] also explained that micro and macroeconomics policies significantly have a big influence in the banking sector. The implication of this is that macro sectors are wider and cover broader banking areas as compared to microeconomic policies which are sector based. It is undisputed that there is a relationship between the banking system and the performance of the economy. Mark Bertus and others[380] have argued that the stability and performance of

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[374] Article 127 The EU Treaty

[375] Erlend W Nier, 'Towards Effective Macroprudential Policy Frameworks: An Assessment of Stylized Institutional Models'(2011) Monetary and Capital Markets Department IMF Working Paper 11/250 <https://www.imf.org/external/pubs/ft/wp/2011/wp11250.pdf> accessed 09 January 2020

[376] www.wsbi-esbg.org/SiteCollectionDocuments/1169.pdf

[377] Schumpeter, J.A. (1911), The Theory of Economic Development, Harvard University Press

[378] Sethi, D. and Sethy, S.K. "Financial inclusion matters for economic growth in India: some evidence from cointegration analysis", International Journal of Social Economics, (2018), Vol. 46 No. 1, pp. 132-151

[379] Peter Flaschel, 'Employment Multipliers and the Measurement of Labour Productivity' In Topics in Classical Micro-and Macroeconomics(2010) Springer Berlin Heidelberg 129,143 <https://www.researchgate.net/publication/281763976 Topics in classical micro and macroeconomics Elements of a critique of neoricardian theory> accessed 10 January 2020

[380] Mark Bertus and others, 'The Relation Between Bank Regulation and Economic Performance: A Cross-Country Analysis' (2007)2(3) Banks and Bank Systems 3,5 <http://harbert.auburn.edu/~yostkev/research/BertusJaheraYostGDP.pdf> accessed 10 January 2020

banks are directly related to the ability of the various markets to supervise and monitor their discipline. The research was done in over 153 countries demonstrates that countries which have set better macro and microeconomic policies in their banking sectors are highly associated with lesser risks and more wealth in the banking system. This may be conclusive evidence that macro and microeconomic policies have a direct impact on the banking system. This is a cycle which shows the importance of maintaining sound banking practices. Levine[381] shows that in return, the banking system, if stable and sound, helps improve the general economic conditions of a country hence the connection between the macro, microeconomic and the banking sector.

Over the last few decades, there have been a number of major banking crises, these disasters caused major losses throughout the globe.[382] These losses could directly be traced from the practice of unsound banking like the increment in the risk profile of bank loans and the shift to non-traditional income generating avenues. These crises have provided a foundation and impetus for industry participants and policy makers to rethink the whole banking sector policy in terms of sustainable industry wide and specific banking policies.[383]

The role of micro and macro-economic policies for achieving sound banking systems and practices is seen through the implementation of universally effective practice policies for the banking sectors.[384] Various international organisations and stakeholders agree that by allowing policies in the broad banking sphere and also in the specific sphere, the level of compliance, good governance and banking accountability is channelled to the banking sectors.[385] Barth and his colleagues[386] have revealed that economic policies, which contain openness, legality, democracy, accountability, public participation, and anti-corruption policies, not only ensure suitability of the banking sector to attract investors but also allow a top-down compliance to these principles which bind various sectors to maintain higher practices in their respective field. This shows that the broader and sector-based policies in banking sectors have an impact on the

381 Ross Levine, 'Finance and Growth: Theory and Evidence'(2005)1 Part (1) Chap 12 Handbook of Economic Growth ElSVIER 865,934 <https://econpapers.repec.org/bookchap/eeegrochp/1-12.htm> accessed 10 January 2020
382 GFC of 2007/2008 and others crisis as discussed in this chapters and others.
383 Mark Bertus, 'The Relation Between Bank Regulation and Economic Performance: A Cross-Country Analysis' (2007)2(3) Banks and Bank Systems 3,5 <http://harbert.auburn.edu/~yostkev/research/BertusJaheraYostGDP.pdf> accessed 10 January 2020
384 Andrew Crockett, 'Marrying the Micro-and Macro-Prudential Dimensions of Banking Stability' (2008) BIS Working Paper1 speeches 21 ISBN 92-9131-615-6< https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1165494> 10 January 2020
385 Carl-Johan Lindgren, Bank Soundness and Macroeconomic Policy (International Monetary Fund, 1996) ISBN-155775599X, 9781557755995
386 James Barth, Gerard Caprio, Ross Levine, ' Bank Regulation and Supervision: What Works Best?' (2004) 13(2) Journal of Banking Intermediation 205,248
<https://econpapers.repec.org/article/eeejfinin/v_3a13_3ay_3a2004_3ai_3a2_3ap_3a205-248.htm> 10 January 2020

banking system. The international community has also been developing sound policies to regulate the banking sectors in terms of good practices. In as much as other policies are in the forms of recommendations and good practice and therefore not binding, these have been used by governments, regulators, and supervisors all around the world in crafting sound banking requirements especially in the banking sector[387]. These include the move from the traditional banking ratio analysis to a more practical method of using the risk-based method of supervision.

The impact of a sound banking system is shown by the efforts undertaken by the Basel Committee which aims to ensure that there is a proper process for the development of insights and tools for the banking sectors to avoid banking crises. This is achieved by top-down policy change spanning from the international environment to the macro-banking ecosystem and down to the banking sector from international fora. For instance, the implementation of international economic tools in supervision, risk-based supervisions as compared to ratio analysis, risk management, and market participation as addressed by the Basel Committee has been proved to provide sustainable practices.

The Basel Capital Accord provides that microeconomic policies have to be aligned for capital regulation in order to ensure better banking supervisory and regulatory practices. It is also through the emphasis of better banking disclosure that the banking system has been continuously put on stress in order to allow the sector to develop self-regulation and internal measures for banking disclosures and good practices.[388] This effectiveness of banking policy at a macro and micro level is also confirmed by Blum[389] who has revealed that there is a relation between the banking system and economic development and hence countries have undertaken the role of setting policy at a national level to impact positively in the banking sector. There is a relation between capital regulation policy and the manner and extent to which the banking

[387] Daniel LNielson and MichaelJ Tierney, ‘Delegation to International Organisations: Agency Theory and World Bank Environmental Reform’ (2003) 5 (2) International Organisation Cambridge University Press 241-276 < https://doi.org/10.1017/S0020818303572010> 10 January 2020

[388] Mark Bertus and others, ‘The Relation Between Bank Regulation and Economic Performance: A Cross-Country Analysis’ (2007)2(3) Banks and Bank Systems 32,45 <http://harbert.auburn.edu/~yostkev/research/BertusJaheraYostGDP.pdf> accessed 10 January 2020

[389] Jürg Blum, ‘Do Capital Adequacy Requirements Reduce Risks in Banking?’ (1999) 23(5) Journal of Banking & Finance 755,771< https://doi.org/10.1016/S0378-4266(98)00113-7> accessed 10 January 2020

system issues credit. These microeconomic elements in capital requirement are required for the development of a sound banking system.[390]

In order to understand the connection between monetary and economic policies, it is crucial to understand economic and banking stability. The advent of a number of economic crises have revealed that price stability is not in itself a full guarantee to economic stability. The framework of economic and banking policies was broadly converging to cover price stability targets and short-term rates of interest as a major tool of policy. The implication is that price stability failed to ensure economic stability since the business cycle and banking cycle were not perfectly being synchronized. This necessitated the implementation of newer economic and banking regulation in order to boost the resilience of an economy and therefore its banking institutions. The emerging and new model is the one where monetary economic policy is geared at ensuring stability of prices while the macro-prudential policy is directed to the stability of the economy by focusing on banking sustainability and stability.[391]

This aspect creates a relationship between the Central bank and Government in terms of policy making in the economy. The central banks of Australia, Belgium, France, Italy, the Netherlands, Sweden, and the United Kingdom have long been established to be subservient to the central governments in terms of conduct and formulation of monetary policy. This aspect is highly dependable on the type of regulation making agent and the level of independence. Robert J Gordon[392], Barro and David B. Gordon[393], and Allan H. Meltzer and Cuklerman[394] argue that banking policy and regulation do highly depend on the autonomy of the banking regulator.

This relation between macro and micro economic factors and banking regulations are considered especially when there are major regulatory proposals and policy making organs

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[390] Ergungor O Emre, 'Banking System Structure and Economic Growth: Structure Matters' (2008)17(2) International Review of Economics & Finance ELSEVIER 292,305 <https://ideas.repec.org/a/eee/reveco/v17y2008i2p292-305.html> accessed 10 January 2020

[391] Marek DABROWSKI and others,' Interactions Between Monetary Policy and Bank Regulation: Monetary Dialogue' (2015) European Parliament on Economic and scientific Policy A CASE <http://www.europarl.europa.eu/RegData/etudes/IDAN/2015/563458/IPOL_IDA(2015)563458_EN.pdf> accessed 10 January 2020

[392] Robert J Gordon, 'The Demand for and Supply of Inflation' (1975)18(3) The Journal of Law and Economics The University of Chicago Press 807,836< https://www.jstor.org/stable/725066?seq=1> accessed 10 January 2020

[393] Robert J Barro and David B Gordon, 'Rules, Discretion and Reputation in a Model of Monetary Policy' (1983)12(1) Journal of Monetary Economics IMF101,121<https://doi.org/10.1016/0304-3932(83)90051-X> accessed 10 January 2020

[394] Alex Cukierman, 'Central Bank Behaviour and Credibility: Some Recent Rheoretical Developments' (1986)68(5) Federal Reserve Bank of St. Louis Review 5,17< https://research.stlouisfed.org/publications/review/1986/05/01/central-bank-behavior-and-credibility-some-recent-theoretical-developments/> accessed 10 January 2020

such as the Ministry of Finance collaborates with the banking sector in terms of ensuring that the laws are in compliance with the prevailing monetary policy. The fact that policy making has a political connection means that everything which is passed in terms of banking laws should have a political bearing in terms of being an economic policy by the ruling political class. The laws in the banking sector always have an underlying economical aspect and as such the impact of prevailing economic conditions and microeconomic aspects and changes always go into the root of banking legislations.[395]

The treasury of a government, in charge of economic policies, will have a direct or indirect impact on the banking policy and regulations in the banking sector. For example, in Australia, there is a requirement for coordination between the Reserve bank and the Federal Treasury even when there are disagreements. The role of economic policy is seen by the fact that the body in charge of Australia Federal Economic Policy, the Federal Treasury, has to work with the Reserve Bank in implementing economic policies and ensuring the same is incorporated in the banking system. “The Governor and the Secretary of the department of the Treasury shall establish a close liaison with each other and shall keep each other fully informed on all matters which jointly concern the Bank and the department of Treasury.”[396]

The relationship between economic policy and banking laws are further seen by central banks consulting with treasuries which can submit monetary policies based on economic data to the central banks; this can be used to determine the banking policies and regulations which are adopted in a given sector.[397] Regulations are usually passed through the government ministry concerned by means of consultation and participation, and thereafter through the parliament which analyses the regulation’s impact on the banking and economic climate. Bade,[398] pointing out that the banking sector can influence the economy and vice versa, agrees that the two areas are required to be well balanced.[399]

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[395] Robin Bade and Michael Parkin, ‘Central bank laws and monetary policy’ (1988) Department of Economics, University of Western Ontario 5 < https://www.researchgate.net/profile/Michael_Parkin3/publication/245629808_Central_Bank_Laws_and_Monetary_Policy/links/564a30e208ae127ff98687e5/Central-Bank-Laws-and-Monetary-Policy.pdf> accessed 10 January 2020
[396] Reserve Bank Act Australia, 1959-1973
[397] Iftekhar Hasan, Paul Wachtel and Mingming Zhou, ‘Institutional Development, Banking Deepening and Economic Growth: Evidence from China’ (2009) 33(1) Journal of Banking & Finance 157,170 < https://doi.org/10.1016/j.jbankfin.2007.11.016> accessed 10 January 2020
[398] Robin Bade and Michael Parkin, ‘Central bank laws and monetary policy’ (1988) Department of Economics, University of Western Ontario https://www.researchgate.net/profile/Michael_Parkin3/publication/245629808_Central_Bank_Laws_and_Monetary_Policy/links/564a30e208ae127ff98687e5/Central-Bank-Laws-and-Monetary-Policy.pdf> accessed 10 January 2020
[399] Bade & Parkin (n. 398)

This relationship between economic policy and law is also seen through the working of the French Government and the Bank of France by examining the Codified Statute of the bank. The banking policy of France involves three agencies in order to make sure that proper economic aspects are present for the prosperity of the banking sector.[400] The Bank of France has to take into account the economic and monetary aspects of policy, and it must work with the bodies in charge of these aspects that is the national Credit Council and Banking Control Commission to ensure that banking policies are formulated in a framework that allows competence in the industry and that the bank takes part in formulating monetary policies.

This relationship is also recognised in the Italian law where the Bank of Italy has no power to make monetary and banking policy; the Statute of the Bank of Italy is mandated to make proposals to the government through the Minister of Treasury. The government will then have to look at the proposal and ensure that it captures the micro and macro-economic aspects.

In the Netherlands, the Ministry of Treasury, which is basically in charge of Banking policy, must consult with the Bank Council before giving any directions to the Governing Board of Bank as it thinks prudent for the Bank's policy. This means that the Ministry must be made aware of any directions.[401]

Any major banking regulations are usually accompanied by broad stakeholder participation with various economic regulators such as competition authorities, capital markets regulators and ministries, with a view of creating a sound practice in the banking sector which is in line and compatible with a country's monetary policy and banking policy. This close connection and relationship acts in two ways in that inasmuch as the macro and micro economic policies can impact on the enacted laws, the laws also have the impact on affecting the elements of the economy such as available credit and liquidity.[402]

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[400] Robin Bade and Michael Parkin, 'Central bank laws and monetary policy' (1988) Department of Economics, University of Western Ontario 5 < https://www.researchgate.net/profile/Michael_Parkin3/publication/245629808_Central_Bank_Laws_and_Monetary_Policy/links/564a30e208ae127ff98687e5/Central-Bank-Laws-and-Monetary-Policy.pdf> accessed 10 January 2020

[401] The Bank Act 1948, De Nederlandsche Bank N.V

[402] Giovanni Dell'Ariccia and others, Monetary Policy and Bank Risk Taking (IMF Staff Position Notes 2010/09, 2011) ISBN/ISSN:9781455253234/2072-3202

From a banking crisis perspective, the connection between banking regulations and the existing framework on economic policy is clear. Capital requirements are a result of macro and micro economic data which reveals the stability and sustainability of the banking sector. Further, banking aspects like competition have trickled down to regulate the conduct of banking.[403] Evidence can be extrapolated from New Zealand where the Reserve Bank of New Zealand is mandated to generally consider "the soundness and efficiency of the banking system" when deciding monetary policy and bank regulation.[404] Even though there is difference in the determination of banking stability, many economists and policy makers agree that banking stability is crucial and must be included in the banking sector regulations.[405]

The central banks' primary role of maintaining banking stability, stabilizing inflation, and economic activity maintenance means that the central bank's main functions include both micro stability within the banking sector and promoting the macroeconomic indicators. The central banks will have to formulate any policies and regulations in a manner which allows for the smooth functioning of the banking sector and avoiding direct conflict with the banking stability. Woodford explained that the relations which the banking stability and maintenance have with the banking sector plays a crucial role in ensuring sanity and congruence even from a theoretical perspective.[406] When the central bank, by using macro and micro banking stability elements, allows the imperfection within the credit markets to reduce the implementation of mechanisms which are not reflected in economic activity and inflation forecast.[407]

The principles of coordination and cooperation are very crucial; if a central bank is mandated with the role of regulation and other bodies are given the role of setting macro prudential policies and monetary policies. The central bank cannot on its own undertake regulation without coordinating and considering the macro prudential input of these other statutory bodies. The law is used as a tool to connect the central bank's role of prescribing regulation and guidelines and the role of other authorities like the Treasury in terms of creating macro

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[403] Ralph C Bryant, Dale Henderson and Torbjörn Becker, 'Maintaining Banking Stability in an Open Economy: Sweden in the Global Crisis and Beyond' (SNS 2012) Brookings Report < https://www.brookings.edu/research/maintaining-Banking-stability-in-an-open-economy-sweden-in-the-global-crisis-and-beyond/> accessed 10 January 2020
[404] Toby Fiennes, ' Regulation and the Banking System: A Speech Delivered to Law and Economics Association of New Zealand in Wellington (Reserve Bank of New Zealand 19 June 2013) < http://www.rbnz.govt.nz/-/media/ReserveBank/Files/Publications/Speeches/2013/5326589.pdf> accessed 10 January 2020
[405] William C Dudley, 'Why Banking Stability is a Necessary Prerequisite for an Effective Monetary Policy' (2013) Federal Reserve Bank of New York < https://www.newyorkfed.org/newsevents/speeches/2013/dud130624.html> accessed 10 January 2020
[406] Michael Woodford, 'Inflation Targeting and Banking Stability' (2012) 17967 EconPapers NBER WP 7,32 < https://econpapers.repec.org/paper/nbrnberwo/17967.htm> accessed 10 January 2020
[407] Woodford (n 406)

prudential policies. Even in cases where parent legislations have to be amended, the monetary policy which the central banks set and prescribe is relied upon heavily in addition to macro prudential finance instruments.[408]

Both the central bank and legislators have always focused upon any potential threat to banking stability and the impact of the guidelines and banking laws on economic activity and inflation.[409] Further, these authorities must be able to consider how the proposed laws will impact on banking stability, if and how the monetary policy in the banking industry will be impacted, and/or if any imbalances caused by the law can be counteracted.

Gelain has argued that allowing effective transmission between the regulator and the banking ecosystem allows effective monetary policy which reflect the prevailing market conditions and hence effective laws. The law has to be analysed in relation to the uncertainties which can be caused to the monetary transmission system. If the law or banking regulation do not ensure the banking stability or will most likely cause an instability in the banking market, then the law has to be amended or aligned before it is passed. Sweden has recently adopted this approach in the recent legislations by adopting the model of separation in banking regulations by assigning the Swedish Banking Supervisory Authority the task of macro prudential policy instruments; in doing this task, the agency should work in close cooperation with the Swedish Riksbank, the Swedish National Debt Office, and the Swedish government via the Ministry of Finance. Each of these bodies have been assigned specific roles in banking stability, monetary policy, and macro prudential tools of the economy. In addition to these, the authorities are given mandates to meet regularly, and tackle issues related to the Swedish banking stability and how imbalances in the banking markets can be remedied through the use of laws, policies, and regulations.[410]

The practical result for banking laws is not different in the above model, it is important that the laws have to respond to optimal monetary policy and the changes that occur at a macro level affecting Banking stability, at the very time incorporating inflation and economic activity

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[408] Sveriges Riksbank, The Riksbank and Banking Stability (February 2013) ISBN:978-91-89612-72-3; Sveriges Riksbank, ’Monetary Policy Report’ (July 2013) <http://archive.riksbank.se/Documents/Rapporter/PPR/2013/130703/rap_ppr_130703_eng.pdf> accessed 10 January 2020

[409] Claudio Borio, Monetary Policy and Banking Stability: What Role in Prevention and Recovery? (2014) BIS Working Paper 440 ISBN 1682-7678

[410] Paolo Gelain and others, ‘House Prices, Credit Growth and Excess Volatility: Implications for Monetary and Macroprudential Policy’ (2013)9 (2) International Journal of Central Banking UCB 219,276 < https://www.ijcb.org/journal/ijcb13q2a11.htm> accessed 10 January 2020

aspects such as effective payment systems. These legal responses have to be backed by monetary policy and macro prudential policy at large and in an empirical and quantitative manner. This aspect clearly shows the importance of macro monetary policy and macroprudential policies within the economic space. The reasoning expounded by the economic theory, that sound monetary policy can be put to use in promoting and boosting banking stability through the use of regulations and otherwise, is engraved in the roles of the central bank and other regulators within a banking setting. These relations are expounded by scholars such as Capie and his colleagues.[411]

One reason for the widespread banking crisis was the lack of system sharing information between the regulatory bodies. The Bank of England made an incorrect analysis of the Northern Rock bank and ended up failing to communicate with the Financial Services Authority.[412] The diversified regulatory system can easily lead to regulatory overlap and regulatory vacuum. Therefore, in order to avoid further economic turmoil to enhance communication and cooperation and clear regulatory accountability to prevent systemic risk is required.

The UK government has, since April 2009, promoted the firm establishment of Financial Stability Board which is not only a clear example of the acknowledgment of the need to minimise the asymmetry of segregation of economic policies from banking regulation, but it also ensures the fusion of the economic sector with the banking regulations sector. The Council is composed of the Ministry of Finance, The Bank of England, and Financial Conduct Authority.[413]

The central bank communication is an important aspect of the monetary policy that aims to reduce economic and financial uncertainty. During unusual economic conditions, some central banks also communicate the future monetary policy stance which is referred to as forward guidance. This could take various forms such as qualitative forward guidance, quantitative forward guidance, or guidance conditional on specific economic developments and/or for a given duration.

[411] Forrest Capie and others, 'The Development of Central Banking' The Future of Central Banking: the Tercentenary Symposium of the Bank of England Cambridge University Press CUP November 2011 1,261 ISBN:9780511983696
[412] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/hbos-complete-report [accessed on 16 February 2021]
[413] https://www.fsb.org/about/ [accessed on 16 February 2021]

2.6 FINANCIAL STABILITY & BANKING SYSTEM

A functional financial system has three underlying functions that play decisive roles in fostering economic growth: (i) mediating payment, (ii) converting savings or reserves into funding, and (iii) risk management. By implication, an effective financial system is a sine qua non for promoting sustainable economic growth as well as the stability of financial systems.[414]

Financial stability can be defined by its various qualities, such as "improving economic procedures, managing risks, and absorbing shocks."[415] Financial stability refers to a financial system's ability to easily absorb the shock it faces. Financial stability is a broad notion that encompasses a variety of financial issues. It applies to market architecture (a high degree of concentration increases the danger of spreading from one bank to another) and financial institutions especially on a micro scale (depending on the fact that their business model requires high or low risk). On a macro level, it also has to do with monetary stability and payment service functionality.

A financial system has six parts, each of which plays a fundamental role in our economy. Those parts are money, financial instruments, financial markets, financial institutions, government regulatory agencies, and central banks. We use the first part of the system, money, to pay for our purchases and to store our wealth. We use the second part, financial instruments, to transfer resources from savers to investors and to transfer risk to those who are best equipped to bear it. Loans, Stocks, mortgages, and insurance policies are examples of financial instruments. The third part of our financial system, i.e., financial markets, allows us to buy and sell financial instruments quickly and cheaply. The Stock Exchange is an example of a financial market. Financial institutions, the fourth part of the financial system, provide a myriad of services, including access to the financial markets and collection of information about prospective borrowers to ensure they are creditworthy. Banks, securities firms, and insurance companies are examples of financial institutions. Government regulatory agencies form the fifth part of the financial system. They are responsible for making sure that the elements of the financial system including its instruments, markets, and institutions operate in a safe and reliable

[414] Cecchetti, Stephen G. (Stephen Giovanni) Money, banking, and financial markets / Stephen G. Cecchetti, 4th Edition. ISBN 978-0-07-802174-9
[415] Schinasi, M. G. J. (2004). Defining Financial Stability (EPub) (No. 4-1887). International Monetary Fund.

manner. Finally, central banks, the sixth part of the system, monitor and stabilize the economy.[416]

2.6.1 Characteristics of Financial Stability

The financial stability exhibits a few essential characteristics that are related to the role we ask them to play in our economies: the investors need protection; borrowers' promises to pay lenders must be credible; individuals must be assured that their investments will not simply be stolen; and lenders must be able to enforce their right to receive repayment (or to seize the collateral) quickly and at low cost.[417] In countries that have weak investor protections, firms can behave deceptively when borrowing as they have no intention of repaying the funds and no risk of going punished. The lack of proper safeguards dampens people's willingness to invest. Thus, governments are an essential part of financial markets because they set and enforce the rules of the game. While informal lending networks do develop and flourish spontaneously, they can accommodate only simple, small-scale transactions. Because modern financial markets require a legal structure that is designed and enforced by the government, countries with better investor protections have bigger and deeper financial markets than other countries.[418]

Financial institutions sit between savers and borrowers, they are also known as financial intermediaries, and what they do is known as intermediation. Banks, insurance companies, securities firms, and pension funds are all financial intermediaries. These institutions are essential; any disturbance to the services they provide will have severe adverse effects on the economy.[419] Banks reduce the information costs of screening and monitoring borrowers to make sure they are creditworthy, and they use the proceeds of a loan or security issue properly. Banks, while making long-term loans, give savers ready access to their funds.[420] Central banks, responsible authorities, and private corporations coordinate and monitor these sectors to ensure the smooth operation of the payment scheme between financial firms.

The global financial crisis of 2007/2008 directed the attention of investors, policymakers, and

[416] Cecchett (n414)
[417] Cecchett (n414)
[418] Cecchett (n414)
[419] Cecchett (n414)
[420] Cecchett (n414)

governments toward the financial stability of the banking sector. In the current global environment, the banks are performing multiple functions to provide a variety of products, services and providing the latest facilities to their customers. It influences and facilitates many integrated economic activities like resource mobilization, poverty elimination, production, and distribution of public finance. Whether it is the purchase of a car or building of homes, banks are always there to serve better.[421]

The financial stability index is important for decreasing the losses and unnecessary costs faced by an economy. When a banking institute becomes destabilized, all the stakeholders have to suffer financial losses. All over the world, financial institutions have been disrupted and deteriorated due to the non-detection of financial distress. Thus, an index that can quickly detect financial instability in the financial system is required, especially in developing countries. Further, a financial stability index is a highly desirable tool to test financial disturbances in an economy.

A well-developed financial system not only encourages local investment but also attracts foreign investment. The inflow of foreign capital will stimulate domestic economic activities and increase labour demand. It will in turn encourage the exposure of foreign banks in the domestic economy. Further, a stable financial sector reduces the risk of financial crises. The financial crises of the 1990s and global crises of 2007 highlighted the importance of banking stability. Hence, banking sector stability is necessary for the efficient functioning of the financial sector, which is indispensable for economic development.

2.6.2 Pakistan Banking System and Financial Stability in Pakistan

In Pakistan, financial stability management is still in its formative years. This implies that at this stage, a financial stability index will continually be of substantial value to financial players, stockholders, depositors, borrowers, employers, and policymakers to take pre-emptive measures and overcome weaknesses and fragilities in the financial system. We have seen two major financial catastrophic incidents in recent history; the response from Pakistan Central Bank and banking systems shows how compulsive compliance with international regulatory

[421] Cecchett (n414)

standard had well equipped the banking system in Pakistan to successfully deal with these crises:

2.6.2.1 Global Financial Crisis 2007/2008[422]

In this section it is argued and demonstrated that applying international standards not only support establishing a sound banking system in developing countries but also provide shield to such developing countries against the economic shocks. In Pakistan, the indirect impact of the Global Financial Crisis (GFC) and ensuing recession was clearly evident in 2009. There was a decline in exports due to recession in economies which were Pakistan's major trading partners, and there was pressure on capital flows where strained liquidity position in global financial markets impacted foreign portfolio investment. Factors such as the energy crisis leading to under-utilization of industrial capacity and rise in the cost of production, the long-standing issue of inter-corporate circular debt, considerable decline in foreign direct investment due to weak economic fundamentals, and above all, the mounting fiscal deficit breaching previous records in the country's economic history, all had a role to play in keeping the process of economic recovery in Pakistan tenuous at best.[423]

The macroeconomic environment was characterized by a decline in GDP growth, growing macroeconomic imbalances, relentless upsurge in inflation, depreciating domestic currency, and monetary tightening by the central bank. These domestic developments were accompanied with a deteriorating financial and business environment at the global level due to: (a) the financial markets turmoil, with a contagion effect of the US subprime mortgage crisis which emerged in mid-2007; (b) sharp increase in commodity prices, especially of oil and food during 2007 and early months of 2008; (c) and an impending slowdown in global economic growth.[424]

Nevertheless, Pakistan banking system had lucky escape from liquidity issues, like many banking systems in developed world, due to the implementation of Basel standards resulting in

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[422] The State Bank of Pakistan (2010), The State of Pakistan's Economy 2009-10, Annual Report, Volume 1" https://www.sbp.org.pk/

[423] Mark Bertus and others, 'The Relation Between Bank Regulation and Economic Performance: A Cross-Country Analysis' (2007)2(3) Banks and Bank Systems 3,5 <http://harbert.auburn.edu/~yostkev/research/BertusJaheraYostGDP.pdf> accessed 10 January 2020

[424] Mark Bertus and others, 'The Relation Between Bank Regulation and Economic Performance: A Cross-Country Analysis' (2007)2(3) Banks and Bank Systems 3,5 <http://harbert.auburn.edu/~yostkev/research/BertusJaheraYostGDP.pdf> accessed 10 January 2020

the fourth year in succession, in 2007, strong expansion in the assets of the banking system, which grew by 18.8 percent to reach Rs 5.2 trillion by the end of the year. A key characteristic of this growth was the huge expansion in the investment portfolio, which surged to Rs 1.3 trillion, with an annual growth of 53.0 percent.[425] Asset growth during 2007 and first quarter of 2008 was funded by substantial growth in the deposits of the banking system, well-supplemented by the strong growth in capital. Specifically, deposits of the banking sector surged to Rs 4.2 trillion by the first quarter of 2008, showing an increase of 28.7 percent during the 18 months as reported between first quarter of 2008 and third quarter of 2009.[426]

This continued during 2009, the overall assets of the banking sector were increased by 15.8 percent, amounting to Rs. 6.5 trillion. There was a notable change in the composition of the asset base, with an increase of 60.0 percent in banks' investments portfolio, constituting mainly of government securities, and only a meagre increase of 2.1 percent in the advance's portfolio. In 2009, banks' equity base widened by a healthy 17.3 percent as against only 3.4 percent in 2008. Increase in banks' minimum capital to Rs. 6.0 billion by end of 2009 in line with The State Bank's requirements leading to an increase in the aggregate risk-weighted capital adequacy ratio (CAR) to 14.0 percent in 2009, compared to 12.2 percent at end of 2008, well above the requirement of 10.0 percent. Of the 40 banks in the banking sector, 27 banks had their respective CAR in excess of 12.0 percent and were considered as well-capitalized banks.[427] The following table taken from the State Bank website has demonstrated the consistent increase in deposits.

Table: Composition of Banks' Deposits

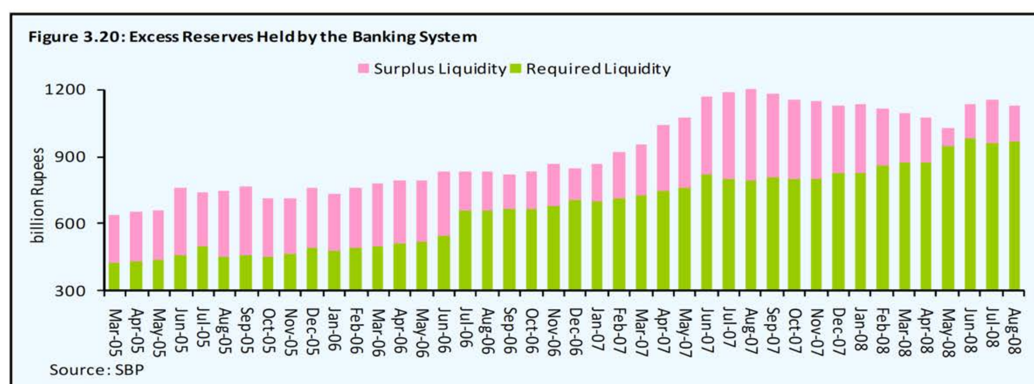
percent of Total Deposits

	CY00	**CY01**	**CY02**	**CY03**	**CY04**	**CY05**	**CY06**	**CY07**	**H1-CY08**
Fixed deposits	24.9	22.1	22.5	18.5	18.5	25.9	31.3	30.1	30.8
Savings Deposits	44.5	47.3	49.1	50.9	48.3	41.2	37.1	37.3	36.1
Current deposits	19.6	21.4	21.3	26.1	28.4	27.3	26.2	27.3	27.6
Institutional Deposits	10.4	8.8	6.5	3.8	4.1	4.8	4.6	4.6	4.4
Others	0.6	0.5	0.5	0.7	0.8	0.8	0.8	0.7	1.1

Source: BSD, SBP[428]

[425] www.sbp.org.pk/reports/annual/arFY21/Chapter-03.pdf
[426] www.sbp.org.pk/reports/annual/arFY21/Chapter-03.pdf
[427] https://www.sbp.org.pk/FSR/2010/index.htm
[428] www.sbp.org.pk/reports/annual/arFY21/Chapter-03.pdf

Monetary tightening not only curtailed credit expansion during 2007, but also increased the amount of liquid assets held by the banking sector. Sharp increase in excess reserves held by the banks was also visible from table below:[429]



Concurrent developments in Pakistan had been such that the financial sector had not been directly impacted by then ongoing events in advanced countries, albeit the economy had a build-up of pressures of its own, emanating from the weakening macroeconomic environment. Notably, Pakistan had been impacted most severely by the unprecedented rise in commodity prices which peaked in middle of 2008, with a direct impact on the external current account deficit, and a consequent sharp depletion of foreign exchange reserves and weakening of the Rupee. Rising commodity prices also adversely impacted the already high fiscal deficit by adding on to the level of petroleum subsidies. Notably, the fiscal deficit had been financed largely by borrowings from the central bank, with a negative impact on the already high inflation as seen in the table below:[430]

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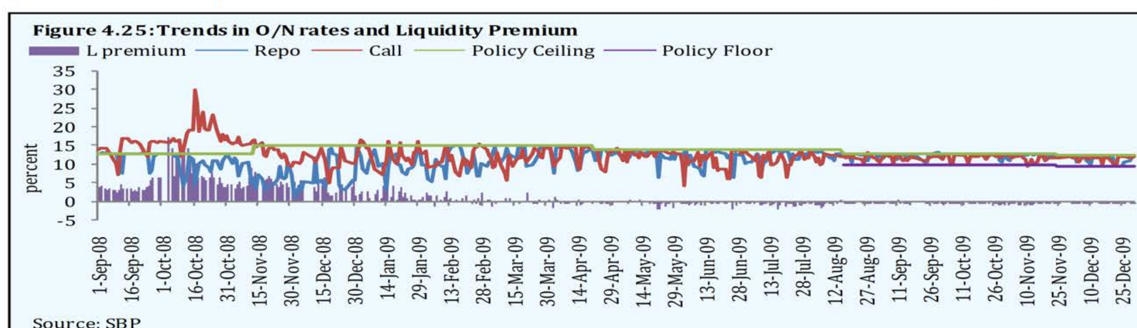
	FY 08				**FY09 Jul-Oct**
	Jul-Sep	**Oct-Dec**	**Jan-Mar**	**Apr-Jun**	
CPI-YoY (end-period) in percent	8.4	8.8	14.1	21.5	25.0
Fiscal Deficit as percent of GDP	-1.5	-1.9	-1.3	-2.7	-1.0*
Budgetary Borrowing (Net) billion Rs	71.6	153.1	87.5	242.4	206.7^

429 https://www.sbp.org.pk/FSR/2010/index.htm
430 https://www.sbp.org.pk/FSR/2010/index.htm

Borrowing from SBP: billion Rs	-13.9	214.5	208.7	279.4	376.3^
Private Sector Credit: billion Rs	-2.9	218.5	128.8	64.0	136.6^
NFA of Banking System: billion Rs	-23.1	-103.6	-130.1	-59.6	-346.4^
Trade Deficit: billion US$	2.4	3.9	4.8	4.3	5.8
Current Account Deficit: billion US$	2.3	3.8	3.8	4.2	5.9
SBP-Reserves End Period: billion US$	13.9	13.4	11.1	8.6	6.0**
Exchange Rate	60.7	61.2	62.7	68.3	78.8**
* Upto Sep, ** end Nov, ^ Upto Nov 15					

Source: SBP Database

In retrospect, severe but temporary liquidity strains seen in the domestic financial market in September-October 2008, was subsided by the end of the year on account of policy actions taken by the State Bank; in consequence relatively improved liquidity position and less volatility in overnight rates was witnessed in beginning of 2009; this is demonstrated in table below:[431]



Banks' ability to absorb risks is determined by their profitability and sustained by their capital position. Profits retained in the form of reserves and fully paid-up capital provide the first line of defence, acting as buffers against negative shocks. Besides the primary function of absorbing losses emanating from banking operations, profitability also serves to build a financial institution's capital base. Profitability of the banking system posted a gain of 27.6 percent in 2009, with a (before tax) profit of Rs 80.7 billion. Overall, both ROA and ROE, as shown in this table, increased during 2009:[432]

Table: Profitability of the Banking Sector

[431] https://www.sbp.org.pk/FSR/2010/index.htm
[432] https://www.sbp.org.pk/FSR/2010/index.htm

billion Rupees	CY00	CY01	CY02	CY03	CY04	CY05	CY06	CY07	CY08	CY09
Profit Before Tax	4.5	1.1	19.0	43.8	52.1	93.8	120.8	106.9	63.2	80.7
Profit After Tax	-2.8	-9.8	2.9	24.7	34.7	63.3	81.9	73.1	43.3	54.4
No. of banks in loss	10	12	6	8	5	7	7	10	16	18

Source: BSD, SBP

Dissecting the increase in interest income through changes in rate and changes in volume revealed that its growth during 2009 was primarily driven by a variation in loan volume contributing 63.6 percent to the total increase in interest income. This was in contrast to the previous year where the increase in interest income was attributed to a rate variation. On the other hand, variance analysis of non-interest income revealed that the change seen in 2009 was driven by a change in charges and commissions rather than change in volume of transactions. With slow growth in advances, banks made efforts, as shown in table below, to compensate for deterioration in income by increasing charges on sources comprising non-interest income:

Table: Sources of Change in Interest Income on Customers' Loans and Interest Expense on Deposits

Billion Rupees	Balance of the Previous Year	Change Due to Rate Variation	Change Due to Volume Variance	Balance for the year
Interest income on Customers' Loans				
CY04	67	-11.6	21.6	77
CY05	77	46.7	25.4	149
CY06	149.1	37.5	35.7	222.2
CY07	222.2	8.4	35.1	265.7
CY08	265.7	48.6	38.7	353.1
CY09	353.0	19.1	33.2	405.3

Interest Expense on Deposits				
CY04	33.4	-11.7	6.5	28.2
CY05	28.2	26.2	5.6	59.9
CY06	59.9	40.1	9.9	110
CY07	110	24.1	17.5	151.6
CY08	151.6	33.1	21.8	206.5
CY09	206.4	43.6	23.8	273.8

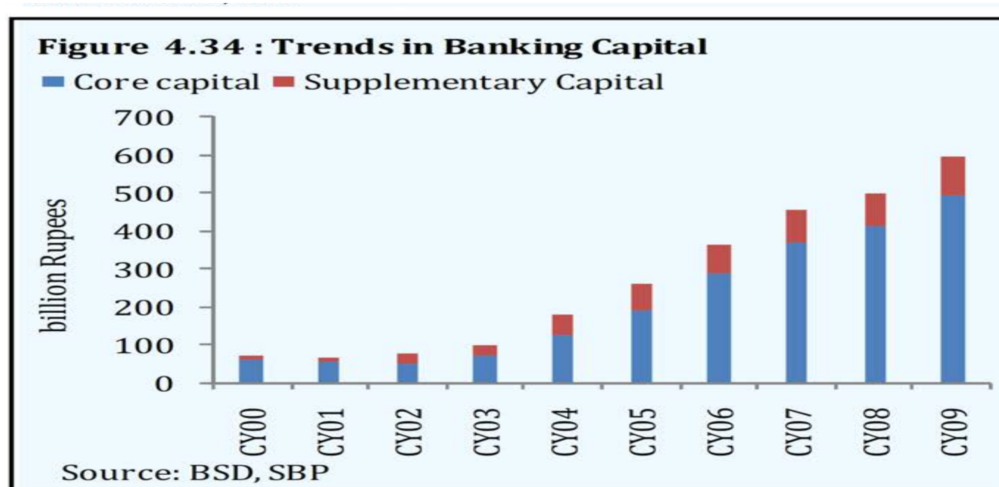
Source: BSD, SBP

The table below reflects the 17.3 percent (YoY) equivalent to Rs. 660.3 billion increased in banks' overall equity. Local private banks, with a share of 73.9 percent in total equity, were the main contributors to this growth. The increase in equity base during 2009 resulted largely from:

(1) FSV benefit which limited the provisioning charge

(2) increase in un-appropriated profits by 25.6 percent, and

(3) a substantial increase in the surplus on revaluation of assets.



Corresponding changes are also visible in the qualifying capital (net of losses) for the MCR in the following table. At end of 2009, 23 banks were fully compliant with MCR while the

remaining were in the process of increasing their capital base by injecting fresh capital or through mergers and acquisitions within the industry:[433]

Table: Category wise Position of Banks' Equity

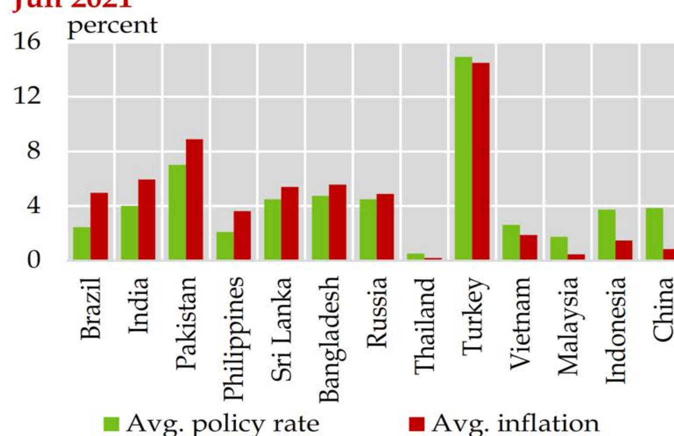
	billion Rupees		% Share in Total	% YoY Growth
Equity	**CY08**	**CY09**		
PSCB	112.0	139.2	21.1	24.3
LPB	421.2	487.7	73.9	15.8
Foreign	34.0	35.7	5.4	5.2
SB	-4.2	-2.4	0.4	41.8
All	563.0	660.3	100	17.3

Source: BSD, SBP

2.6.2.2 Pandemic-Covid 19 response

Pakistan's monetary policy stance remained on the lower spectrum in comparison to many emerging economies, as shown in the table, during Jul 2020 – Jun 2021, thereby providing a conducive environment for a revival in economic activity:

Average Inflation and Policy Rate in Emerging Markets during Jul 2020 - Jun 2021 **Figure 3.1**



Source: Haver Analytics

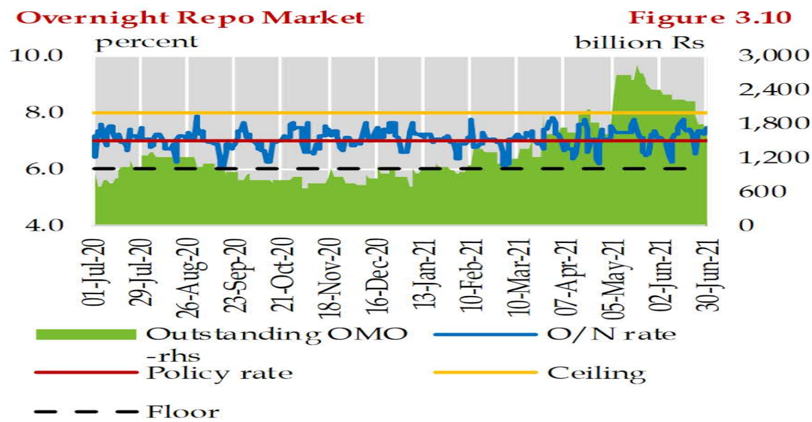
433 https://www.sbp.org.pk/FSR/2010/index.htm

To further incentivize economic growth, The State Bank also announced extensions and relaxations for some of the refinance schemes launched after the outbreak of the pandemic in 2020. The Monetary Policy Committee (MPC) continued with the accommodative stance during 2021 to counter the impact of Covid-19 fallout and supported the economic recovery. The policy decision was mainly supported by well-anchored inflation expectations, subdued inflationary pressures, improvement in then current account balance, adequate availability of external financing and improvement in foreign exchange reserves position. Taking all these factors into consideration, and heightened uncertainty created by the pandemic, the MPC deemed it appropriate to continue its emphasis on reviving economic growth.[434]

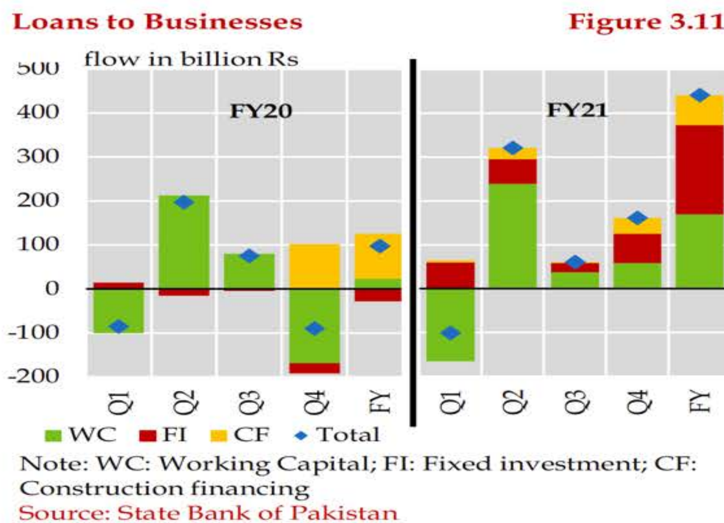
In July 2020, The State Bank mandated banks to increase their housing and construction finance portfolio to at least 5 percent of their private sector advances by December 2021. In addition, to minimize the economic impact and to protect businesses and daily wagers, the government adopted a more targeted strategy and remained inclined towards intermittent smart lockdowns instead of complete closure of businesses.

The interbank repo market remained relatively liquid at the start of the fiscal year and required lower interventions as the year progressed, liquidity pressures started to emerge. The State Bank proactively managed these pressures via its open market operations as reflected by the increase in outstanding OMOs towards the later part of the fiscal year**.** During 2021 deposit mobilisation coupled with other factors such as the State Bank's FX management, retirements from Public Sector Enterprises and government procurement agencies helped in easing out liquidity pressures in the overnight repo market. As a result of these inflows, the market required lower the State Bank's support. The average outstanding OMO injections fell down to Rs 936.0 billion in 2021 compared to Rs 1,125.2 billion in the same period last year. During Q4-FY21, the liquidity pressures increased further and required higher volume of OMO injections. Therefore, average outstanding OMO, as shown in the table below, increased to Rs 2.1 trillion in fourth quarter of 2021 compared to Rs 1.0 trillion, Rs 0.8 trillion and 1.2 trillion in Q1, Q2 and Q3 of FY21 respectively:[435]

[434] www.sbp.org.pk/reports/annual/arFY21/Chapter-03.pdf
[435] www.sbp.org.pk/reports/annual/arFY21/Chapter-03.pdf



Credit to the private sector also grew by 11.2 percent in FY21, compared to an increase of 2.9 percent last year. This year's growth was also led by fixed investment loans and consumer financing as shown in the table below. The overall credit offtake during FY21 was driven by three main factors. First, a better domestic demand along with an improved business confidence during the year compared to subdued demand last year,12 particularly during the fourth quarter of FY20 due to Covid-related lockdowns:



Secondly, in contrast to 2020, the low interest rate environment further augmented the overall credit offtake during 2021. Third, The State Bank's concessional financing schemes, mainly enhanced LTFF during Covid and TERF drove up the fixed investment loans during the period under review. The breakdown of this sector wise credit is shown in table below:[436]

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[436] www.sbp.org.pk/reports/annual/arFY21/Chapter-03.pdf

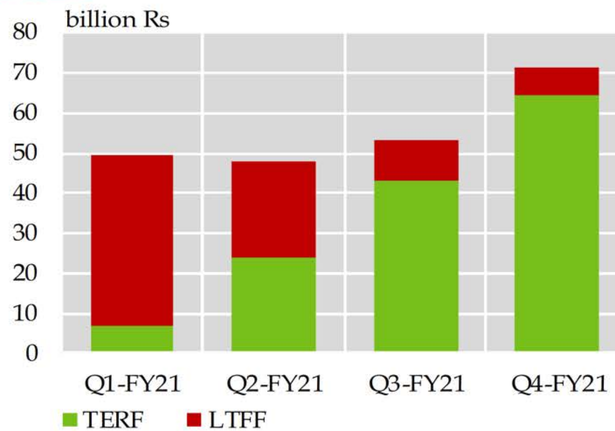
Loans to Private Sector Businesses
(flow in billion Rupees)

	Total Loans*		Working Capital**		Fixed Investment	
	FY20	FY21	FY20	FY21	FY20	FY21
Private Sector Businesses	**97.6**	**441.4**	**23.3**	**169.5**	**-27.9**	**203.5**
Manufacturing	161.4	258.2	109.8	111.1	48.3	141.5
Fertilizers	-31.9	37.6	-26.6	41.0	-5.3	-3.4
Vegetable and animal oils and fats	-11.1	34.8	-12.8	29.2	1.7	5.6
Rice Processing	-1.4	28.0	-1.7	26.7	0.3	1.3
Sugar	15.1	24.1	12.8	16.0	2.0	7.9
Refined petroleum	-20.4	13.7	-18.9	13.1	-1.4	0.5
Basic pharmaceutical products	7.9	18.5	5.0	6.2	2.8	12.3
Paper & paper products	-7.1	6.4	-5.0	2.3	-2.2	4.1
Cement, lime, and plaster	26.2	0.2	26.4	-8.0	-1.2	7.8
Motor vehicles	14.6	-15.8	11.3	-23.7	3.3	7.9
Textile	168.8	26.3	125.9	-42.6	42.9	66.0
Non-manufacturing	-63.8	183.2	-86.5	58.4	-76.2	62
Electric power gen., trans., and distribution	9.0	66.5	15.1	7.2	-7.4	59.7
Telecommunications	25.5	21.8	-8.0	9.3	33.5	12.4
Wholesale and retail trade	-46.4	16.6	-43.4	7.5	-5.5	8.4
Transportation and storage	13.0	-5.9	22.8	-5.9	-10.1	-0.1
Accommodation	-3.7	4.1	-1.5	0.2	-8.3	-0.9
Mining and quarrying	15.0	-15.8	7.7	-13.4	7.3	-2.4
Real estate activities	1.1	1.5	-2.4	-1.0	-11.7	-2.7
Agriculture, forestry, and fishing	-21.3	12.1	-10.4	17.0	-11.0	-5.0
Construction	-24.1	24.9	-46.0	3.0	-46.3	-16.7

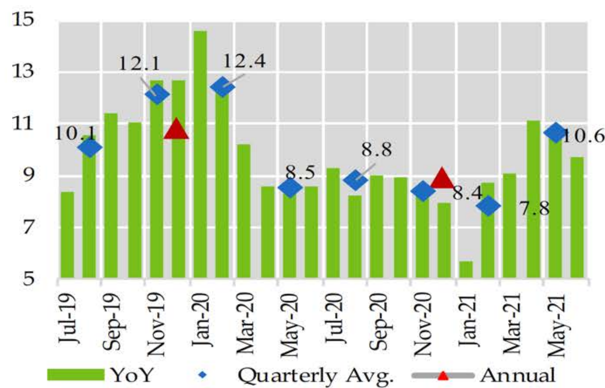
*Total loans include construction financing of Rs 102.2 billion in FY20 and Rs 68.4 billion in FY21, as the data on credit/loans has been revised since June 2020 due to inter-sectoral adjustment in private sector business (see IH&SMEFD Circular Letter No. 28 of 2020). Therefore, the loans data by type of finance for FY20 and FY21 may not be fully comparable; ** working capital includes trade financing

The State Bank had launched TERF in March 2020 to counter the impact of Covid-19 pandemic through promoting industrial activity in the country. The scheme was valid for one year (till March 2021). By end-June 2021, a total financing of Rs 434.7 billion was approved under the scheme, out of which, Rs 138.6 billion (32 percent) were actually disbursed. Fixed investment loans posted a significant increase of Rs 203.5 billion in 2021, compared to a net retirement of Rs 27.9 billion last year. The higher offtake in long-term loans was mainly on the back of the State Bank's concessionary financing schemes, mainly LTFF during the first half of FY21, and TERF afterwards as shown in the following table:[437]

[437] www.sbp.org.pk/reports/annual/arFY21/Chapter-03.pdf at pg. 63



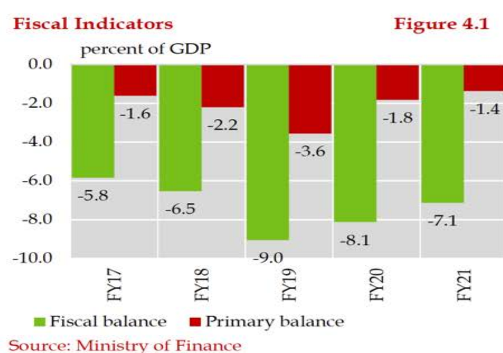
National CPI inflation decelerated to 8.9 percent in FY21 compared to 10.8 percent last year, in line with The State Bank forecast range for inflation announced in May 2020. With the start of the year, particularly in the first quarter of 2021, inflation continued to stabilize around single digit, a trend observed since April 2020, after experiencing double-digit inflation in 2020. Tax relief measures along with other factors, in the wake of Covid-related situation in the Budget 2020-21 had proved largely effectively contributed, as shown in the table, to overall slowdown in inflation observed during the year:[438]

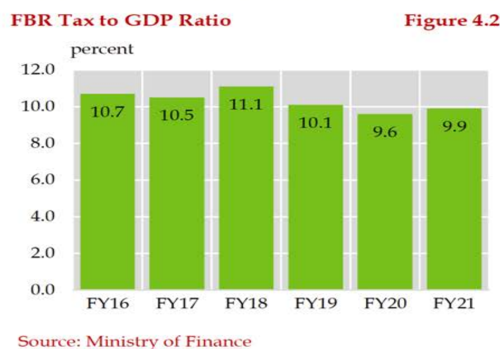


As a consequence of these actions taken by the Central Bank along with the country's consistent implementation of fiscal consolidation during 2021 witnessed a notable reduction in the fiscal deficit to 7.1 percent of GDP from 8.1 percent. This improvement was driven by a large increase in tax collection and a slowdown in non-interest current spending. Tax revenue

[438] www.sbp.org.pk/reports/annual/arFY21/Chapter-03.pdf at pg. 65

edged up by 19.5 percent during FY21, compared to 4.3 percent previous year. This improvement was contributed by both the federal and provincial governments. The following tables clearly demonstrate the result in particular a five years' high tax growth of 18.4 percent, which was posted by Federal Board of Revenue, had surpassed the revised target by Rs 41.0 billion:[439]





Consolidated Fiscal Indicators
billion Rupees, growth in percent

			YoY growth		Q4	
	FY20	**FY21**	**FY20**	**FY21**	**FY20**	**FY21**
1. Total revenue (a+b)	**6,272.17**	**6,903.37**	**28.0**	**10.1**	**1582.3**	**1910.8**
(a) Tax revenue	4,411.54	5,272.70	4.3	19.5	1046.0	1507.7
Federal	3,997.92	4,764.30	4.4	19.2	953.6	1369.4
Provincial	413.617	508.397	2.9	22.9	92.4	138.3
(b) Non-tax	1,860.63	1,630.67	177.9	-12.4	536.3	403.1
Federal	1,758.24	1,480.40	201.5	-15.8	513.5	335.0
Provincial	102.389	150.275	18.6	46.8	22.8	68.1
2. Total expenditure (a+b+c)	9,648.49	10,306.6	15.6	6.8	3272.4	3662.1
(a) Current expenditure	8,532.02	9,084.01	20.1	6.5	2920.5	2998.6
Of which: Mark-up payments	2,619.74	2,749.73	25.3	5.0	740.0	645.9
Non-markup expenditure	7,028.75	7,556.96	12.4	7.5	2532.4	3016.2
Defence	1213.281	1316.418	5.8	8.5	410.8	532.5

439 www.sbp.org.pk/reports/annual/arFY21/Chapter-04.pdf at pg.77

Subsidies	359.9	425.0	84.2	18.1	n.a.	220.8
(b) Development expenditure & net lending	1203.741	1315.7	-1.3	9.3	422.3	592.7
(c) Statistical discrepancy	-87.273	-93.0	-	-	-70.4	70.8
3.Overall budget balance	-3,376.32	-3403.3	**-2.0**	**0.8**	-1690.1	-1751.3
percent of GDP	-8.1	-7.1			-4.1	-3.7
4.Primary balance	-756.6	-653.6	-44.1	-13.6	-950.1	-1105.4
percent of GDP	-1.8	-1.4			-2.3	-2.3
5. Revenue balance	-2259.9	-2180.6	2.6	-3.5	-1338.2	-1087.8
percent of GDP	-5.4	-4.6			-3.2	-2.3
6. Financing (a+b)	3,376.3	3,403.32	**-2.0**	**0.8**	1690.1	1751.3
(a) External (Net)	895.5	1338.090	114.9	49.4	213.1	775.9
(b) Domestic (Net)	2,480.8	2,065.23	-18.1	-16.8	1477.0	975.3
Non-Bank	540.2	196.189	-29.4	-63.7	138.2	-95.9
Bank	1,940.6	1869.041	-14.3	-3.7	1338.7	1071.3

Source: Ministry of Finance

In overall terms, the above tables show that the improvement in the fiscal account stemmed from both the revenue and the expenditures side. The increase in tax revenues was driven by a large base effect from last year along with the economic rebound and FBR policy efforts. On the other hand, the prudent management of non-interest current spending amid fiscal pressures arising from power sector subsidies, provision of economic stimulus, and pandemic management was instrumental in achieving a reduction in the fiscal imbalance. The overall revenues grew by 10.1 percent in FY21 compared to 28.0 percent last year. This growth entirely came from tax collections, while the non-tax revenue (NTR) declined due to lower The State Bank profits and absence of one-off GSM license renewal fee. The collection from petroleum levy showed a marked increase compared to last year, which partly neutralized the decline in NTRs during the year. The increase was driven by an uptick. FBR taxes registered a 5-years' high growth of 18.4 percent in FY21 and surpassed the revised collection target by a slight margin.[440]

[440] www.sbp.org.pk/reports/annual/arFY21/Chapter-04.pdf at pg. 79

Another factor as shown in the table below was Import related taxes (sales tax on imports and custom duty) that contributed the most in the indirect taxes during FY21. The revival in economic activity translated into higher imports of POL, iron & steel, vehicles, edible oil, and machinery, which augmented these receipts. The increase in global commodity prices further shown, below, to have inflated tax receipts:[441]

Import Related Taxes **Table 4.3**
billion rupees, growth in percent

	FY20	FY21	Growth	Growth Cont.
Sales tax	**876.3**	**1,118.2**	**27.6**	**27.6**
POL	231.3	255.7	10.6	2.8
Iron and steel	82.9	110.8	33.7	3.2
Vehicles	42.9	81.4	89.6	4.4
Edible oil	52.0	75.2	44.7	2.7
Plastic	55.2	70.9	28.5	1.8
Machinery	52.0	55.6	6.9	0.4
Custom duty	**626.6**	**747.3**	**19.3**	**19.3**
Vehicles	56.9	110.9	95.0	8.6
POL	83.2	94.3	13.3	1.8
Iron and steel	45.4	55.6	22.3	1.6
Machinery	59.9	59.7	-0.3	0.0
Edible oil	29.4	34.4	17.0	0.8

Cont.: Contribution
Source: Federal Board of Revenue

Similarly, the GST on domestic sales, as shown in the table below, propped up with a revival in domestic demand for POL, automobiles, cement, electricity, etc. The increase in prices of some categories such as electricity, sugar, power tariffs provided further impetus to collection:

Sales Tax (domestic) **Table 4.4**
billion rupees, percent

	FY 20	FY 21	Growth	Growth Cont
Electrical energy	91.8	127.2	38.6	4.9

[441] www.sbp.org.pk/reports/annual/arFY21/Chapter-04.pdf at pg. 84

POL	231.4	300.9	30.1	9.7
Sugar	39.8	62.8	57.8	3.2
Cement	20.8	37.3	71.2	2.5
Cotton yarn	25.8	44.1	317.1	1.7
Motor cars	3.8	15.7	19.8	0.1
Beverages	12.9	15.4	19.8	0.4
Cigarettes	20.3	27.9	37.2	1.1
Others	250.8	199.1	-20.6	-7.2
Total	**720.5**	**863.2**	**19.8**	**19.8**

Cont.: Contribution
Source: Federal Board of Revenue

The table below shows that direct taxes also posted a significant increase of 13.3 percent in FY21 compared to 5.4 percent last year. This growth mainly came from withholding taxes followed by voluntary payments and collection on demand:

Direct Taxes **Table 4.5**

billion rupees, growth in percent

	FY20	**FY21**	**Growth**	**Growth Cont**
Collection on demand	**60.8**	**80.1**	**31.8**	**1.3**
Voluntary payments	**404.6**	**465.8**	**15.1**	**4.0**
Withholding taxes	**1,091.7**	**1,237.1**	**13.3**	**9.5**
Imports	199.7	218.5	9.4	1.2
Salaries	129.4	151.8	17.3	1.5
Dividends	55.1	63.7	15.6	0.6
Bank interest and securities	128.3	134.8	5.1	0.4
Contracts	237.4	272.1	14.6	2.3
Export	38.5	42.2	9.9	0.2
Cash withdrawals	15.2	15.1	-0.2	0.0
Electric bills	45.4	51.3	12.8	0.4
Telephone	54.6	63.2	15.6	0.6
NET DT	**1,523.4**	**1,726.0**	**13.3**	**13.3**

Cont.: Contribution
Source Federal Board of Revenue

2.7 The Role of Central Banks in Developing and Implementing an Effective Banking System

The role of a central bank in ensuring a good banking system is not an exclusive role. From the perspective of a central bank, banking stability can be described as a "condition whereby the banking system is able to withstand shocks without giving way to cumulative processes, which impair the allocation of savings to investment opportunities and the processing of payments in the economy."[442] One of the major roles which a central bank plays in the banking practice is that of ensuring banking stability and maintaining a monetary policy. For proper functioning, the Central Bank should collaborate with other agencies such as the Ministry of Finance and commercial banks alike. Even if banking market development and banking sector stability take a long period, central banks have a mandate to ensure that there is improved monetary stability in banks. This role of the central bank is seen through its supervisory authority and the power to issue guidelines to commercial banks on issues like interest rates and lending. In the wake of the banking crises which managed to ignite very serious debates on the appropriateness and the powers of the central banks to effectively supervise commercial banks, the key concern for many legislators was to enact various legislative tools to allow better supervision by the central banks. To the public, the major role of this institution is to regulate the commercial banking sector, any failure of these banks is usually associated with bad supervision as one of the reasons.[443]

There is no doubt that price stability supports sound investment and sustainable growth, which is crucial for banking stability; the central bank, by seeking to maintain stable prices, allows the banks to have stability and hence maintain sound practices. There are various tools which the central banks use in maintaining optimal conditions for the commercial banking system. The central bank can monitor the commercial banking sector by using its power to access or be given access to the systems of the banks or for these banks to report any standard which they are mandated to do under the banking laws and the banking regulations.[444] The central bank also has the power to monitor any financial imbalances in the banking systems and if this

[442] Padoa Schioppa,‘ Central Bank and Banking Stability’(2003) European Central Bank Eurosystem<https://www.ecb.europa.eu/press/key/date/2003/html/sp030707.en.html> accessed 10 January 2020
[443] Schinasi Garry, Responsibility of Central Banks for Stability in Banking Markets International (2003) Monetary Fund IMF Working Paper 03/121 ISBN:9781451854404/1018-5941;
[444] Tommaso Padoa-Schioppa, ‘The Transformation of the European Banking System’ Central Banks and Banking Stability: Exploring the Land in Between (2003) 25 second ECB Central Banking Conference October 2002 269,310 ISBN 92-9181-348-6

imbalance can cause a widespread disruption, then it is the power of the central bank to act to take enforcement action. Any central bank should be aware of how the international economy can adversely affect the local commercial banks as well as the interest rates or how inflation can creep into the commercial lending system. It is the task of the central bank to cushion the local commercial sector against such shocks.[445]

The practice of the central bank has been to use proper tools to maintain price stability, market operations and interest rates at an optimal level, not too high to hurt the economy and not too low to eat into the profitability of the commercial banks. Many countries in Africa empower their central banks to issue regulations to the banks in terms of how to conduct borrowing and setting interest rates. This must be done to maintain sanity in the commercial bank lending and create sustainable banking practices. An example from developing countries is Kenya Banking (Amendment) Act 2016, that empowers the Central Bank of Kenya, by amending the above-mentioned Act, to set the maximum interest rate of credit facility in the country for commercial banks.[446] In this way central banks use primary tools which are intended for maintaining interest rates, price stability and market operations, to promote general banking stability. This is because the central banks have always strived to ensure that monetary stability and long run banking stability have to reinforce each other in commercial banking practices. In the short run, the central bank could ease monetary conditions to adequately respond to the bank's concern particularly concerning banking fragility which has spilled over into the commercial banking system, which could lead to the destabilization of monetary stability.

Many central banks have decided to adopt micro-prudential regulations and supervision and deposit insurances to help maintain good banking practice and caution the banking system from collapsing. The central bank as a regulator and as a supervisor ensures that the banking institutions comply with minimum deposit insurance requirements and set micro-prudential banking requirements. Here the central bank's role is seen as developing the commercial banking sector through emphasis on macroprudential policy within the monetary policy.[447]

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[445] Andrew Large, Banking Stability: Maintaining Confidence in a Complex World (2003)15 Bank of England Banking Stability Review FSR 170,174 ISSN 1365-7267

[446] The Kenyan Banking Amendment Act 2016, (August 31, 2016) 143(Acts No. 25 Kenya Gazette Supplement <http://kenyalaw.org/kl/fileadmin/pdfdownloads/AmendmentActs/2016/Banking_Amendment_Act2016.pdf> accessed 10 January 2020

[447] Milton Friedman, 'The Role of Monetary Policy' (1968)58(1) The American Economic Review American Economic Association1,17< www.jstor.org/stable/1831652> accessed 10 January 2020 ;

In terms of regulatory implementation, the central bank ensures that commercial banks adhere to regulatory standards and comply with statutory filings and disclosures. This, for instance, concerns specific instruments in the banking sector like risk limits, policymaking, capital charges, etc. Central Banks have primarily made use of these tools in a macro prudential perspective, emphasising on the use of these aforementioned tools to prevent the occurrence of a failure of a banking system.[448]

Many central banks all over the world have agreed that their efforts to encourage the commercial banking sector to adopt and practice prudential safeguards geared to ensuring banking stability. It has been revealed that massive progress has been made in commercial banking by the central banks' efforts in their emphasis for prudential banking practices.

The function of the central banks in terms of provisional policies to limit the risks is also impressive; they have allowed commercial banks to have strong defences in good times and managed to allow these commercial banks to have reserves which they can rely on when they are in crisis. Even though the role of central banks in implementing these standards has been faced with challenges such as increased risk exposures in terms of market fluctuations, it shows that the role of the central banks in implementing and developing policies is an ongoing area which is ever changing to keep up with the changing commercial banking sector, and hence its importance is significant.[449]

The other traditional tool which is used by central banks to ensure compliance by the commercial banks is that of the lender of last resort. This is sometimes referred to as emergency liquidity assistance. This is perhaps one of the most ancient tools which is available to central banks for these state regulators in ensuring that there is a sound and stable commercial banking system. When the markets are down, the central bank has powers to offer liquidity into the Banking system for a while via market operations, and even emergency lending to specific commercial banks.[450] The other manner in which the central banks help maintain a sound banking system in commercial banks is by their involvement in the development of non-cash payment systems either in an oversight capacity or a direct capacity. In a commercial banking

[448] Richard Clarida, Jordi Gali and Mark Gertler, 'Monetary Policy Rules and Macroeconomic Stability: Evidence and Some Theory' (2000)115(1) The Quarterly Journal of Economics 147,180< https://doi.org/10.1162/003355300554692> accessed 10 January 2020
[449] Clarida, Gali & Gertler (n 448)
[450] https://www.ecb.europa.eu/ecb/educational/explainers/tell-me-more/html/what-is-a-lender-of-last-resort.en.html

sector, any delay in the payment system in terms of online transactions, direct wire transfer, etc. can be disastrous. Central banks have primarily taken or been tasked with the role of developing systems that have a limiting impact on the increase of these risks in the payment mechanisms. In the area of large volume and transaction payments, central banks have been on the forefront of enhancing and promoting safer arrangements in the net settlement systems, developing the settlement and payment system, and introducing or supporting real time gross settlement systems in the commercial banking sector. Here one can see the work of the central bank as a supporter and not a regulator, by taking an active role of support and working together with commercial banks[451] in developing and upgrading payment structures.[452]

Communications between commercial banks and central banks are crucial tools in coordination and collaboration. The law provides for certain disclosure to the central bank by the commercial banks in many jurisdictions. The governor of the central bank has an array of power to seek any information from commercial banks which must be supplied within a reasonable time. This tool allows the central bank to be aware of any instability in the banking sector made aware of by any commercial bank or other agencies. Similarly, any communication from the central bank easily reaches the commercial banking sector effectively hence mitigating any risks or behaviour of a bank[453].

Central banks are aware of the fact that not all risks can be foreseen and hence it is good practice to ensure that all key players and especially commercial banks are not prone or left open to risks should the market become unstable. This approach is taken by many central banks in ensuring that the commercial banking sector is not open to risks. It is the job of the central bank to undertake risk-based research and inform the commercial banks on how to operate given the balance between banking stability and monetary policy. One way in which the central bank goes around this is its guidelines and regulations on corporate governance in the commercial banking sector.[454]

[451] James R Barth, Gerard Caprio Jr and Ross Levine, 'Bank Regulation and Supervision in 180 Countries from 1999 to 2011' (2013) 5(2) Journal of Banking Economic Policy 111,219 < https://www.researchgate.net/publication/254947992_Bank_Regulation_and_Supervision_in_180_Countries_from_1999_to_2011> accessed 10 January 2020
[452] Saunders Anthony and Berry Wilson, 'The Impact of Consolidation and Safety-Net Support on Canadian, US and UK Banks: 1893–1992' (1999)23 (2) Journal of Banking & Finance 537,571< https://ideas.repec.org/a/eee/jbfina/v23y1999i2-4p537-571.html> accessed 10 January 2020
[453] Kramer Michael, Hal Brill, Christopher Peck, Jim Cummings and David-Jan Jansen, 'Central Bank Communication and Monetary Policy: A Survey of Theory and Evidence' (2008) 46(4)Journal of Economic Literature 910,945
[454] Clarida, Gali & Gertler (n 448)

Continuing from above, the central bank has been instrumental to incorporating corporate governance in the commercial banking sector and other related credit institutions. Apart from core standards which have been on a continuous basis advocated by the central banks, they have set up additional corporate governance requirements to be adhered to by all credit institutions and deposit taking ones. Some of these requirements have even been branded High Impact by the various central banks in order to create an appropriate robust corporate governance structure in the commercial banking sector.

The Irish central bank is another example, for this kind of arrangement. In Ireland, for example, the institution has managed to inform all the commercial banks of its Impact on corporate governance. This mandates deposit taking and credit institutions to disclose in their annual or quarterly reports will have to be in line with the institution's requirements.[455] The legal backing of the working of the central banks in terms of the corporate governance is also backed by statute hence creating an effective tool for the developing of good practices in the banking sector especially in terms of transparency, management of commercial banks, and remuneration of directors and accounting standards. In Ireland, the specific law is the backing of section 10 of the Central Bank Act 1971, the Building Societies Act 1989, and the Asset Covered Securities Act 2001. The European Union Regulations also empower the Ireland central bank to undertake this corporate governance so long as in the opinion of the Bank these requirements are necessary to the sound credit compliance and market sanity. This is provided by the European Union (capital requirements) Regulations 2014.[456]

The commercial banks and related institutions are required to submit to the central bank all the statements and such information and returns as needed under the Central Bank Act 1971.[457] Central bank's requirements on corporate governance create a binding effect and any commercial bank is held liable if it fails to comply with them or meet the minimum standards. Some of the sanctions that can be imposed on a banking institution including and not limited to an administrative action or sanction as provided under the Part IIIC of the Central Bank Act 1942: commencing an action in terms of prosecution as an offence either against an officer of the institution required to comply or as against the institution; removal, prohibition and

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455 Central Bank of Ireland, 'Corporate Governance Requirement for Credit Institutions' 2015, <www.centralbank.ie/docs/default-source/Regulation/industry-market-sectors/credit-institutions/regulatory-requirements/gns-4-4-3-2-cgr-2015.pdf?sfvrsn=2> accessed 10 January 2020

456 European Union (Capital Requirements) Regulations 2014 S.I, 158/2014 Regulation 61< http://www.irishstatutebook.ie/eli/2014/si/158/made/en/print> accessed 10 January 2020

457 S. 18 Central Bank Act 1971

suspension of an officer or individual from undertaking any controlled function as prescribed by the regulatory body as under part 3 of the Central Bank Reform Act 2010; and refusal of appointment of a proposed director to any given pre-approved function in the commercial banking institution as prescribed by Part 3 of the Central Bank Reform Act 2010.[458]

In countering terrorism financing and money laundering,[459] the central bank's prescription has been geared to ensuring that there is collaboration, coordination and allows government agencies to effectively and quickly detect any attempt to launder through commercial banks. The effective enforcement of these policies has allowed the sector to inter alia, to restore the full integrity of the banking system. The central banks mandate all commercial banks to take reasonable measures to ensure that they are able to detect any suspicious transactions.[460]

The State Bank Vision 2020 envisages designing and implementing a formal Financial Stability structure in the country. With a view to institutionalize the financial stability function in The State Bank, a new department namely Financial Stability Department (FSD) was established in 2016 to monitor and assess financial system wide risks and propose measures to mitigate such risks.[461] Further, the Financial Stability Executive Committee has also been constituted under the chairmanship of the Governor to serve as an internal forum for discussions and coordination on financial system stability issues. During FY17, The State Bank and Securities and Exchange Commission of Pakistan (SECP) signed a Letter of Understanding (LoU) to establish a Council of Regulators (CoR) to mitigate systemic risk covering the broader spectrum of the financial sector.[462] The Council will provide a forum for deliberating issues related to systemic risk, particularly those having cross market and stability implications. It will suggest possible arrangements for crisis preparedness and come up with a coordinated response. The formation of the Council is aligned with international practices in the post global financial crisis scenario. It will not only facilitate The State Bank and SECP in achieving their statutory and strategic objectives but also further enhance their collaboration for ensuring the financial system stability. Besides the CoR, work is underway for establishment of an

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[458] Bade & Parkin (n. 398)

[459] Brent Bartlett, 'The Negative Effects of Money Laundering on Economic Development' (2002) 5967 Asian Development Bank Regional Technical Assistance Project Economic Research Report < https://waleolusi.files.wordpress.com/2013/05/the-negative-effects-of-money-laundering-on-econom.pdf> accessed 10 January 2020

[460] Hans Geiger and Oliver Wuensch, The Fight Against Money Laundering: An Economic Analysis of a Cost-Benefit Paradoxon (2007) 10(1)Journal of Money Laundering Control 91,105 Emerald ISSN:1368-5201

[461] www.sbp.org.pk/reports/annual/arFY17/Vol-1/Chapter-3.pdf

[462] www.sbp.org.pk/reports/annual/arFY17/Vol-1/Chapter-3.pdf

overarching National Financial Stability Council (NFSC) comprising The State Bank, SECP and Ministry of Finance to discuss and resolve the systemic level issues.[463]

2.7.1 Financial Stability Mandate in the Law

In line with international best practices, The State Bank is strengthening its Financial Stability regime. Presently The State Bank however lacks the "explicit legal mandate for financial stability", which is inconsistent with international best practices. In line with most countries' central banks have explicit legal mandates for attaining financial stability by virtue of their legal framework. The State Bank has reviewed the legal framework vis-à-vis international best practices and identified some areas for explicitly covering the financial stability mandate and other related provisions in the relevant laws.[464]

2.7.2 Deposit Protection Corporation (DPC)

The deposit insurance scheme is widely acknowledged as one of the key components of the financial stability regime. It provides a variety of benefits to the financial system including (i) contribute towards a stable financial system and protects financially unsophisticated depositors from the loss of their deposits, (ii) create a formal protection mechanism thus removing the uncertainty about how depositors will be treated in case of bank failures, and (iii) reducing the potential fiscal burden on the government. The State Bank Vision 2020 accordingly envisaged establishment of Deposit Protection Corporation (DPC) as a key milestone towards achieving the financial stability goal. The Deposit Protection Corporation Act was promulgated in August 2016 which has allowed for the establishment of Deposit Protection Corporation (DPC) as a wholly owned subsidiary of The State Bank. In terms of Section 12 of DPA, The State Bank has already appointed Managing Director of DPC for the period of five years. The general superintendence, direction, and management of DPC shall vest in the Board to be appointed by the Federal Government. The State Bank has approached the Federal Government for nomination of the Directors on the DPC Board. The membership of DPC is mandatory for all scheduled banks. The periodic premium payments to be made by the banks shall be the major source of funding for the DPC. The threshold of deposit coverage and rate of premium shall be determined by the DPC Board. The DPC will invest the premium received from the banks in

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[463] www.sbp.org.pk/reports/annual/arFY17/Vol-1/Chapter-3.pdf
[464] www.sbp.org.pk/reports/annual/arFY17/Vol-1/Chapter-3.pdf

secured investments (mainly government bonds) and will build up the resource/funds base for payment to the depositors in case of failure of a bank.[465]

2.8 The Central Bank's Role in Economic Growth: The State Bank of Pakistan

The responsibility of a Central Bank in a developing country goes well beyond the regulatory duties of managing the monetary policy to achieve the macroeconomic goals. This role covers not only the development of important components of monetary and capital markets but also to assist the process of economic growth and promote the fuller utilisation of a country's resources. The State Bank of Pakistan, besides discharging its traditional functions of regulating money and credit, has also played an active developmental role to promote the realisation of macroeconomic goals.[466] The explicit recognition of the promotional role of the Central Bank evidently stems from a desire to re-orientate all policies towards the goal of rapid economic growth. The orthodox central banking functions have seemed to be combined by The State Bank of Pakistan with a well-recognised developmental role.

Under The State Bank of Pakistan Order 1948, the Bank was charged with the duty to regulate the issue of Bank notes and keeping of reserves with a view to securing monetary stability in Pakistan and generally to operate the currency and credit system of the country to its advantage. The scope of Bank's operations had been widened considerably by including the economic growth objective in its statute under The State Bank of Pakistan Act 1956. The Bank's participation in the development process has been in the form of rehabilitation of banking system in Pakistan, development of new Banking institutions and debt instruments to promote banking intermediation, establishment of Development Banking Institutions (DFIs), directing the use of credit according to selected development priorities, providing subsidised credit, and development of the capital market.[467]

As mentioned earlier, the scope of the Bank's operations was considerably widened in The State Bank of Pakistan Act 1956, which required the Bank to "regulate the monetary and credit system of Pakistan and to foster its growth in the best national interest with a view to securing

[465] www.sbp.org.pk/reports/annual/arFY17/Vol-1/Chapter-3.pdf
[466] https://www.sbp.org.pk/press/2008/FPCCI-09-Feb-08.pdf
[467] www.sbp.org.pk/press/2009/MaintainStable-19-Jun-09.pdf

monetary stability and fuller utilisation of the country's productive resources". Under Banking sector reforms, the State Bank of Pakistan was granted autonomy in February 1994. On 21st January 1997, this autonomy was further strengthened by issuing three Amendment Ordinances (which were approved by the Parliament in May 1997) amending the laws namely, The State Bank of Pakistan Act 1956, Banking Companies Ordinance 1962, and Banks Nationalisation Act 1974.[468]

The changes in The State Bank Act gave full and exclusive authority to The State Bank to regulate the banking sector, to conduct an independent monetary policy and to set limits on government borrowings from The State Bank of Pakistan. The amendments to Banks Nationalisation Act abolished the Pakistan Banking Council and institutionalised the process of appointment by assigning the role of appointments of the Chief Executives and Boards of the nationalised commercial banks and development finance institutions to The State Bank. The amendments also increased the autonomy and accountability of the Chief Executives and the Boards of Directors of banks. Like Central Banks in developing countries, The State Bank of Pakistan performs both the traditional and developmental functions to achieve macroeconomic goals.[469]

Being the Central Bank of the country, the State Bank of Pakistan has been entrusted with the responsibility to formulate and conduct monetary and credit policy in a manner consistent with the Government's targets for growth and inflation and the recommendations of the Monetary and Fiscal Policies Coordination Board with respect to macroeconomic policy objectives. The basic objective underlying its functions is two-fold (a) the maintenance of monetary stability, thereby leading towards the stability in the domestic prices; and (b) the promotion of economic growth.[470]

To regulate the volume and the direction of flow of credit to different uses and sectors, the State Bank makes use of both direct and indirect instruments of monetary management. Until recently, the monetary and credit scenario was characterised by acute segmentation of credit markets with all the attendant distortions. Pakistan embarked upon a programme of banking sector reforms in the late 1980s. A number of fundamental changes, as discussed in this chapter

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[468] https://www.sbp.org.pk/about/pdf/LF/Brief-1.pdf
[469] https://www.sbp.org.pk/about/core_functions/index.htm
[470] www.sbp.org.pk/ZahidHusainLectureSeries/Lectures/Lecture_21.pdf

and chapter 6 of this thesis, have since been made in the conduct of monetary management which essentially marked a departure from administrative controls and quantitative restrictions to market-based monetary management. A reserve money management programme has been developed. While such indirect instruments are constantly being used to control such as cash reserve ratio and liquidity ratio, the programme's reliance is mainly on open market sectors.[471]

One of the major responsibilities of the State Bank is the maintenance of the external value of the currency. In this regard, the State Bank is required, among other measures taken by it, to regulate foreign exchange reserves of the country in line with the stipulations of the Foreign Exchange Act 1947. As an agent to the government, the Bank has been authorised to purchase and sell gold, silver or approved foreign exchange and transactions of Special Drawing Rights with the International Monetary Fund under sub-sections 13(a) and 13(f) of Section 17 of The State Bank of Pakistan Act, 1956.

The Bank is also responsible to keep the exchange rate of the rupee at an appropriate level and prevent it from wide fluctuations to maintain competitiveness of the country's exports and maintain stability in the foreign exchange market. To achieve the objective, various exchange policies have been adopted from time to time keeping in view the prevailing circumstances. The Pakistani Rupee remained linked to Pound Sterling until September 1971 and subsequently to the U.S. Dollar. However, it was decided to adopt the managed floating exchange rate system with effect from January 8, 1982, under which the value of the rupee was determined on a daily basis, with reference to a basket of currencies of Pakistan's major trading partners and competitors. Adjustments were made in its value as and when the circumstances so warranted. During the course of time, an important development took place when Pakistan accepted obligations of Article-VIII, Section 2, 3 and 4 of the IMF Articles of Agreement, thereby making the Pak-rupee convertible for current international transactions with effect from July 1, 1994.[472]

On 28 May 1998, Pakistan conducted an experiment of nuclear bombs' detonation to introduce its capability in nuclear atomic energy. In anticipation of the economic sanctions from International Bodies, a two-tier exchange rate system was introduced with effect from 22nd July 1998, with a view to reducing the pressure on official reserves and preventing the economy to

[471] www.sbp.org.pk/FSR/2017/Chp-1.pdf
[472] www.sbp.org.pk/fe_manual/pdf/2018/Chapter-6.pdf

some extent from adverse implications of sanctions imposed on Pakistan. However, with effect from 19th May 1999, the exchange rate has been unified, with the introduction of a market-based floating exchange rate system, under which the exchange rate is governed by the demand and supply positions in the foreign exchange market.

As the custodian of a country's external reserves, The State Bank is also responsible for the management of the foreign exchange reserves. The task is being performed by an Investment Committee which, after taking into consideration the overall level of reserves, maturities, and payment obligations, takes the decision to make investment of surplus funds in such a manner that ensures liquidity of funds as well as maximises the earnings.[473]

This shows that the responsibility of a Central Bank in a developing country goes well beyond the regulatory duties of managing the monetary policy to achieve the macroeconomic goals. This role covers not only the development of important components of monetary and capital markets but also to assist the process of economic growth and promote the fuller utilisation of a country's resources. The State Bank of Pakistan, besides discharging its traditional functions of regulating money and credit, has played an active developmental role to promote the realisation of macroeconomic goals. The explicit recognition of the promotional role of the Central Bank evidently stems from a desire to re-orientate all policies towards the goal of rapid economic growth. Accordingly, the orthodox central banking functions have been combined by The State Bank with a well-recognised developmental role.[474]

The Bank's participation in the development process has been in the form of rehabilitation of banking system in Pakistan: development of new Banking institutions and debt instruments in order to promote banking intermediation, establishment of Development Banking Institutions (DFIs), directing the use of credit according to selected development priorities, providing subsidised credit and development of the capital market.

2.9 CONCLUSION

Banking system plays role of an engine by mobilization and allocation of scarce resources in an economic system. Banking system monetises economy, promotes employment, boosts

[473] www.sbp.org.pk/fe_manual/pdf/2018/Chapter-6.pdf
[474] www.sbp.org.pk/press/2009/MaintainStable-19-Jun-09.pdf

economic development, and eliminates poverty.[475] The monetary and economic policies play crucial roles in establishing and maintaining financial stability. Banking policies and monetary policies are inseparably interconnected.[476] The crash in a banking system is usually caused by shortage of funds. The banks, in consequence, are required to pump the money for the development of new entrepreneurial ideas and necessary credit arrangements.[477] The developing and developed Countries have often joined together to figure out solutions to prevent the triggers causing such banking instability. This issue of sound banking has always been under discussion in pursuit of the factors for constant improvements to the economy.[478]

Banking industry is not merely an essential part of the financial system; the banks are also embedded in our lives. The collapse of the banking industry can cause a recession that will affect all the inhabitants of the state, no matter whether they are engaged with banks through any means or not at all. The stability of the banking industry is nonetheless backed by trust: the loss of public confidence in the banking system increases the demand for liquidity and financial crisis. Hence, an efficient banking system has become the mainstay for the sustainability of the financial system.[479]

Mark Bertus and others[480] have concluded that the stability and performance of banks are directly related to the ability of the various markets to supervise and monitor their discipline. Their research, in over 153 countries, concluded that countries which have set better macro and microeconomic policies in their banking sectors are highly associated with lesser risks and more wealth in the banking system. Levine[481] also shows that the banking system, if stable and sound, helps improving the general economic conditions of a country hence the connection between the macro, microeconomic and the banking sector.

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[475] Demid, E. Heterogeneity in the Relationship Between NPLs and Real Economy: Evidence from the Mongolian Banking System. Journal of Central Banking Theory and Practice, (2021) 2, 133-155

[476] Roberto Billi and Anders Vredin, 'Monetary Policy and Banking Stability–a Simple Story' (2014)2 Sveriges Riksbank Economic Review 1,22 <https://pdfs.semanticscholar.org/e31e/d6c4094343d28222e6f7d115f4cfecdc9f10.pdf> accessed January 2020

[477] Hubbard, R. G., & Hubbard, R. G. (1994). Money, the financial system, and the economy

[478] Feijó, C. A. Credit risk and macroeconomic interactions: Empirical evidence from the Brazilian banking system. Modern Economy, (2011) 2(05), 910

[479] Kelvin Mkwawa, "Importance of Banking Industry", (3 May 2018), The Citizen, https://www.thecitizen.co.tz/magazine/businessweek/Importance-of-banking-industry/1843772-4543558-b68977/index.html [Accessed October 2022]

[480] Mark Bertus and others, 'The Relation Between Bank Regulation and Economic Performance: A Cross-Country Analysis' (2007)2(3) Banks and Bank Systems 3,5 <http://harbert.auburn.edu/~yostkev/research/BertusJaheraYostGDP.pdf> accessed 10 January 2020

[481] Ross Levine, 'Finance and Growth: Theory and Evidence'(2005)1 Part (1) Chap 12 Handbook of Economic Growth ElSVIER 865,934 <https://econpapers.repec.org/bookchap/eeegrochp/1-12.htm> accessed 10 January 2020

The main role which a central bank plays in the banking practice is that of ensuring banking stability and maintaining a monetary policy. From the perspective of a central bank, banking stability can be described as a "condition whereby the banking system is able to withstand shocks without giving way to cumulative processes, which impair the allocation of savings to investment opportunities and the processing of payments in the economy."[482]

The Pakistani banking sector has gone through different phases of growth. The sector was directed by the government of Pakistan to implement the development strategies till 1980's. From the early 1970s to 1990, the banking business in Pakistan was subject to credit ceilings, directed and subsidized credit, control on deposit and lending rates, etc. The banking sector of Pakistan has gone through three phases which are pre-nationalization, nationalization, and post nationalization. In 1974, under this nationalization program, all the private banks were brought into public control. This was partly due to the fact that merit was not followed by the banks while forwarding loans, and only political clout was the required criterion. Consequently, the economic growth was declining because these loans were never paid back to the financial institutions. In the early 90s, the government started to denationalise banks. This was due to realisation that nationalised banks' role in the economy was adversely affecting the growth and efficiency of the financial sector for the reasons of government ownership, political intervention into credit allocation and recovery. The Banks had huge numbers of nonperforming loans with consequential heavy losses. To respond to this issue several policy reforms were undertaken to motivate the private sector in this industry.[483]

This process of privatization streamlined the banking system. The government overcame the legal obstructions and setbacks in the recovery of bad loans in 2001. According to the new reforms all banks or financial institutions commence consolidation to meet the regulatory requirement i.e., capital adequacy forced by The State Bank. The role of a central bank in ensuring a good banking system is not an exclusive role. For proper functioning, the bank should collaborate with other agencies such as the Ministry of Finance and commercial banks alike. Both microfinance supervision, and banking supervision go hand in hand as roles within

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[482] Padoa Schioppa,' Central Bank and Banking Stability'(2003) European Central Bank Eurosystem<https://www.ecb.europa.eu/press/key/date/2003/html/sp030707.en.html> accessed 10 January 2020

[483] Akhtar, Muhammad, Ali, Khizer., &Sadaqat, Shama (2010). Performance Efficiency of Commercial Banks of Pakistan: Non-Parametric Technique Data Envelopment Analysis (DEA). Asian Journal of Business and Management Sciences, 1(2), 150-156

the ambit of many central banks together with the task of developing a non-cash payment system is acceptable at an international level.

CHAPTER 3:
THE NATIONAL SUPERVISORY AUTHORITIES AND A DYNAMIC BANKING SYSTEM

3.1 INTRODUCTION

This Chapter aims at critically examining the needs for a dynamic banking system in developing countries particularly in Pakistan and the role of National Supervising Authority in developing a dynamic banking system. It ought to be remembered that published works on supervision of banks in Pakistan are limited and not originated through independent sources but published by regulators. Therefore, this chapter contains material that is available on western banking system particularly the United Kingdom.

The interaction between the banking sector and the other financial sectors, as seen in first two chapters, renders the banking sector crucial to the economy. In such a system the shareholders and the stakeholders are required to work together to maintain the dynamism of the banking. The role of the private sector and the public agencies show the reason that it is important to develop such a system for both the state and the investors and as such the direct role the government plays in the functioning of the sector.

3.2 WHAT IS A "DYNAMIC BANKING SYSTEM"?

A dynamic banking system is one which has capacity to deal with the dynamic hypothesis that if there is a tension which exists between specific commercial targets and rule compliance in the Banking entities it may drive the behaviours in the system and cause violations of rules. This causes changes in the compliance culture and the element of periodic erosion of compliance, which in the long term triggers a regulatory response from the supervisory or regulatory body. The banking sector fits these shoes properly, it is one of the sectors which is highly dynamic because it has many stakeholders like depositors, shareholders, regulators, and supervisors.[484] It is also affected by banking markets' price imbalances and market risks and shocks. The industry is also defined by a number of regulations from both company law and

[484] Richard Allen and Philipp Krause, 'The Role, Responsibilities, Structure and Evolution of Central Finance Agencies' In The international Handbook of Public Banking Management (Palgrave Macmillan UK 2013), 98-115 978-1-137-31530-4

banking and other secondary areas such as money laundering, capital markets and corporate governance; this means that disturbance in any of these areas could cause an imbalance throughout the entire banking sector.[485]

Dynamic banking is premised on the fact that there is homogeneity in the banking system and that the difference in the banking institutions is what makes the system function properly, create innovation, creativity and able to cover the needs of the different depositors and hence adequately intermediate the movement of money in the banking sector and create capital for investments. Dillard, Rigsby and Goodman describe dynamic banking systems from structuration theory and institutional theory for understanding the dynamic nature of change and the impact of material structures and external environment on internal organisational practices. In the context of banks, "legislators, regulators and standard setter groups develop regulations or accounting standards for an industry within the parameters set by the political and economic context."[486]

This dynamic nature of the banking system makes it susceptible to external risks and internal control interactions. In a banking system there are various actors across the different layers of the structure who are subject to conflicting objectives; regulators must regulate in a manner that does not slow down the economy. Risk management must be achieved by the regulators and supervisors and the banks alike through internal mechanisms without compromising the performance, operations, and profitability of banks. The bankers, at the same time are required to make sure that profit targets are met without any breach of regulations and the relevant banking laws. An efficient market is one where "there are large numbers of rational, profit-maximisers actively competing, with each trying to predict future market values of individual securities, and where important current information is almost freely available to all participants.[487]

Financial regulators challenged by the dynamics of modern evolving international financial systems can look to the oldest known Code of Hammurabi for inspiration. Law 48 of the Code

[485] Ivan Radulovic, 'Regulatory Pressure and Organisational Behaviour in the Dutch Banking System a System Dynamics Approach' (2016) EMSD Radboud University <http://www.innovatiefinwerk.nl/sites/innovatiefinwerk.nl/files/field/bijlage/ivan_radulovic_-_ma_thesis.pdf> accessed 13 January 2020.
[486] J. F. Dillard, J. T. Rigsby and C. Goodman, "The making and remaking of organisation context: duality and the institutionalisation process" [2004] Accounting, Auditing & Accountability Journal 17(4), 506–42
[487] Eugene F Fama, "Random Walks in Stock Market Prices' (1965) 21 Fin An J 55, 56

provided prompt, automatic and dynamic relief to a distressed debtor whose field was ravaged by a crisis, to reduce his loan to the extent of his losses; to write-off loan principal and up to one year of accrued interest. He could unilaterally "alter his tablet" by publicly washing it as a signal to his creditors that he had restructured his own debt.[488]

In a dynamic banking system, banks are expected to voluntarily adopt self-regulatory initiatives.[489] For instance, the Reimbursement Model Code[490] sets standards for prevention, detection, dispute resolution and reimbursement of victims of APP scams. A voluntary code also offers banks some sort of redemption or at least an opportunity to restore the degradation of their public image which followed the 2007–2009 financial crisis.[491]

In a dynamic banking system, there are appropriate risk management and management strategies which are based on risk profiling before the risk objectives and risk appetite are set. These entail banking institutions taking into consideration the risk depending on the business activities. The traditional command-and-control is complemented by a public-private collaborative form of regulation that is befitting the gatekeeper role of banks and its supporting theoretical foundation.[492] This regulatory form posits dynamic cooperation and dialogue between regulatory authorities and the private sector via sharing information and developing standards to achieve common regulatory goals.[493]

The idea of a dynamic banking system is grounded upon the reliance of every aspect of banking including law, market forces, regulators, risks, etc. This is seen by the reason that in order to achieve progress in risk management any banking institution must consider the implications of having a well-enshrined and strong corporate governance structure. This dynamic nature of the banking system is not only seen through risk management but also through other regulated aspects such as capital requirements, deposit insurance and liquidity. The risky nature of the banking sector in itself mandates banks to approach risks at a level which is within regulations

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[488] C. H. W. Johns, The Code of Laws Promulgated in the 3rd millennium BC by Hammurabi, King of Babylon, 2285–2242, 7th edn (Edinburgh: T&T Clark, 1911), 12
[489] J. Black, "Constitutionalising Self-Regulation" (1996) 59(1) The Modern Law Review 24
[490] https://www.lendingstandardsboard.org.uk/wp-content/uploads/2021/01/LSB-review-of-the-CRM-Code-FINAL-January-2021-.pdf [Accessed December 2022].
[491] J. Short and M.W. Toffel, "Making Self-Regulation More Than Merely Symbolic: The Critical Role of the Legal Environment" (2010), Georgetown Public Law and Legal Theory Research Paper No.11-14.
[492] R. Weber, "New Governance, Financial Regulation, and Challenges to Legitimacy: The Example of the Internal Models Approach
[493] J. Freeman, "Collaborative Governance in the Administrative State" (1997) 45(1) UCLA Law Review 1

and taking care to ensure that all other elements such as corporate governance, market stability, price stability.

By Dynamic Banking System it is also meant a system of banking which principally looks after the interests of customers. The dynamism in a banking system generally depends upon the regulations of central banks; in countries like Pakistan regulations are not enforced or selectively enforced due to the issues with corporate governance, the lack of qualified people and the relaxed approach that is adopted in enforcing regulations.[494]

An element of dynamism could be recommended through the commercial banks by providing an effective supervision whereby the banks will be obliged to comply with their regulator. In most developing countries there is lack of supervision in addition to the lack of qualified people. Whereas banks' most important function is seen to satisfy customers and therefore the banks do not feel need to be accountable to the central banks but to please their customers and in pursuing the aim of profit maximisation tends to ignore the regulations; the Central Bank of a country should give appropriate instructions to commercial banks in order to ensure that the economy remains vibrant, in addition to their looking after the customers. If developing countries' economies do not remain vibrant owing to high inflation or unsafe loans extended to their customers, then banks would lose their money. Furthermore, the banks are required to be careful in handling customers' money in order to ensure that all transactions are legal, and customers do not lose their money. A close supervision of commercial banks by the central bank becomes essential.[495]

Therefore, banks in any country need very stringent regulations and should take corporate governance very seriously in order to counter money laundering whereby bank officers' performance can be monitored by the Central Banks' expert enforcement officers. Their inspection should take place without prior notification. Dynamism in this context may be defined as a structure for thinking and determining how the operational policies of an entity, the competitors, customers, regulations, market fluctuations and imbalances, risks, and other factors which interact with the firm impacts it or affects its performance over time.

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[494] Adrian Docherty, Franck Viort. "Better Banking", Wiley, 2013

[495] Marco Cangiano, Teresa Curristine and Michel Lazare, Public Banking Management and its Emerging Architecture (IMF 2013) ISBN-147551221X, 9781475512212

3.3 Role of National Supervisory Authorities in Creating a Dynamic Banking System

The role of the National Supervisory Authorities in the regulations and creation of a dynamic banking sector is important. In many Countries, the relevant body is mainly tasked with the responsibility of implementing and formulating core functions of the government and taking responsibility for implementing fiscal and economic policies in the country. It is crucial to note that in addition to the finance ministries, there are other several public entities of the state which share responsibility for carrying out banking functions of the government. These functions cover the agencies which are tasked with fiscal forecasting and macroeconomic development, collection of government revenues, national development planning, debt management, and public procurement. The agencies and ministries, together with the minister of finance, have been defined to form the central finance agency of a country.[496] The current trend has also shown that there is a tendency of these institutions to focus on perceived best practices.[497]

3.3.1 Ministry of Finance

The role of the Ministry of Finance is so crucial in the banking sector because the role of the government has been increasing exponentially due to the increased government involvement in public finance. The finance ministry is responsible for the regulatory, policy and transactional functions in finance. These wide ranges of the financial and fiscal functions in the government have a major impact on the banking system as a whole.[498] One of the major roles of the ministry is setting targets and fiscal policy rules in a country. This includes the management of risks, formulation of annual budget, a framework for medium-term budget, and the issuing of alternative policies on taxation. These performances are core to any ministry of finance even though they may vary from ministry to ministry.[499]

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[496] Richard Allen and Francesco Grigoli, 'Enhancing the capability of central finance agencies' (2012) 1 (73)World Bank-Economic Premise 1-7 < http://documents.worldbank.org/curated/en/177621468155131777/Enhancing-the-capability-of-central-finance-agencies> accessed 13 January 2020

[497] Matt Andrews, The Limits of Institutional Reform in Development: Changing Rules for Realistic Solutions (CUP 2013) ISBN- 9781139060974

[498] Allen Richard, Richard Hemming and Barry Potter, eds, The International Handbook of Public Banking Management (Palgrave Macmillan UK2013) ISBN-978-1-137-57489-3

[499] Richard Allen, Yasemin Hurcan and Maximilien Queyranne, 'The Evolving Functions and Organization of Finance Ministries' (2016) 36 (4)Public Budgeting & Finance SSRN 3-25 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2879727> accessed 13 January 2020

Many ministries are also directly involved in regulatory functions that can be divided into three categories namely: (a) ensuring that the regulatory and legal framework for public finance and budgeting is enforced and respected by the various lines of agencies responsible for implementation; (b) the supervision of key specific sectors in the economy such as telecommunication, electricity, water, etc., in order to ensure that there is an effective sector that allows competition, protects the interests and exploitation of consumers and prevents formation of cartels in the economy; and (c) the supervision of the banking institutions and commercial banks with tasks such as supervision and regulation of banking, pension funds and supervision and regulations in regard to insurance companies.[500] The functions of the ministries are core to the running of the economy and cover all aspects incidental to the exercise of internal control mechanisms, processing of budgetary payments, the creation and issuance of government securities.[501]

This supervisory role of the national authority can also be seen in the Netherlands where the role to supervise is mandated to two bodies that is the Netherland's Authority for the Banking Markets (AFM) and De Nederlandsche Bank (DNB). As provided by the Netherland's Banking Supervision Act, both the Authority and the BND have a joint role in supervision. The Authority which is the equivalent of an extension of the Ministry of Finance has the role of ensuring stability within the banking system in the Netherlands, protecting the consumer from bankruptcy and unacceptable conducts which are caused by financial and banking institutions; and make sure that the banking market is working in a smooth and proper manners without market disturbance.[502]

Even though the DNB has a direct role in supervision of banks, the Ministry of Finance in the Netherlands has the final say over majority of the matters. The implications of these are clear on all financial sectors including banking. The Ministry can directly and indirectly impact on the banking system in the country through policy or regulation. Further, it must be noted that the Ministry is empowered to exercise prudential supervision of the various banking businesses and ascertain whether such businesses are working in a sound manner.

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[500] Panayiotis G Artikis, Stanley Mutenga and Sotiris K Staikouras, A Practical Approach to Blend Insurance in the Banking Network (2008)9(2) The Journal of Risk Finance emerald 106,124 ISSN: 1526-5943
[501] Roberto Billi and Anders Vredin, 'Monetary Policy and Banking Stability–a Simple Story' (2014)2 Sveriges Riksbank Economic Review 1,22 <https://pdfs.semanticscholar.org/e31e/d6c4094343d28222e6f7d115f4cfecdc9f10.pdf> accessed January 2020
[502] Government of Netherlands, Banking Sector Supervision of the Banking Sector (Annual Report Euro system 2017) ISSN: 1566-7200 accessed 13 January 2020.

The DNB can issue various Decrees which impact on the working of the banking sector ensuring better supervision and conduct; the Ministry is also empowered to issue the same Decrees which can change how the banking sector lends or borrows. An example in the Netherlands is the Ministerial Decrees which have the impact of allowing the Dutch government to put limits on the DSTI ratios and LTV ratios.[503] These enactments have the power to regulate and create a dynamic banking system. The range of powers given to the Ministry are crucial for creating a banking system which responds to the needs of the entire financial sector. The Ministry can evaluate the level of risks in the finance sector and proceed to cure any imbalances using Ministerial Decrees on DSTI ratios and LTV ratios. The Ministry is also directly involved in law making, when the DNB and the AFM may be of the opinion that more supervisory power was needed for an effective operation, it is the Ministry which approaches the Dutch parliament with that proposal.[504]

In developing countries like Pakistan, Botswana, Nigeria, South Africa, and Kenya, the role of the Ministry of Finance is well engraved in the banking system and banking laws. It is also important to note that some of the roles between the Ministry of Finance and the Central Bank can overlap even though many countries have made it a point to stipulate that the central banks are the main regulatory bodies. For a country like Botswana the Ministry of Finance plays a very crucial role in the banking sector. The Ministry has a branch of the Banking Supervision Department which is tasked with handling banking related issues. The main role is to ensure stability in the banking sector by supervision and regulations of banking institutions and other non-banking Banking institutions too. Even though there is the Bank of Botswana, the role of the Supervision Department is a crucial one and has direct bearing in the dynamic nature of the banking system. The law also recognises this body through the Banking Act of Botswana (cap 46:04), the Bank of Botswana Act (Cap 55:01) and the Collective Investment Undertakings Act (Cap 56:09).[505]

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[503] International Monetary Fund, Kingdom of Netherlands, Netherlands: Banking System Stability Assessment (April 2017) 17/79 IMF Country Report ISBN/ISSN:9781475591828/1934-7685
[504] International Monetary Fund, Kingdom of Netherlands, Netherlands: Banking System Stability Assessment (April 2017) 17/79 IMF Country Report ISBN/ISSN:9781475591828/1934-7685
[505] Bank of Botswana, Banking Supervision (August 2017) Annual Report IMF <www.bankofbotswana.bw/sites/default/files/publications/BSD%20Annual%20Report%202017.pdf> accessed 13 January 2020

One of the main roles of the Department encompasses prudential standards and policies; monitoring of large risk exposures, liquidity, insider loans, solvency, risk management and risk management strategies, prudent provision, and corporate governance. In other words, the Department undertakes both regulatory and supervisory role; it is pertinent to say that the Ministry of Finance in Botswana helps shape the banking sector from a birds-view point for setting macro prudential guidelines and from a direct point of prescribing corporate governance regulations, risk management, liquidity, solvency, etc.

In Pakistan, the Board of Directors of the Central Bank is entrusted to perform the functions[506] along with the Monetary Policy Committee, overseeing foreign exchange reserve management and approving strategic investment and risk policy, submitting a quarterly report to the Parliament on the state of the economy with special reference to economic growth, money supply, credit, balance of payment and price development. The very structure of the Board of Directors has significance of showing the role of the board in ensuring the stability within the banking system. The board consists of the Governor; Secretary Finance Division, Government of Pakistan; and eight directors, who shall be eminent professionals from the fields of economics, finance, banking, and accountancy, to be appointed by the Federal Government.[507]

3.3.2 Regulatory Agencies

The UK system being one of the most developed systems is a good example to understand the role of regulatory agencies. The national regulator also acts as a banking system stakeholder. The regulatory mandate and powers of the national regulatory institutions in the UK arose from informal practices which mandated a more deepened and dynamic banking to protect the depositors.[508] The Financial Conduct Authority in conjunction with the Bank of England have a long-standing history of supervision which involves both internal and external compliance schemes of corporate governance; as a result the supervisors in the UK have been able to ensure that the banking sector is maintained in terms of liquidity, stability and lending.[509] These banking institutions then came up with multi-faceted and complex risk management models

[506] Section 9A The State Bank Act 1956
[507] Section 9 The State Bank Act 1956
[508] Maximilian Hall, Handbook of Banking Regulation and Supervision in the United Kingdom 205 (3d edn Edward Elgar Publishing Ltd 1999) (Discussing the flexible supervisory approach of regulation in the UK) ISBN-10:1858988187
[509] Hall (n508)

which allowed them to be able to price their products and then hedge all their risk exposures in a way which improved their liquidity challenges in particular circumstances.[510]

Flexibilities have been created in the banking sector in the UK and competition is also encouraged so that the depositors and the public can get value for their money.[511] To some extent there has been increased profitability, faster processing of transactions and payments, easy monitoring of large activities and rapid restructuring of banks in the UK.[512] The UK supervisor considers when regulating the banking system in the UK that the banks should be able to have the required internal flexibility to cope with the market changes. To achieve this required level of dynamic banking system, the Prudential Regulatory Authority has an active role which it undertakes to ensure that the banking management undertakes processes and practices which have the impact of achieving an optimal level to protect creditors of the bank, the shareholders, the customers, and the broad banking system.[513]

3.3.3 Corporate Governance

The Dynamic Banking system in the UK is created through the use of corporate governance which has primarily been fashioned to involve the banking supervisor making use of statutory stipulation to advance governance standards, as discussed in chapter 5, for banking institutions. As a regulator, the UK Prudential Regulation Authority has increasingly devised various frameworks which mandate the banking institutions to undertake and adopt self-monitoring, internal processes, and systems in order to fully comply with regulatory and statutory standards. The role of this national regulatory body is thus cemented and entrenched in the UK Financial Services Act of 2012.[514] The Act obligates banking institutions to put in place internal systematic control structures, compliance and obligates the senior management of banking institutions to report on the finances, remuneration and related aspects of banking. Other key

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[510] Avinash Persaud, Liquidity Black Holes: Why Modern Banking Regulation in Developed Countries Is Making Short-Term Capital Flows to Developing Countries Even More Volatile 1 (UNU/WIDER 2002)45,58 ISBN-10:1858988187

[511] Allen Berger and Andea Deyoung, 'The Economic Effects of Technological Progress: Evidence from the Banking Industry' (2003)35(2) Credit and Banking Journal of Money JSTOR141-76 https://www.jstor.org/stable/3649852 accessed 13 January 2020

[512] Neil Marshall and others, 'Regulatory Change, Corporate Restructuring and the Spatial Development of the British Banking Sector'(1992)26(5) Regional Studies 453-467< DOI: 10.1080/00343409212331347111> accessed 13 January 2020; J N Marshall and Ranald Richardson, 'The Impact of Telemediated Services on Corporate Structures: The Example of Branchless Retail Banking in Britain' Environment and Planning A'(1996) 28(10) SAGE Journal1843-1858. <https://doi.org/10.1068/a281843> accessed 13 January 2020

[513] Prudential Regulatory Authority, PRA Handbook: Supervision § 10.4.5, http://www.PRA.gov.uk/handbook/BL3SUPppb/SUP/Chapter_10.pdf (Jan. 2004); Prudential Regulatory Authority, PRA Handbook: Senior Management Arrangements, Systems and Controls § 3.1.1, http://www.PRA.gov.uk/handbook/BL1SYSCpp/SYSC/Chapter_3.pdf (Jan. 2004).

[514] Financial Services and Markets Act of 2000, c. 8 (Eng.)

personnel of the bank also have various duties and obligations under the Act. These duties are under the mandate of the Prudential Regulation Authority which is tasked with overseeing that there is compliance with the law by the various banks in the UK.[515]

Under the Financial Services and Markets Act, the Prudential Regulatory Authority has the authority to sanction and review banking institutions in terms of compliance systems and internal control methods which they put in place. This is designed to ensure that the corporate governance is encouraged both internally and externally and hence create a more stable banking culture. Thus, banking institutions should adopt systems that are based on accepted and recognised standards and principles on corporate governance.[516] These regulatory principles and standards are designed to ensure that the UK banking system is more stable, and that the banking system can support the Banking sector and help to create a dynamic system which is not susceptible to Banking shocks.

The Prudential Regulatory Authority and the Banking Services and Markets Act places unto the senior management responsibility to oversee the different aspects of banking in an effective way and in a manner which does not cause instability in the banking system, they are mandated to report and show that they have undertaken steps to ensure that there is proper control and systems by reporting to the Prudential Regulatory Authority. The Prudential Regulatory Authority's power does not stop there in ensuring that there is integrity and good internal corporate governance, it is further given authority to take reasonable measure to ensure compliance and additional disciplinary actions if the responsible person i.e. the senior manager, the director, or any key personnel of the banking institution deliberately acts in a manner which violates the set regulatory standards or if the behaviour of such personnel is a way below the expected standards that the Authority would expect of such a person in that position. The implication is that key banking personals have the burden of showing that the internal processes in the banking institution are regularly updated and comply with set principles of corporate governance. Failure to ensure the existence of minimum standards would mean that the Authority would step in to ensure compliance.[517]

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[515] ibid
[516] Ibid, section 66
[517] Prudential Regulatory Authority, 'Consultation Paper 17: Banking Services Regulation: Enforcing the New Regime 33(Dec. 1998).

The role of Prudential Regulatory Authority in corporate governance is designed to ensure that the Banking sector remains dynamic through sound banking practices. By allowing qualified and competent personnel to run the banking institution then it has the impact of increasing ingenuity and dynamic banking. Skills, integrity, and care[518] are recommended for controlled Banking functions,[519] there must also be proper minimum standards of banking and market conduct,[520] and the banks have to interact with the PRA in an open and transparent manner providing crucial information for the creation of a sound banking sector.[521]

3.3.4. International Bodies

Creating a dynamic banking environment in developing countries mandates the Ministries to work with first of all the international monetary agencies such as the International Monetary Fund and the World Bank Group in adopting international goals, policies, and priorities. What these entails are that ministries are mostly involved in monitoring the performance of the Banking sector and encouraging short-term and long-term crises management in the Banking sector. The importance of working with development partners is that these development partners provide tools to developing Countries to gain long term capital and banking models which help boost their banking sectors.

The input of these international agencies finds their way into the banking law through direct inclusion of monetary policy. While the central bank plays the primary role of regulations, the ministries have been given an umbrella power to the setting up of a sound banking system. Further, the role of the ministry in enacting legislation is an indirect way in which the ministries ensure that there is a sound banking system.[522]

3.3.5 Legislative Tools & Mechanism

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[518] PRA Code of Practice, supra n. 146, at s 4.1.1. Principle One states, "An approved person must act with integrity in carrying out his controlled function."
[519] Ibid at s 4.2.1. Principle Two states, "An approved person must act with due skill, care and diligence in carrying out his controlled function."
[520] Ibid, at s 4.3.1. Principle Three states, "An approved person must observe proper standards of market conduct in carrying out his controlled function."
[521] Ibid, at s 4.4.1. Principle Four states, "An approved person must deal with the PRA and with other regulators in an open and cooperative way and must disclose appropriately any information of which the PRA would reasonably expect notice."
[522] Dirk Schoenmaker, 'The Role of Central Bank in Banking Stability' (Encyclopedia of Banking Globalization G. Caprio (ed), Elsevier Amsterdam April 2011) 20 <http://personal.vu.nl/d.schoenmaker/Encyclopedia_Role_of_Central_Banks_v1%20%2828-4%29.pdf> accessed 13 January 2020.

The main role which a central bank plays in the banking practice is that of ensuring banking stability and maintaining a monetary policy. The banking crises ignited very serious debates on the appropriateness and the powers of the central banks to effectively supervise commercial banks, the key concern for many legislators was to enact various legislative tools to allow better supervision by the central banks. To the public, the major role of this institution is to regulate the commercial banking sector, any failure of these banks is usually associated with bad supervision as one of the reasons.[523]

3.3.6 Regulatory modes and Regulatory Tools

Modern regulatory tools can be similarly designed by contract or statute to deliver dynamic regulatory outcomes for financial stability, activated automatically and immediately upon the occurrence of a predetermined event (a trigger event). This outcome is possible in Dynamic Financial Regulations' tools driven by automaticity i.e., "self-acting, having the power of motion or action within itself" in a way that effectively imitates human-directed action by way of automatic response to pre-defined stimuli; the dominant automatic condition or nature inherent in the operation of a regulatory tool the activation of which is contingent upon the occurrence of a predetermined trigger event. Automaticity is relevant in modern financial regulation because in order to meet the demands of dynamic evolving banking systems, regulators will need to design tools that can respond quickly and objectively to provide well-timed and dynamic solutions to particular problems, e.g., a sudden fall in a bank's capital ratio.

The term automaticity here refers primarily to: (a) statutory automaticity when design and activation of the trigger mechanism is facilitated by statute and (b) contractual automaticity when design and activation of the trigger is facilitated by a contract. Contractual automaticity is currently evident in a wide range of Dynamic Financial Regulations tools including tools for: auto-levy of a penalty; auto-termination of an obligation upon the occurrence of an event of default;[524] auto-conversion of debt to equity; auto-write-down of a certain liability; and auto-payment of a certain sum in insurance contracts. A third form of hybrid automaticity can be

[523] Schinasi Garry, Responsibility of Central Banks for Stability in Banking Markets International (2003) Monetary Fund IMF Working Paper 03/121 ISBN:9781451854404/1018-5941; Tommaso Padoa-Schioppa, 'The Transformation of the European Banking System' Central Banks and Banking Stability: Exploring the Land in Between (2003) 25 second ECB Central Banking Conference October 2002 269,310 ISBN 92-9181-348-6 ; Andrew Large, Banking Stability: Maintaining Confidence in a Complex World (2003)15 Bank of England Banking Stability Review FSR 170,174 ISSN 1365-7267

[524] Belmont Park v BNY Corporate Trustee Services Ltd [2011] UKSC 38; [2012] 1 A.C. 383; [2011] 3 W.L.R. 521; [2012] 1 All E.R. 505 at [26] and [116]

said to arise when the trigger design involves both contractual and statutory automaticity.[525]

Financial regulators regulate and supervise risk-taking dynamic financial markets. To ensure viability, banks must balance risk-taking with capital, the "lifeblood" and currency by which they operate in the financial marketplace. For banks, some "risks are riskier" today arising from non-traditional intermediation,[526] greater concentration, interconnectedness, complexity, and opacity.[527]

Dynamic Financial Regulations can be contrasted with static financial regulations to be "more dynamic" which refer to discretionary adjustments by regulators; Cooper argued that "financial regulation needs to be more dynamic, with a means of being refocused to meet the changing conditions of the market"[528] for example automatic provisioning or loan-to-value ratios in response to signs of a bubble.[529] On the contrary to Dynamic Financial Regulations' design focus, "judgement focused approach" advocates for the sole use of supervisory discretion.[530] Dynamic Financial Regulations are also distinguishable from principles and rules based regulation: the former uses standards[531] or principles articulated in "open textured language"[532] whereas the latter is an advance determination of what conduct is permissible while leaving the factual issues for the adjudicator of a kind said to be unsuitable for regulating dynamic financial services.[533] Both approaches are, however, criticised as convenient advertising labels at opposite ends of a continuum that are neither scalable nor suitable for complex regulatory systems of the kind that Dynamic Financial Regulations will positively impact.[534]

Another approach to regulation was proposed by Awrey proposed "More Principles Based Regulation" (MPBR); Awrey argued that issues stemming from the complexity and innovativeness of modern financial markets requires MPBR due to perceived lack of post-crisis

[525] A. G. Haldane, "Capital Discipline", Remarks given at the American Economic Association, (Denver, January 9, 2011) used the term "contractual automaticity" in the same context
[526] H. Davies, Financial Services Authority, Press Release (London: January 21, 1999
[527] IMF, Global Financial Stability Report (October 2012), 3–5
[528] J. Cooper, "The Regulatory Cycle: From Boom to Bust", in I. MacNeil (ed), The Current Financial Crisis and the Economic Impact of Future Regulatory Reform (Oxford: Hart Publishing), 455, 456
[529] C. Borio, Pro-cyclicality of the Financial System and Policy Options (2001) BIS Paper 1
[530] P. Yeoh, "Current Reform Initiatives for Too-Big-to-Fail Financial Firms" (2011) 32 (2) Bus. Law Review 35–42, 41
[531] L. Kaplow, "Rules Versus Standards: An Economic Analysis" (1992) 42 Duke Law Journal, 557–629, 560, fn.2 noting the interchangeable use of "rules" and "standards
[532] E. V. Ferran, "Principles-based, risk-based regulation and effective enforcement" in Michel Tison (ed), Perspectives in Company Law and Financial regulation: essays in honour of Eddy Wymeersch (Cambridge Univiversity, 2009), 427, 429.
[533] D. Langevoort, "Global Securities Regulation after the Financial Crisis" (2010) 13 J.I.E.L. 799.
[534] L. Cunningham, "A Prescription to retire the Rhetoric of 'Principles-Based Systems in Corporate Law, Securities Regulation, and Accounting" (2007) 60 V.L. Rev 1409, 1492

regulations.[535] DFR and MPBR share certain conceptual similarities, but MPBR is best suited to enforcing financial product regulation.

Lobel[536] and Karkkainen[537] have endorsed Rhodes on new governance[538] and Ford has emphasised polycentric and collaborative regulatory structures which span the public-private divide[539] using private (i.e., non-state) actors in shaping public policy and regulation[540] as proposed by Ferran and others.

"Responsive regulation" is a regulatory enforcement strategy that uses an enforcement pyramid; a responsive, flexible, and iterative model to transcend the "intellectual stalemate" between those who favour "strong state regulation of business and those who advocate deregulation."[541] In a regulatory context, responsive regulation is said to be principles-based and capable of enhancement by another new theory known as "really responsive regulation" (RRR). Baldwin and Black have advocated RRR as a wider strategy that covers the gamut of the enforcement activity aimed at creating a framework in which regulators can regulate really responsively and avoid the "expensive process of shooting in the dark".[542] Smart regulation enunciated by Cunningham, Grabokwsy and Sinclair uses "automatic triggers", to achieve graduated, balanced enforcement.[543]

Financial instability spawns banking crises. Banking crises are the "train wrecks" of modern international finance.[544] The 2007–09 financial crisis exposed serious shortcomings in the global regime for bank capital regulation, including capital levels, capital quality, and lack of mechanisms for risk internalisation. Capital requirements are among the most potent tools regulators use to make firms internalise systemic dangers and reduce the probability and impact of crises.[545]

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[535] D. Awrey, "Regulating Financial Innovation: A More Principles-Based Proposal" (2010–2011) 5 B.J.C.F & C.L 273, 314.
[536] O. Lobel, "The Renew Deal: The Fall of Regulation and the Rise of Governance" 89 (2004) Minnesota. L. Rev. 342
[537] B. C. Karkkainen, "'New Governance' in Legal Thought and In the World" (2004) 89 Minnesota. L. Rev. 471.
[538] R. A. W. Rhodes, "The New Governance: Governing Without Government" (1996) 44 Political Studies 652–67
[539] L. Ford, "New Governance, Compliance, and Principles-Based Securities Regulation" (2008) 45 A.B.L.J. 1–60, 428
[540] E. V. Ferran, "Principles-based, risk-based regulation and effective enforcement" in Michel Tison (ed), Perspectives in Company Law and Financial regulation: essays in honour of Eddy Wymeersch (Cambridge Univiversity, 2009), 427–429.
[541] I. Ayres and J. Braithwaite, Responsive Regulation: Transcending the regulatory Debate (New York: OUP, 1992).
[542] R. Baldwin and J. Black, "Really Responsive Regulation" (2008) 71 M.L.R.65–68
[543] N. Gunningham et al, Smart Regulation: Designing Environmental Policy (OUP, 1998); N. Gunningham and D. Sinclair, "Designing Smart Regulation" (OECD Papers, 1997
[544] J. Barth, Rethinking Bank Regulation (CUP, 2006), 26
[545] C. Spatt, "Complexity of Regulation" (March 2012) H. B.L. Rev., HBLR Symposium

3.4 Identifying the functions of national supervisory authorities in creating a dynamic banking system particularly in developing countries

The central banks have power to access or be given access to the systems of the banks or for these banks to report any standard which they are mandated to do under the banking laws and the central bank statutes. By doing this the central bank can monitor the commercial banking sector. The central bank also has the power to monitor any Banking imbalances in the banking systems and if this imbalance can cause a widespread disruption, then it is the power of the central bank to act according to the law. This is true both in the developing and developed Countries; any central bank should be aware of how the international economy can adversely affect the local commercial banks as well as the interest rates or how inflation can creep into the commercial lending system. It is the task of the central bank to cushion the local commercial sector against such shocks.[546]

Nevertheless, the problem remains in developing countries is the overreaching political role in the operations of the Central Bank; the influence by such political personals in policy making has consequential effects on application or selective application of the regulations and principles of corporate governance. The Monetary and Fiscal Policies Coordination Board of the Central Bank of Pakistan requires two Ministers (i.e., of Finance and of Commerce) as board members.[547] The Board performs very crucial functions such as: coordinates fiscal, monetary and exchange-rate policies; ensures consistency among macroeconomic targets of growth, inflation and fiscal, monetary and external accounts; determines the extent of Government borrowing, before budget, from commercial banks taking into account credit requirements of the private sector, liquidity expansion and expected changes in net foreign assets of the banking system; review the consistency of macro-economic policies and to revise limits and targets set at the time of the formulation of the budget, keeping in view the latest developments in the economy; and review the expenditure incurred in connection with raising of loans and Government borrowing.[548]

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[546] ibid
[547] Section 9B The State Bank Act 1956
[548] ibid

In developing countries, many banking laws are at their infancy and they are constantly trying to keep up with the international standards. The narrative for many developing countries has been the influence of the Ministries in the regulation of banks. This creates two dimensions in the regulatory framework of the banking sector. In India, the Committee on the Banking System recommended that the duality of control over the banking system between the Central Bank and the Banking Division of the Ministry of Finance should end and that the Central Bank should be the primary agency for the regulation of the banking system.[549] The role of the Ministry was thus made limited to concentration on an overseeing function rather than a regulatory function. Monetary policies are, however, set by some ministries in collaboration with the regulators i.e., the central banks.

3.5.1 Support Role of Basel Accord for Supervisory Authorities

In chapter 2.9, we have discussed in detail that the central banks are supported by non-governmental organisations such as the Basel Committee and the Organisation for Economic Co-operation and Development (OECD). The modern regime for global regulatory bank capital standards developed by the Basel Committee on Banking Supervision is a powerful soft law. "Basel standards" or "Basel capital requirements" from Basel I (1988), Basel II (2004), Basel 2.5 (2009) and most recently Basel III (2010 revised in June 2011) are continuously being upgraded to reflect new risks, to standardise bank capital and regulate its adequacy. Regulators can determine the particular financial risks (e.g., credit risks) that an institution faces and the appropriate level of loss absorbing capital by calibrating capital to those risks.[550] The chapter 2 of this thesis discussed the salient features of Basel II.

Basel III significantly changes banks' capital requirements involving substantial costs and potentially altering international competitive dynamics.[551] Basel III's likely competitive impact depends largely on the extent to which Basel rules are uniformly implemented by different countries and whether such implementation occurs at the same time. The European Union recently proposed more aggressive capital requirements than are required by Basel III,

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[549] Aditya Narain and Saibal Ghosh, 'Bank Supervisory Arrangements: International Evidence and Indian Perspective' (2001)36(37) Economic and Political Weekly 3543,3553 ISSN- 2349-8846 accessed 13 January 2020

[550] E. Ferran and K. Alexander, "Can Soft Law Bodies be Effective? The Special Case of the European Systemic Risk Board" [2010] E.L.R. 751; K. Alexander, "Rebuilding International Financial Regulation" (2011) B.J.I.B.F.L. 489–494, 491

[551] Ward Jonathan, 'The New Basel Accord and Developing Countries: Problems and Alternatives'(2002)Working Paper 04 <https://g24.org/wp-content/uploads/2016/01/The-New-Basel-Accord-and-Developing-Countries-Problems-and-Alternatives.pdf> accessed 10 January 2017;

including a tier one capital requirement that is 7 percent of risk-weighted assets.[552] While the European Union is content to establish higher capital requirements than Basel, it is worried that countries in the Union will adopt even higher standards by "gold plating". This has led to a concern in the European Union that the banks with higher capital requirements will have a competitive advantage.[553] In this way, Basel III's helps in creating a dynamic banking system by impacting the changes in capital ratios as it affects bank lending mainly due to a higher return on equity and a higher share of risk-weighted assets in bank balance sheets" in the United States.[554]

3.5 Should supervisory authorities be only concerned with economic and legal measures in making a banking system dynamic?

As it is discussed and established in the first two chapters that the economics, banking system and financial stability are interlinked. The legislators, policy makers and regulators are expected to take into account both economic and legal measures in terms of devising regulations and regulatory models in pursuing the goal of creating a sound and dynamic banking system. The other issue which is equally paramount in creating an effective banking structure is banking and monetary policies and their role in ensuring soundness and safety in the banking system. In addition, the interaction between economic elements and regulations in terms of policies improve performance and efficiency, and the safety of the banking system. Economic elements and regulations also play a crucial role in ensuring transparency in the banking system.[555]

Research in the economic sector, economic imbalances and economic risks in the banking sector has for a long time impacted on how dynamism and soundness of the banking system is determined. Core banking requirements like capital requirement, banking deposit insurance,

[552] Jim Brunsden, "EU Seeks to Triple Banks' Minimum Reserves in Basel Law", Bloomberg, July 20, 2011, http://www.bloomberg.com/news/2011-07-20/eu-seeks-to-triple-minimum-capital-levels-for-banks-in-basel-law.html [Accessed August 2022].

[553] Gonzalo Vina, "IMF Backs U.K. Bid to Exceed Basel Bank Rules in Clash With EU", Bloomberg, August 1, 2011, http://www.bloomberg.com/news/2011-08-01/imf-backs-u-k-bid-to-exceed-basel-bank-rules-in-clash-with-eu.html [Accessed August 2022].

[554] Patrick Slovik and Boris Cournède, "Macroeconomic Impact of Basel III" (Organisation for Economic Cooperation and Development, Economics Department Working Paper No. 844, 2011), http://dx.doi.org/10.1787/5kghwnhkkjs8-en [Accessed September 21, 2011]

[555] Frederick T Furlong and Simon H Kwan, 'Safe and Sound Banking, 20 Years Later: What Was Proposed and What Has Been Adopted' (2007)2 Federal Reserve Bank of San Francisco SSRN WP 2006-27 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1004571> accessed 13 January 2020

risk management and liquidity are originated from the economic perspective but are grounded and prescribed in law at the same time.[556]

McBarnet argues that law is a facilitative structure available for use and manipulation: "if law is in the interests of capital it is not simply because it is handed over on a plate by predetermined structures, however complex, or by a captive state, but because of continuous work upon it on a day to day pragmatic basis to try and make it fit the specific, dynamic and sometimes conflicting interests of the moment; practical lawyers are always working in someone's interests. Given market forces that clientele is dominated by private and corporate capital."[557]

It is discussed in the second chapter that the role of law functions from conceiving instrumental rules for policy actions (ex-ante regulation) to establishing legal mechanisms to render discretionary actions accountable (a model of ex post regulation). Lord Denning observed If we never do anything which has not been done before, we shall never get anywhere. The law will stand still whilst the rest of the world goes on; and that will be bad for both.[558] The legal structure for an accountability relationship is ex post since it constitutes the assessment of an act (or of its omission) that was already implemented by the monetary authority. Even if it takes into consideration previous parameters for the central bank's behaviour, this ex-ante element has properly a cognitive nature. In turn, the accountability's legal relationship implies the scrutinization of a discretionary action, based on parameters previously defined by a normative instrument. Furthermore, if monetary regulation is constituted as a process (a deferred exercise of power by central banks), the legal system for the policy's evaluation and judgement would also match its design, namely, a sequence of procedures.[559]

For the role of the central banks, it is very crucial that both monetary policy and banking stability are seen to be linked in the way a central bank can properly ensure that the right concepts are employed in ensuring banking stability within the existing monetary policy. Since there is no doubt that price stability supports sound investment and a growth which is sustainable, which eventually is crucial for banking stability, the central bank by seeking to maintain stable prices allows the banks to have stability and hence maintain sound practices.

[556] Ibid
[557] D. McBarnet, "Law and Capital: The Role of Legal Form and Legal Actors" (1984) 12 International Journal of the Sociology of Law 231-238 at 233
[558] Packer v Packer [1954] P. 15; [1953] 3 W.L.R. 33; [1953] 2 All E.R. 127
[559] Marie-Anne Frison-Roche, Le couple ex ante-ex post, justification d'un droit propre et spécifique de la régulation in Marie-Anne Frison-Roche (ed), Les engagements dans les systèmes de regulation (Paris: Dalloz, 2006) p.34).

Further, without price stability of the central bank in the commercial banking sphere, there is an inherent danger that there is more likely to be fragility within the banking sector. By the fact that the central banks tend to ensure that stability is maintained, monetary stability is also maintained in the long run.[560]

In addition to economic and legal measures, dynamic banking also requires taking into account other matters including sufficient market information, costs of operation and public policy. These are discussed briefly as follow:

3.5.1 Market Information

. The Prudential Regulatory Authority in the UK, as a good example, has been in the forefront in ensuring that the government supervisors, the creditors, bank owners, and other market stakeholders have sufficient information[561] which include incentives to undertake proper banking supervision. In order to achieve this goal, the Prudential Regulatory Authority has also been able to adopt a number of comprehensive regulations which impose civil liability for the directors and the senior managers for breach of corporate governance principles and their duties to ensure that no banking institution is left behind any compliance procedure with the corporate governance principles. Even if there is no direct knowledge by the senior management or when they had not taken part in the violation of the corporate governance mandate, like when a banking institution's rogue worker conducts an unauthorized trade and steals money from the client, the Prudential Regulatory Authority has the authority to hold into account the senior management especially if they had failed to take all appropriate measures to ensure that there are relevant and adequate measures to prevent such acts from occurring. Therefore, the senior management and the board can be liable for both direct and indirect acts through omissions to take proper corporate governance measures for internal control.

3.5.2 Costs of Operations

The governance structure should be proper enough to ensure that costs of operations are not inflated, and the smaller institutions are not adversely affected at the expense of large banking institutions; this dynamic nature and working of the banking sector is very crucial and has to

[560] Ibid

[561] Allen Berger and Robert DeYoung, 'Technological Progress and the Geographic Expansion of the Banking Industry (2006)38(6) Credit and Banking Journal of Money 1483-1513 <http://dx.doi.org/10.1353/mcb.2006.0077> accessed 13 January 2020

be considered by any national regulator. The Prudential Regulatory Authority has adopted a number of high-level principles of business which are now part and parcel of the UK banking sector and banking legislations.[562] These high-level principles apply to all firms and all persons in the financial services. They cover the duties of the directors and the senior management of the banking institutions. These principles are general and can be applied in a flexible manner. These principles include skills, integrity, care, banking prudence, diligence, market conduct, control and management, and the relations with the supervisors and regulators. These principles are policy based and highly determine the standards and rules in the banking sector. This allows the principles to be used as a justification for accessing and evaluating the sustainability and suitability of all applicants to be taken as approved in undertaking the banking services of the UK. The second principle holds that "a firm must conduct its business with due care, skill and diligence"[563] and the Prudential Regulatory Authority has been interpreting that principle as a principle which sets the objectives and reasons that reasonable personnel standards are used in the direction and management of authorized banking firms.[564]

Banks can adopt frameworks which are best suited for their organizational operations and structure. Another principle holds that a basic framework for the banking internal corporate governance standards requires banking institutions to control and organize its internal affairs in a responsible manner.[565] Concerning the agents and employees of the bank, a banking institution must have suitable and adequate measures and arrangements to make sure that these personnel are properly trained and adequately supervised and that they have proper and well-outlined compliance procedures.[566]

3.5.3 Public Policy

Public policy is the course of action, laws and funding priorities and regulatory measures that are given to a given area of interest or topic which is promulgated by the government or its agencies. A banking system is expected to take into account public interest and public policy

[562] Prudential Regulatory Authority, Press Release, The PRA Publishes Response Paper on Principles for Business, http://www.PRA.gov.uk/pubs/press/1999/099.html (Oct. 12, 1999)
[563] Ibid
[564] Prudential Regulatory Authority, Statement of Principle and Code of Practice http://www.PRA.gov.uk/handbook/legal_instruments/2001/nov15_aper.pdf (Dec. 01, 2001)
[565] Fin. Servs. Auth., Press Release, Paine Webber International (UK) Limited Fined £ 350,000, http://www.PRA.gov.uk/pubs/additional/sfa009-01.pdf (Aug. 22, 2001).
PRA Code of Practice, supra n. 146, at § 4.1.1. Principle One states, "An approved person must act with integrity in carrying out his controlled function." Id.
[566] Ibid

because the banks undertake a crucial role in the economy, that of provision for retail banking, as a custodian of the public monies and also in the provision of the payment system for the wholesale and retail markets. Further, the very nature that the banking sector allows channelling of investments and savings for the economy ensures that there is economic growth in the banking sector and other sectors of the economy such as capital markets, real estate, insurance, agriculture, pension funds, etc. Additionally, the banking sector creates credits through investment, providing all manner of Banking packages, but these acts must not go beyond the purview of public policy. Another reason is that a banking system has the power to have a cross-border effect and affecting both multiple finance industries like real estate and capital markets mean it is a sector which has to be treated with the seriousness it deserves. The public policy underlying, and implications of the banking development got engraved and reinstated when the governments started bailing out commercial banks. Further the sovereigns started using the taxpayer money to extend and guarantee deposit insurance to depositors. This development caused uproar among many citizens and the fact that the banks were being bailed out by the taxpayers' money caused public anger and people clamoured for tighter regulation and government involvement in the banking regulation. Examples such as the Basel Committee and the G20 took this issue seriously as banking stability emanated from the depositors who advocated for more regulation of the banking sector and put pressure on the sovereign.[567]

The institutional structure of banking regulations has transformed major issues of public policy.[568] The question which is brought forward is: whether there is a need to create an integrated prudential body with all banking markets and firms in a jurisdiction; or whether supervision and regulation should be undertaken by specialised bodies like banking, competition, security, insurance, etc. Additionally, there is a major question: what the role of the central bank in the banking regulation model is and if it is desirable that the conduct-of-business regulation must be included within a similar framework and agency as prudential regulations or should that be undertaken by a separate and dedicated body.[569] According to Borio," … financial busts and an aggressive and prolonged monetary response to them can undermine the central bank's independence. If central banks engage in extensive balance-sheet

[567] Centre for Advanced Banking Research and Learning, Public Policy and Banking ((n.d) <http://www.cafral.org.in/sfControl/content/Speech/12312013125512PMPublicPolicyandBanking2013_Speech.pdf> accessed on 13 August 2017

[568] Llewellyn, David T. "Institutional structure of Banking regulation and supervision: The basic issues." In Paper dipresentasikan pada World Bank seminar "Aligning Supervision Structures with Country Needs" tanggal, vol. 6. 2006.

[569] Llewellyn, David T. "Institutional structure of Banking regulation and supervision: The basic issues." In Paper dipresentasikan pada World Bank seminar "Aligning Supervision Structures with Country Needs" tanggal, vol. 6. 2006.

policy, that independence will come under threat even earlier."[570]

Additionally, these banking institutions are very powerful in any economy and can facilitate desirable economic growth through various channels like real estate and credit and in many jurisdictions like in emerging markets like India and Brazil. Therefore, the banking inclusivity as a policy objective is an issue which has gained momentum globally; this can be seen by the reason that the G20 has a special work stream on this subject. The reason that the crisis made it possible for the developed countries and markets to see public policy measures and their advantages in finance, which is seen as a stimulant to economic growth and as a prudential tool, which is crucial for ensuring supply of credit to the small business sector.[571]

The role of public policy in banking was described by Reddy in his speech in 2002.[572] The public influence on the banking sector was linked to a number of achievements in terms of policy change since 1991.[573] The development and introduction of multi-institutional structure in financial and in the banking system at large was highly linked to public policy. The public policy in India is what led to the diversification of the public-sector banks. The issue of flexibility was also linked to public policy with evidence drawn from the banking system lending base being able to lend using genuine and practical credit decisions through a reduction in the deregulation. The flow of credit was argued to have been facilitated by ensuring that it was channelled to the sectors which needed it most and on priority basis.

Public Policy clearly has a major role in reminding the legislature, the regulatory and supervisory bodies of the banking system that the banking sector is the backbone to any economy and must be treated with the seriousness and caution it deserves. It is not an active element like regulation and economic elements such as Banking risk, but it is through public policy that prudential guidelines and regulations have been making it an essential tool in creating a dynamic banking system.

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[570] Claudio Borio, Central banking post-crisis: what compass for uncharted waters? BIS Working Paper (2011) 353, Bank for International Settlements p.6.
[571] Ibid
[572] YV Reddy, 'Globalisation of Monetary Policy and Indian Experience' (June 2005) 8th Meeting of the BIS Working Party on Monetary Policy in Asia Reserve Bank of India June 6-7 2005 < https://www.rbi.org.in/scripts/BS_SpeechesView.aspx?Id=202> accessed 14 January 2020
[573] Sara Hobolt Binzer and Robert Klemmemsen, 'Responsive Government? Public Opinion and Government Policy Preferences in Britain and Denmark' (2005)53(2) Political Studies 379,402 < https://doi.org/10.1111/j.1467-9248.2005.00534.x> accessed 14 January 2020

The public policy contribution in the banking sector and its role in shaping the regulation is seen in the public protest in the developed Countries such as the US after the 2008 Banking crisis. The American political persuasion is a good example in that case, it has been argued that public policy is one tool which rescued the USA from the 2007-2008 great recession. In certain times it would be proper for the governments to step in and regulate to install sanity to ensure the common good and broad-based economic growth, there has been clear evidence that it is public policy which saved the US Banking market.[574]

The American Recovery and Reinvestment Act of 2009 was instrumental in helping the US avoid another great depression and also helped start a renewed economic progress and growth. Another synergy even though not directly connected to the banking sector was the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 which was very instrumental to fledging the economic recovery through reduction of payroll taxation and progressively continued to extend insurance unemployment benefits.

Therefore, public policy has a very crucial role in the creation of sanity and hence a dynamic banking system. The same impact of public policy in the shaping of the banking sector is seen in developing Countries too. This is seen in India all the way from the country's independence to the period of pre-nationalization. The emphasis of public policy in India has been regarded as an instrument to protect and caution the Indian banking sector especially the protection of the small depositors and owing to this policy, India was historically the first country to introduce the scheme for deposit insurance. Further in 1969 public policy consideration became the main reason why nationalisation of major banks occurred in 1969 and the merging of various banks such as The State Bank of India and the Imperial Banks have been linked to public policy objectives. The use of public policy in creating sanity in the banking sector is so crucial to ensure that there are no underhand deals in banking loans, hence preventing corrupt deals. The input of public policy continued in India until the late 1990s where there was a major shift in public policy moving from a command economy to one which encourages competition in the banking sector, there was also a call by the public policy to make sure that there is productivity and improved efficiency based on international prudential policies.[575]

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[574] American Progress, '10 Reasons Why Public Policy Rescued the US Economy' (2012) <https://www.americanprogress.org/issues/economy/news/2012/05/29/11593/10-reasons-why-public-policies-rescued-the-u-s-economy/> Accessed on 15 August 2017

[575] TG Arun and JD Turner, 'Public Sector Banks in India: Rationale and Prerequisites for Reform' (2002)73Annals of Public and Cooperative Economics 89,109< DOI: 10.1111/1467-8292.00187> accessed 14 January 2020

The role of public policy in India was so crucial for market-oriented pricing of commodities, liabilities, and assets. The landscape of banking was also greatly changed and liberalized. A dynamic banking system is characterized by a liberalized market with ease of entry and exit. This is what public policy achieved in the era where the sector was regulated through command and was easily to be politically manipulated. The Ministry of Finance in India also played an active role in the supervision of the banking sector due to public concerns and adopted crucial guidelines and policies in ensuring that there was increased provision of projects like Jawaharlal Nehru National Urban Renewal Mission (JNNURM), which facilitated the restructuring of the loan system in the banking sector and growth of the economy. These evidence from India and the USA show that public policy has a major role in creating a sound banking sector and further that due to public policy various inconsistencies in the banking sector such as monopoly and insider lending may become controllable. Given that public policy is engraved in the wishes of the governed and that their powers have been instrumental to changing of legislations in the wake of banking crisis, it is only reasonable that one recognises the role it plays as a catalyst in the streams of amendments and banking regulations which come to cure various malpractices in the banking sector.[576]

3.5.4 Banking Inclusivity

The banking sector has recorded a tremendous growth in complexity and volume since the last decades, with the major concern being the reason that many banking services have not been able to reach the majority of the segments in a society. In the developed countries, this is not a problem per se, but it doubles up as a major concern for the developing banking markets in Africa and Asia. Various markets have taken measures to ensure this banking inclusivity in the banking sector as a way of ensuring growth and sustainability in the banking sector[577]. It also goes without saying that by ensuring that there is banking inclusion the other crucial concepts of banking and finance such as banking advancement and growth can be achieved. Banking inclusion can be defined as the process of ensuring that there is access to banking services in a manner that is timely and in adequate proportion in terms of credit facilities. The element of

[576] Ibid
[577] Joydeep Chakraborty, Role of Public Sector Banks in Banking Inclusion-A case study on West Bengal (2014) Research Bulletin 39, 105-116

inclusion means that even the vulnerable group in the society should have access to banking services.

This concept of banking inclusivity has been with the banking sector since 1969 but unfortunately for some developing countries, the vulnerable groups have not been able to access banking services in an equitable manner. Even though there may be an undisputed functional and outreach of commercial banks, marginal and small firms, unorganized sector workers, women, self-employed, artisans, pensioners, unemployed, etc. have continuously remained excluded from the services and opportunities that are provided by the formal banking sector.[578] There are other issues such as branch timing, the distance to banking, complexities in procedures and documentation, staff attitude and language barrier have also contributed a great deal to this element of exclusivity. This shows that the creation of a dynamic banking system is not solely based on legislation, and that elements such as access to banks and the inclusion of the private sector are crucial in creating dynamism in a banking sector.

Anjum Bimal and Rajesh Tiwari[579] and Chibba Michael have advocated for banking inclusion as a way of increasing banking awareness and at the same time ensuring the growth of the economic space which is a plane where the banking sector operates.[580] They demonstrated a correlation between increased bank penetration and a concomitant increase in economic growth in various Indian states, indicating that banking inclusion is a way of increasing the reach of banks in terms of their ledger, lending and liquidity. They further observed that the region of Bihar managed to record the largest percentage of increase in terms of the ratio in development expenditure to the gross domestic product of the state. This was attributed to the increased banking awareness and number of new banking branches in the region and the transparency of the State in terms of elections and its governance. The results of the report also revealed that the North-Eastern parts of India were showing higher development expenditure as compared to other bigger states to the Gross State Domestic Product (GSDP) ratio. This phenomenon could directly be linked to the increased number of private banks in the state as well as other variables.[581]

[578] Ibid, 106
[579] Bimal Anjum and Rajesh Tiwari, 'Role of private sector banks for Banking inclusion' (2012)2(1) International Journal of Multidisciplinary Research ISSN-22315780 <
file:///Users/riannarussell/Desktop/RoleofPrivateSectorBanksforBankingInclusion.pdf> accessed 14 January 2020
[580] Ibid
[581] Ibid

In Pakistan the level of financial exclusion from the formal sector is dramatic, especially in rural areas. The formal sector mainly means different types of banks (and other types of financial institutions). Only 15% (25 million) of the population of 160 million has bank accounts and less than 4% (5.5 million) are borrowers; only one quarter of households has a member with a bank account. Moreover, while two- thirds of the population resides in rural areas, only 25% of total bank depositors and 17% of total borrowers reside in rural areas; in value terms the shares of rural customers are even smaller, only 10% and 7% of the total value of deposits and advances, respectively. Limited access to services is also evidenced by the low level of branch penetration in rural areas, where there are less than 2,500 branches for a population of 105 million people—or an average of 42,000 inhabitants per branch. This has held back the growth of savings and access to credit.[582]

In order to address the issue, The State Bank and Pakistan Microfinance Network (PFM) developed a multi-faceted microfinance strategy to triple the number of microfinance (MF) beneficiaries from 1 million to 3 million by 2010 and then to 10 million by 2015. To support this program, SBP encouraged commercialization of the microfinance industry so that it becomes financially and socially sustainable. Some of the specific actions taken included[583]:
(i) A more flexible prudential regulatory regime for microfinance banks (MFBs) to allow innovation and organic growth without abandoning prudential objectives.
(ii) Encouragement of MFBs to improve their earnings quality and asset portfolios through improved risk management structures and practices, credit analysis and end-use monitoring. These measures will address the concerns over reduced capital adequacy ratios of these banks.
(iii) Encouragement of partnerships between commercial banks and MF providers to help banks enter into microfinance.
(iv) Encouragement of a partnership between the post office (PO) network and MF providers. POs already manage over 4 million savings accounts, mainly small accounts below Rs 10,000, through more than 12,000 branches. There is scope for the PO and MF providers to join forces with the latter acting as intermediaries for funds raised by POs, especially as the operations of many MF providers are constrained by limited funding.
(v) Encouragement of mobile phone-based banking services which was considered a cost-effective way of bringing financial services even to the most remote areas of the country.

[582] https://www.sbp.org.pk/bsd/10yearstrategypaper.pdf
[583] https://www.sbp.org.pk/bsd/10yearstrategypaper.pdf

(vi) Banks, including MFBs, are encouraged to take advantage of SBP's recently introduced Branchless Banking Regulations for enhancing the provision of financial services through alternative delivery channels.

3.5.5 information Sharing & Monitoring

We have seen in the second chapter that banks are expected to monitor the market by keeping an eye on consumers' behaviour by keeping track of elasticity in consumers' demand and by ensuring that there are sufficient resources of supply chains to meet such demand. This monitoring and timely actions ensure the maintenance of healthy competition as opposed to development of risky monopolistic competition which might result in the concentration of money with the minority turning the majority of the people into economic chaos and non-ending struggle to meet the basic necessities for the subsistence.[584] This is because banks are the only financial institutions that can overcome the information asymmetry between borrowers and lenders. Banks assess and manage risk by processing information on potential borrowers and their creditworthiness. After credit has been extended, banks monitor borrowers' performance and may extend additional credit as businesses develop; they are also closely involved in payments and transactions of their customers. Banks are, therefore, uniquely suitable to deal with smaller and start-up companies and with the household sector and need to move away from their excessive focus on financing large enterprises and the government.[585] Most credit to the enterprise sector then went to the manufacturing sector (especially textiles), which received a disproportionately large share of bank credit (40%) compared with this sector's contribution to GDP (20%). Aggregate data for all credit by borrower size shows an extremely skewed distribution: some 22,000 or 0.4% of all 5.2 million bank borrowers account for 65% of all bank advances—and the remaining 5+ million borrowers for the remaining one-third. At the very top there is even more concentration; the largest 50 borrowers account for 37% of all credit outstanding. In rectifying the situation, The State Banks mandated the banks to focus more on the lower-end company sector and the household sector to diversify risk. Experiences elsewhere show that SME and consumer lending typically is more profitable than lending to large corporations or investing in government securities.[586]

[584] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2018/ss118 [accessed on 16 February 2021]
[585] https://www.sbp.org.pk/bsd/10yearstrategypaper.pdf
[586] https://www.sbp.org.pk/bsd/10yearstrategypaper.pdf

3.6 CONCLUSION

As Mosad argues, the banking sector is a dynamic sector and as such the elements in the sector are constantly changing with time, the dynamic nature of the banking sector is of course the very reason why the central banks and other agencies have been tasked with the role of supervising and regulating. This being the case, it is understood that legislation should not be enacted in a manner which short hands the regulatory and supervisory agents.[587] Another group of authors[588] has revealed that "…. We should pay enough attention to the dynamic nature of the banking structure…" and another writer argues that "…. the relationship reflects the dynamic nature of today's market environment[589]..." We can conclude that the banking systems are complex and dynamic with ever changing variables. A dynamic banking system is one which has capacity to deal with the dynamic hypothesis that if there is a tension which exists between specific commercial targets and rule compliance in the Banking entities it may drive the behaviours in the system and cause violations of rules. Dynamic banking is premised on the fact that there is homogeneity in the banking system and that the difference in the banking institutions is what makes the system function properly, create innovation, creativity and able to cover the needs of the different depositors and hence adequately intermediate the movement of money in the banking sector and create capital for investments. In a dynamic banking system, banks are expected to voluntarily adopt self-regulatory initiatives.

The role of the National Supervisory Authorities in the regulations and creation of a dynamic banking sector is important. The very nature of the regulation of the banking sector would require steady dealing with changing circumstances, such as loan interest rate, the lending base rate, etc. Therefore, in times of an emergency imbalance in the banking sector, secondary regulation in terms of code of conduct, decrees and guidelines can be issued swiftly, enacted, and made enforceable in a matter of short time rather than an act of parliament which entails a lengthy process to enact an Act of Parliament.[590]

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[587] Maureen O'hara, 'A Dynamic Theory of the Banking Firm' (1983)38(1) The Journal of Finance Wiley 127,140 <https://doi.org/10.1111/j.1540-6261.1983.tb03630.x> accessed 14 January 2020

[588] Hajime Inaoka and others, 'Fractal Network Derived from Banking Transaction–An Analysis of Network Structures Formed by Banking Institutions' (2004)04-E4 Bank Jpn WP Econpapers < http://www.boj.or.jp/en/research/wps_rev/wps_2004/data/wp04e04.pdf> accessed 14 January 2020

[589] Zineldin Mosad, 'Quality and Customer Relationship Management (CRM) as Competitive Strategy in the Swedish Banking Industry' (2005)17(4) The TQM Magazine 329,344 ISSN-0954-478x

[590] Thatcher Mark, 'Delegation to Independent Regulatory Agencies: Pressures, Functions and Contextual Mediation' (2002)25(1) West European Politics 125,147 <https://doi.org/10.1080/713601588> accessed 14 January 2020

Lord Denning observed If we never do anything which has not been done before, we shall never get anywhere. The law will stand still whilst the rest of the world goes on; and that will be bad for both.[591] The legal structure for an accountability relationship is ex post since it constitutes the assessment of an act (or of its omission) that was already implemented by the monetary authority. Even if it takes into consideration previous parameters for the central bank's behaviour, this ex-ante element has properly a cognitive nature. In turn, the accountability's legal relationship implies the scrutinization of a discretionary action, based on parameters previously defined by a normative instrument. Furthermore, if monetary regulation is constituted as a process (a deferred exercise of power by central banks), the legal system for the policy's evaluation and judgement would also match its design, namely, a sequence of procedures.[592]

The Prudential Regulatory Authority, in the UK, has adopted a number of high-level principles of business including skills, integrity, care, banking prudence, diligence, market conduct, control and management, and the relations with the supervisors and regulators. These principles are policy based and highly determine the standards and rules in the banking sector. This allows the principles to be used as a justification for accessing and evaluating the sustainability and suitability of all applicants to be taken as approved in undertaking the banking services of the UK. The second principle holds that "a firm must conduct its business with due care, skill and diligence."[593]

In Pakistan, the Board of Directors of the Central Bank is entrusted to perform the functions[594] along with the Monetary Policy Committee, overseeing foreign exchange reserve management and approving strategic investment and risk policy, submitting a quarterly report to the Parliament on the state of the economy with special reference to economic growth, money supply, credit, balance of payment and price development. The very structure of the Board of Directors has significance of showing the role of the board in ensuring the stability within the banking system. The board consists of the Governor; Secretary Finance Division, Government of Pakistan; and eight directors, who shall be eminent professionals from the fields of economics, finance, banking, and accountancy, to be appointed by the Federal Government.[595]

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[591] Packer v Packer [1954] P. 15; [1953] 3 W.L.R. 33; [1953] 2 All E.R. 127

[592] Marie-Anne Frison-Roche, Le couple ex ante-ex post, justification d'un droit propre et spécifique de la régulation in Marie-Anne Frison-Roche (ed), Les engagements dans les systèmes de regulation (Paris: Dalloz, 2006) p.34).

[593] Ibid

[594] Section 9A The State Bank Act 1956

[595] Section 9 The State Bank Act 1956

CHAPTER 4: CONDUCT REGULATIONS VS. PRUDENTIAL REGULATIONS AND BASEL III: COMPARATIVE STUDY

4.1 INTRODUCTION

The need for conduct regulations in modern banking law became clear after the 2007-2009 crisis. conduct regulations guard against risky banking practices to avoid operational risks and systemic risks. In order to fully understand conduct regulations, it would be appropriate to discuss the meaning of "conduct" with reference to the risks. Conduct risk has been defined as

> "… the risk that the detriment is caused to the bank, customers, clients, or counterparties because of the inappropriate execution of business activities."[596]

In discussing the conduct of the banking market, the main emphasis should be on the supervision procedure and institutional framework, marketing and sales practices, charges and fees, disclosure, and the lack of transparency in lending. A central bank's conduct risk regulation model is developed, with consideration to all relevant criteria, and leads to a situation where commercial banks are compliant.[597]

In the UK, the regulation of conduct risk has been undertaken primarily to ensure that there is a proper and greater analysis and scrutiny for a transaction. A lot of work since the crisis, of 2008-2009, has focussed on strengthening the resilience of banking institutions and infrastructure. The spotlight is shifting towards market policies, industry culture, and individual behaviour.[598]

The conduct risk is now concerned with a more intrusive approach to regulations and supervision. The conduct regulations apply the codes of conduct devised by the Bank of England to ensure that their management and the board undertake banking practices in a manner which is appropriate for the market. Banks in the UK must show that their conduct practices are appropriate to the market conditions and that commercial banks are capable of

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[596] Barclays, 2012, 'Barclays PLC: Annual report 2012',
from http://reports.barclays.com/ar12/servicepages/downloads/files/entire_barclays_ar12.pdf, at 189 04 Feb 2015

[597] Hargarter, Antje, and Gary van Vuuren. "Assembly of a conduct risk regulatory model for developing market banks." South African Journal of Economic and Management Sciences 20, no. 1 (2017): 1-11. https://www.researchgate.net/publication/315931654_Assembly_of_a_conduct_risk_regulatory_model_for_developing_market_banks> accessed September 2019.

[598] Speech by Martin Wheatley, Chief Executive, FCA, Modelling integrity through culture, November 19, 2013

implementing them. This practice proves that in major jurisdictions including the UK, the regulation of conduct has been shifted from a desirable objective decision-making process to a process which has to take into account the rules of conduct and subjectivity of the decision based on the operations.[599]

Source: The State Bank[600]

The understanding of Conduct Regulations goes into the root of the decision-making process '… firms need to ask themselves the question: "should we" carry out a certain activity as well as "could we" do it.'[601] This implies that conduct risks have prompted the regulators and supervisors alike to undertake a plan to ensure that its regulations are capable of dealing with any special issues that may have arisen in the banking and financial sectors. The banks must comply with specified laws, guidelines and regulations developed by the central bank. It is likely that, in the absence of Prudential Regulations, deposit-takers, insurers and investment firms would be less resilient against failure and risk more disruption to the continuity of

[599] Norton Rose Fulbright, Beyond law: understanding the scope of conduct regulation (April 2014) Briefing. http://www.nortonrosefulbright.com/files/beyond-law-understanding-the-scope-of-conduct-regulation-115391.pdf 1 September 2017

[600] www.sbp.org.pk/events/2016/Naseer.pdf

[601] Speech by Clive Adamson, Trust and confidence – ensuring firms' ethics are built around their customers, November 12, 2013

Banking services, than is in the public interest.[602] It would be imprudent to think that any single institutional structure would be applicable to all banking sectors in various jurisdictions.[603]

There is a distinction between “Market Conduct Regulations” and “Prudential Regulations”. A prudential regulator is more concerned with the soundness and safety of banking while ensuring that there is a minimal adverse impact on the safety and the stability of the banking system in a country. On the other hand, conduct regulations are concerned with whether banking market is properly functioning and that the conduct of the banking institutions is appropriate.[604]

In conduct regulations, banking consumer protection has been taken to be a core part of the regulatory and supervisory framework. Even though the regulators and supervisors, in creating a sound banking system, have put more emphasis on corporate governance and prudential supervision, it may be maintained that bank supervisors should be able to develop this position and in the existing framework of governance to include proper Conduct Regulations.[605]

In 2013, the UK Prudential Regulations Authority ceased to function autonomously and its operations were placed under the hands of two regulators, namely, the Financial Conduct Authority which is the conduct regulator and the Prudential Regulatory Authority. Other Countries also have adopted this kind of banking regulations which is given the name of the Twin-Peak model. The Netherlands adopted the same in 2002, while Australia had already adopted this model in 1996.

In this chapter we will also discuss what regulatory model is followed by Pakistan to exercise “prudential supervision and control” over its commercial banks with a view to protecting the interests of investors and consumers.[606]

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[602] Bank of England, 2012, ‘Quarterly bulletin 2012 Q4: The prudential regulation authority’, http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/qb120405pre.pdf viewed 09 March 2015,
[603] Llewellyn, D.T., 2006, ‘Institutional structure of Banking regulation and supervision: The basic issues’, Paper presented at a World Bank seminar in Washington, DC, 6th and 7th June, viewed 23 February 2015, from http://siteresources.worldbank.org/INTTOPCONF6/Resources/2057292-1162909660809/F2FlemmingLlewellyn.pdf accessed 29 January 2020
[604] Bank of England, 2012, ‘(Quarterly bulletin 2012) Q4: The prudential regulation authority’ viewed 09 March 2015, from http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/qb120405pre.pdf
[605] OECD, 2011, G20 high-level principles on Banking consumer protection, viewed 25 February 2015, from http://www.oecd.org/regreform/sectors/48892010.pdf
[606] This questions also one of hypothesis of this thesis

4.2 MEANING AND THE MODES OF REGULATIONS MODEL

The regulation of banking institutions can be seen from a number of standpoints. It could be a joint stakeholder model where various supervisors, regulators, and other stakeholder work in unison in regulating the prudential aspects of banks and the conduct of banking or can be seen as a sector which is made up of separate bodies each undertaking a specific mandate in banking regulations. Regulations can also be seen as an act of intervention in a particular sector with the aim of achieving a desired goal such as sound practices. Banking regulations constitute a way by which most of the states regulate banking institutions and the banking sector to adhere to certain requirements, guidelines, and restrictions, which are geared to making the banking sector sound, more deepened, and transparent market.

Generally, financial regulation can be classified into prudential, systemic and conduct. The division is not clear cut, with some regulatory methods belonging to both. But the objective of regulations will usually fall into either or both objectives. Banking experts have argued that it would be a big illusion for one to presume that a particular framework for banking regulation is superior and could be applied to developing countries. The fact that a particular model is successful in a developing banking market may not produce desirable results by applying on others. This is because the banking structure, culture, and scope of operations by banks is different in every country.

There is no better institutional structure or regulatory model which has been shown to be unique, this is because the regulatory framework applied in a particular country cannot be used in another jurisdiction's banking sector. There are a variety of institutional structures hence a number of regulatory models.[607] While some countries have created a single agency to carry out both prudential and conduct regulations, others have taken the route of multiple agencies each undertaking either prudential or conduct regulation.

Systemic regulation is concerned with the safety and soundness of the overall financial system. Prudential regulation is to safeguard the safety and soundness of individual financial institutions for the purpose of protecting consumers.[608]

[607] Goodhart, C.A., Hartmann, P, Llewellyn, D. T., Rojas-Suarez, M, and Weisbrod, S (1999) Banking Regulation: Why, How and Where Now?, London, Routledge
[608] C Hadjiemmanuil and M Andenas, "Banking Supervision and European Monetary Union' (1999) Journal of International Banking Regulation 84-102

Prudential regulation occurs mainly from information asymmetry, which inhibits consumers from being able to make a valid assessment of the financial institution's financial condition. Financial institutions have a general fiduciary duty to consumers, requiring them to act with duty of care.[609] The working of prudential regulations is mostly based on the general objective of creating soundness and safety in the banking services at large.[610] On the other hand, conduct regulations are more inclined to consumer protection, the enhancement of integrity of the banking system, and maintaining competitive markets in the interest of the consumers.

4.2.1 Prudential Regulations

Methods of Prudential Regulation

The Basel Committee's Basel Core Principles provide a list of prudential regulations, but widely used methods of prudential regulation are minimum capital requirements, capital adequacy ratio, legal lending limits or large exposure limits, and fit and proper requirements of management.

Minimum capital requirement

The minimum capital requirement becomes significant when the required legal entity of a financial institution requires extra capital to be registered upfront. This is especially prominent for foreign financial institutions as the legal requirements for establishment will be specified. The minimum capital requirement may be higher for foreign firms, given their lack of trust in the local market and influence from headquarters.

Capital adequacy ratio (CAR)

Capital adequacy ratio is one of the most widely applied and cited methods of prudential regulation. Capital adequacy ratio was standardized by the Basel Committee on Banking

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[609] R Cranston, Principles of Banking Law (2nd edn, OUP, Oxford, 2002)
[610] See generally the functions of the Prudential Regulation Authority under the Banking Services and Markets Act 2000 (FSA), see also Fidelity, Corporate Governance – Banking Conduct Authority (2017) https://www.fidelity.co.uk/investor/about/corporate-governance/Banking-conduct-authority. accessed 2 September 2017

Supervision (Basel Committee) in 1988. The Capital Accord agreed that internationally active banks maintain a minimum 8 percent of their assets in capital. The Capital Accord was first published as a result of increasing pressure to create a "level playing field" for financial institutions competing in the global markets.

Initially, capital adequacy ratio was developed from the USA's CAMEL banking supervisory system. CAMEL is an acronym for Capital adequacy, Asset quality, Management, Earnings and Liquidity, the items it comprises. CAMEL was designed to enhance the objectivity of bank supervision, using these items to calculate a numerical index. While the supervisory method of each country is different, the items subject to monitoring would be more or less similar with CAMEL. Capital adequacy ratio is one of the main components of CAMEL.

Capital adequacy ratio has become the standard method of defining the strength of a financial institution. Capital acts as a cushion to absorb losses from credit risk. Capital adequacy is based on the concept that banks should have a certain amount of capital against their assets (loans).

Legal Lending Limit (LLL)

The legal lending limit is applied to limit the lending of a financial institution to single or connected parties. When the legal lending limit is not fully complied with, the lack of diversification in its investment portfolio may result in financial difficulties when an external shock is perceived. The lack of legal lending limit standards and/or the non-compliance with the legal lending limit is considered one of the main problems which exacerbated the Asian financial crises. Banks were lending heavily to corporates which were linked by family or political connections. Legal lending limits are being gradually brought to the level of 10-25 percent of bank capital.

Fit and Proper Test

The "fit and proper' test usually requires that management and the board of directors are vetted to ensure that they do not have past experience of badly managing a financial institution or are not persons with criminal records. The experience and integrity of the CEO are often examined to ensure that only competent professionals are allowed to manage banks.

Basel Committee's "Core Principles for Effective Supervision' state this as an evaluation of the competence, integrity, and qualifications of proposed management, including the board of directors. The licensing agency should obtain the necessary information about the proposed directors and senior managers to consider individually and collectively their banking experience, other business experience, personal integrity, and relevant skill. This evaluation of management should involve background checks on whether previous activities, including regulatory or judicial judgements, raise doubts concerning their competence, sound judgement, or honesty. It is critical that the bank's proposed management team includes a substantial number of individuals with a proven track record in banking.[611]

In summary, Prudential model concentrates on:

I. the rules and policies which have to be adhered to by banks and cover various aspects like liquidity, capital adequacy and leverage so as to help maintain a sound and effective regulatory framework for banking and banking stability;
II. the supervisory interventions and assessment to reduce the possibility of failure in a banking institution and to minimise the impact of such failures on the entire banking market; and
III. the other major area which Prudential Regulations cover is the mechanisms and policies which are geared to ensuring that there is a proper support mechanism for the reduction of systemic banking risks[612].

Since the prudential aspect is more concerned with the general principles of it, it has to take into account the regulatory principles very seriously. In ensuring that prudential care must be taken not to be strict in regulations and not to give the board and the management a wider scope to allow unsound practices. Efficiency, proportionality, sustainable growth, and equity are some of the considerations of macro and macro prudential guidelines. The primary focus of the prudential model is to focus on a large picture of a comprehensive scenario as compared to narrowing down on specific conducts. In that way, it seeks to ensure that there is stability and determine where there are risks so that supervisory and regulatory measures can be undertaken.

[611] Core Principe 3, Basle Committee, "Core Principles for Effective Banking Supervision' (September 1997).
[612] Allen & Overy LLP, The Prudential Regulation Authority- An Overview (1 April 2013), http://www.allenovery.com/SiteCollectionDocuments/The%20Prudential%20Regulation%20Authority%20April%202013.pdf accessed 2 September 2017

4.3 REGULATORY MODELS IN DEVELOPED & DEVELOPING COUNTRIES INCLUDING PAKISTAN

The UK model of regulation is based on the Twin Peaks: the UK has two separate bodies one which manages the prudential aspects of regulations and the other which handles the conduct of the banking system and financial institutions. There are other developing banking markets in Africa and Asia which have also adopted this model. South Africa adopted the Twin Peak model on the recommendations put forward by the Competition Commission Banking Enquiry.[613] This new development mandated the South African Banking Services Board to implement various directions such as the Treating Customers Fairly approach in order to enable the proper supervision of the banking industry as it welcomed the conduct regulations.[614] This is done by the Bank of England. The Bank of England Act 1998 s.2A states that: (1) An objective of the Bank shall be to protect and enhance the stability of the financial system of the United Kingdom (the "Financial Stability Objective"). (2) In pursuing the Financial Stability Objective, the Bank shall aim to work with other relevant bodies (including the Treasury, the Financial Conduct Authority, and the Prudential Regulation Authority.

Unlike Australia, the UK, South Africa, and others which have developed a model of regulation which separates the regulation of prudential aspects and conduct in banking; other countries like Malaysia and Kenya have sought to have a mode of regulation which is non-Twin-Peaks.

In Malaysia, the working of the banking sector is operated in a manner where the market conducts, consumer protection and the prudential regulations are governed by the central bank. The Malaysian system is basically a singular model, but there exists another level of regulation which may be compared to the Twin Peaks structure. The Central Bank Regulations and this system are designed to ensure that proper checks and balances are in place so that the working of the central bank is not jeopardised; furthermore, these checks and balances are the ones which ensure that the efforts put into safety, soundness and consumer protection are in line with the two major regulatory models, that is, conduct regulation and prudential regulation. The model in Malaysia is designed in a manner which separates prudential from conduct

[613] South Africa. Competition Commission, 2008, Banking Enquiry Panel report makes recommendations for a more competitive banking sector, viewed 29 March 2015, from http://www.compcom.co.za/wp-content/uploads/2014/09/PR3.doc
[614] South Africa. National Treasury, 2015, 'Treating customers fairly in the Banking sector: A draft market conduct policy framework for South Africa', public workshops, March 2015, [PowerPoint Presentation], (Unpublished).

supervision although the two reside in the central banks' Banking Intelligence and Enforcement Department.[615]

Other developing markets like Kenya do not follow any of the aforementioned models i.e., the single regulatory Model or the Twin Peaks. The country's regulatory measures for the banking sector are different, the supervision of banks is done separately with the Central Bank of Kenya (CBK), but there is a framework which allows integration of conduct and prudential supervision of all the other Banking regulators within the working of the Banking Services Council.[616] In 2013, the Central Bank of Kenya published different sets of risk management responsibilities and prudential guidelines. Since it is the main banking regulator in Kenya it also included within these guidelines such as consumer protection and reputational risks in banking. All the major regulators and supervisory powers in terms of conduct and good governance are in the hands of the central bank. The Central Bank Act of Kenya[617] and the Banking Act of Kenya[618] provides the CBK with discretionary powers and remedial powers in supervising and regulating the banking sector. These wider powers cover everything from conduct management, corporate governance and prudential guidelines, consumer protection, etc.[619]

Pakistan's current regulatory architecture is best described as semi-amalgamated. Supervision rests with two main regulators: The State Bank and the Security & Exchange Commission of Pakistan (SECP). Under the existing architecture, supervisory responsibilities for banks, Development Finance Institutions (DFIs), Microfinance Banks (MFBs), and exchange companies reside with the State Bank, while the rest of the financial institutions (including capital markets/securities, non-bank finance companies, insurance companies, and pension funds) are supervised by the SECP.[620] In Pakistan, the Central Bank has adopted the Twin Peak

[615] Ali, S., 2014, 'Institutional framework on market conduct and consumer protection', Presentation at the BNM-AFI Conference in June 2014, [PowerPoint Presentation], (Unpublished).
[616] Central Bank of Kenya, 2013a, Prudential guidelines, 2013,
v https://www.centralbank.go.ke/images/docs/legislation/Prudential%20Guidelines-January%202013.pdf
Central Bank of Kenya, 2013b, Risk management guidelines, 2013,
from https://www.centralbank.go.ke/images/docs/legislation/risk-management-guidelines-january-2013.pdfCentral Bank of Kenya, 2014, National Payment Systems Regulations 2014,
from https://www.centralbank.go.ke/images/docs/legislation/NPSRegulations2014.pdfCentral Bank of Kenya, 2015, Bank supervision, from https://www.centralbank.go.ke/index.php/bank-supervisionCapital Markets Authority Kenya, 2014, Capital market master plan 2014 to 2023,
from http://www.cma.or.ke/index.php?option=com_docman&task=doc_download&gid=293&Itemid=102 All links accessed in March 2015
[617] The Cantral Bank of Kenya Act Chapter 491 of the Laws of Kenya
[618] The Banking Act Chapter 488 if the Laws of Kenya
[619] Fn. 616
[620] www.sbp.org.pk/fsr/2008/PDF/Chapter%206%20Framework%20for%20Consolidated%20Supervision.pdf

model not by setting up two separate institutions but by setting up a different array of issuing regulatory instructions by various departments of The State Bank of Pakistan.[621] The banking supervision departments viz. Banking Policy and Regulations Department (BPRD), Banking Surveillance Department (BSD), Off-Site Supervision and Enforcement Department (OSSED) and Banking Inspection Department (BID) have been assigned this important function to work jointly and severally to ensure the soundness of individual banks and of overall banking industry.[622]

4.3.1 Supervisory Tools apply by the State Bank of Pakistan

In order to identify potential risks that may impact the safety and soundness of an institution and assess the suitability of various supervisory actions, The State Bank relies on a variety of supervisory tools to carry out this work such as Regulations, On-site Assessment, Off-site Supervision, Surveillance and Enforcement & Resolution.

4.3.1.1 On-site Assessment

On-site assessment is the most critical supervisory tool employed by the State Bank to have a good understanding of the institution's business, identify potential risks that may impact institution's reputation, safety, and soundness and to assess the suitability of various supervisory actions. On-site assessment may be a full scope inspection, limited/ focused review or thematic. Besides that, The State Bank also periodically assesses Information Systems and overseas operations of the financial institutions. Apart from these regular on-site assessments The State Bank, under Banking Companies Ordinance, also reviews cases of loans written off by the financial institutions. The on-site assessment methodology involves analysis of Capital, Asset Quality, Management, Earnings, Liquidity and System & Controls broadly on the following parameters:

Capital: It is evaluated in relation to SBP's capital adequacy requirements and overall financial condition of the bank.

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[621] http://www.sbp.org.pk/about/SupRegime-SBP.PDF
[622] Syed Salim Raza, 'Pakistan Branchless Banking Conference (2010)Governor, The State Bank of Pakistan < http://www.sbp.org.pk/MFD/pbbc/Salim-Raza.pdf> accessed 2020

Asset Quality: This is evaluated in relation to the level, distribution, trend, severity of adverse classifications and non-performing assets; the adequacy of provisions (general and/or specific); and management's demonstrated ability to identify, monitor, administer, and collect problem advances and other such assets.

Management: It is evaluated against all factors necessary to operate an institution in a safe and sound manner and thus protect depositors' funds in accordance with acceptable practices.

Earnings: It is examined on the basis of quantity and quality of earnings and the ability to support present and future operations; coverage of losses and build-up of adequate capital; level and trend of profits; and quality with regards to composition of core earnings and recurring nature of profits.

Liquidity: This factor is examined in relation to the overall effectiveness of asset and liability management. These areas are reviewed especially with regard to compliance with cash reserve requirement and liquid asset requirement ratios as well as performance with regard to borrowings, structure, and stability of deposits.

Systems and Controls: The evaluation methodology of SBP includes an assessment of the adequacy of the systems and methodologies followed, the inherent degree of an institutionalized approach and an analysis of the contribution made to the control processes at various organizational levels.

4.3.1.2 Off-site Supervision

Off-site supervision is another important and critical supervisory tool of The State Bank of Pakistan and is also used to reinforce the on-site assessment. It is a continuous supervision process wherein regular meetings with the institutions are held, audit reports on the institutions and regulatory returns are reviewed and key financial indicators and business developments are monitored. The off-site assessment is primarily based on the quarterly data submitted on-line by banks through The State Bank's Data Acquisition Portal under Reporting Chart of Accounts. In addition, non-financial data such as minutes of Board meetings are also analysed. Based on available financial and non-financial data, a quarterly off-site assessment of the

financial institutions is made. This assessment is used for supervisory and surveillance purposes.

The State Bank is empowered to take regulatory actions against those institutions that breach rules, regulations or instructions issued by it under various statutes. These actions may range from imposition of penalties, administrative & financial sanctions, and reference to concerned law enforcement/prosecution agencies. The State Bank also imposes monetary penalties under the relevant provisions of law. Other enforcement actions depend upon the nature, severity and continuity of regulatory breaches and risks posed to the institution and may range from mild to severe. The nature of intervention or corrective actions also takes into consideration behaviour and ability of the institution's management and sponsors, and the previous record of dealing with deficiencies.

The failure to implement mild corrective actions by the institutions leads to initiation of severe corrective measures. Severe actions may require the institution to, inter alia: follow any particular policy in relation to advances, deposits etc; maintain higher level of liquid assets; increase the capital level by a specified amount; remove any key executive/ board of directors; reconstruct/amalgamate the institution; cancel the license and wind up the institution through decree obtained by the High Court.

Banks and development finance institutions exposure to the equity market is governed by a Prudential Regulations which disallows exposures against the security issued by the bank itself or those by prospective borrowers themselves. Banks investment in any single scrip is limited to 5% of their own equity with total investment in listed shares capped at 20%. The margin requirement against the security of shares of listed companies has been set at 30%. Notwithstanding these broader restrictions, banks are allowed to set up or take higher stakes in their subsidiaries that can be formed for specified purposes like asset management, brokerage, etc. This allows banks to diversify their business interests but operate as a separate business entity. Consistent with normal practices, the regulatory framework for banks is all encompassing and covers a broad spectrum of elements which can be classified in six different categories defining; (i) entry requirements, (ii) risk management guidelines, (iii) corporate governance framework, (iv) industry specific guidelines, (v) operational guidelines and (iv) anti money laundering regime. Proper enforcement of the regulatory framework has been helped by a strong State Bank's independent supervisory and surveillance mechanism and

validation process of the external auditors. Effective oversight has induced banks to enhance their corporate governance and compliance with laws and regulations that also follow international accounting and disclosure standards. Despite these achievements, both central bank and banks have to continue with broadening and deepening of structural reforms to help enhance financial services penetration and address the outstanding vulnerabilities in the system, while facilitating industry smooth adoption of risk measurement and management systems advocated under Basel II.[623]

The Central Bank in Pakistan protects the interests of investors and consumers by exercise "prudential supervision and control" over the banking system which is obliged to follow Prudential regulations:

4.3.2 Implementation of Prudential Regulations in Pakistan

On 26 June 2014, The State Bank vide BPRD Circular No. 06 of 2014 issued revised Prudential Regulations.[624] It contained 10 regulations dealing with the risk and five regulations for the operation of the banking system in Pakistan. These regulations have now been further revised and the current prudential regulations are updated on 03 August 2016.[625] The current regulations have also consolidated separate sector based prudential regulations such as prudential regulations for microfinance banks, housing finance and agriculture finance etc.[626] The prudential regulations reproduced hereunder also mutatis mutandis apply to other sector-based regulations.

These prudential regulations impose minimum requirements to strengthen the risk management processes through establishing comprehensive credit risk management systems appropriate to their type, scope, sophistication, and scale of operations and require the Board of Directors of the banks/DFIs to establish policies, procedures, and practices to define risks, stipulate responsibilities, specify security requirements, design internal controls, and then ensure strict compliance with them.

[623]https://www.bis.org/review/r070319d.pdf
[624] www.sbp.org.pk/bprd/2014/C6-PRs.pdf
[625] www.sbp.org.pk/publications/prudential/PRs-Consumer.pdf
[626]https://www.sbp.org.pk/publications/prudential/index.htm

4.3.2.1 Part B: Pre-Operations Obligations

Before embarking upon or undertaking of consumer financing Banks are obligated to comply with following policies:

1. Banks/DFIs shall establish separate risk management capacity for the purpose of consumer financing that should be commensurate with the size, scope and complexity of the consumer finance business and suitably staffed by personnel having sufficient expertise and experience in the field of consumer finance/business.
2. The banks/DFIs shall prepare comprehensive consumer credit policy duly approved by their Board of Directors which shall inter alia cover credit initiation principles, loan administration including documentation, disbursement, effective monitoring, and appropriate recovery mechanism. The policy shall explicitly specify the functions, responsibilities, and various staff positions' powers/authority relating to approval/sanction of consumer financing facility.
3. Islamic Banking Institutions (IBIs) offering Shariah compliant consumer financing products shall have their comprehensive consumer credit policy duly approved by the Shariah Board in addition to their board of directors. IBIs shall also have an efficient Shariah review and compliance mechanism; and their Risk Management Department shall inter-alia consider shariah non-compliance risks while processing the consumer financing application.
4. For every type of consumer finance product, the bank/DFI shall develop a specific product program. The program shall include the objective/quantitative parameters for the eligibility of the borrower and determining the maximum permissible financing limit per borrower.
5. Banks/DFIs shall put in place an efficient and adequately automated computer-based MIS for the purpose of consumer finance, which should be commensurate with the size, scope, complexity of the consumer finance business and be able to effectively cater to the needs of consumer financing portfolio. It should be flexible enough to generate necessary information reports used by the management for effective monitoring of the bank's/DFI's exposure in the area. The MIS is expected to generate the following periodical reports:

- Delinquency reports (for 30, 60, 90, 180 & 360 days and above) on a monthly basis. Depending upon the size and scope of consumer finance business and underlying risks, the delinquency reports should be interrelated in respect of various types of customers, or various attributes of the customers, to enable the management to take important policy decisions and make appropriate modifications in the lending program.
- Quarterly product wise profit and loss account duly adjusted with the provisions on account of classified accounts. These profit and loss statements should be placed before the board of directors in the immediate next board meeting. The branches of foreign banks in order to comply with this condition shall place the reports before a committee comprising of at least CEO/Country Manager, CFO, Head of Consumer Business and Head of Risk Management.

6. The banks/DFIs shall develop comprehensive recovery procedures for the delinquent consumer financing facilities. The recovery procedures may vary from product to product. However, distinct, and objective triggers should be prescribed for taking pre-planned enforcement/recovery measures.
7. The banks/DFIs desirous of undertaking consumer finance will become a member of at least one Consumer Credit Information Bureau. Moreover, the banks/DFIs may share information/data among themselves or subscribe to other databases as they deem fit and appropriate.
8. The financial institutions starting consumer financing are encouraged to impart sufficient training on an ongoing basis to their staff to raise their capability regarding various aspects of consumer finance.
9. The banks/DFIs shall prepare a standardized set of borrowing and recourse documents (duly cleared by their legal counsels) for each type of consumer financing.
10. Banks/DFIs carrying out consumer finance, in coordination with their association (Pakistan Banks' Association), shall develop a common glossary of important terms along with their definitions, in both English & Urdu Versions.

4.3.2.2 Operations:

1. Consumer financing, like other credit facilities, must be subject to the bank's/DFI's risk management process setup for this particular business. The process may inter alia include, identifying source of repayment and assessing customers' ability to repay, his/her past dealings with the bank/DFI, the net worth, objectives of obtaining finance and information obtained from a Consumer Credit Information Bureau. Further, Banks/DFIs are encouraged to also incorporate the extent of fixed & variable expenses of the borrower in credit assessment for better risk management. Banks/DFIs are expected to take reasonable steps to assess and verify the income of borrowers through different modes and depending upon the underlying risks, review, and update income assessment mechanism on a periodic basis. The reasonable timeline for periodical review of income assessment mechanisms shall be specified in the relevant board approved policy.
2. Before allowing any facility, the banks/DFIs shall obtain a consumer credit report(s) from the Credit Information Bureau of The State Bank of Pakistan or from any consumer Credit Information Bureau(s) of which they are member, provided the report(s) incorporates credit data reported by all Banks/DFIs. The report(s) will be given due weightage while making credit decisions.
3. At the time of granting finance facility under various modes of consumer financing, banks/DFIs shall obtain a written declaration on the prescribed format attached as Annexure CF-1 from the borrower divulging details of various finance facilities already obtained from other banks/financial institutions. However, where this information is already part of the loan application form, requirement of obtaining undertaking as per annexure CF-1 may be waived. The banks/DFIs should study the details reported by the customer in financing facility application form/undertaking and allow fresh finance/limit only after ensuring compliance with the limits, set in these PRs, for exposure and for total monthly amortization payments of consumer financing. This should help banks/DFIs to capture information on the finance facilities availed by the customer between the latest available credit information bureau report and financing facility application date.
4. Banks/DFIs shall provide to the customer the statement of account at appropriate intervals e.g., on monthly basis to the credit card/revolving credit customers, unless there has been no transaction or no outstanding balance on the account since last statement, and at least yearly to other product customers. The statement of account of credit card customers should reflect the movement of reward points, if applicable.

5. A detailed repayment schedule, where payment is due in instalments, should be provided to the borrower at the outset. Where alterations become imminent because of prepayments, change in benchmark rate or any other reason, the revised schedule should be provided to the borrower at the earliest convenience of the bank/DFI but not later than 15 days of the change. Further, even in case of insignificant changes, upon the request of the customer, the bank/DFI shall provide him revised repayment schedule free of cost at least once.
6. Internal audit and control function of the bank/DFI, apart from other things, should be designed and strengthened so that it can efficiently undertake an objective review of the consumer finance portfolio from time to time to assess various risks and possible weaknesses. The internal audit should also assess the adequacy of the internal controls and ensure that the required policies and standards are developed and practiced. Internal audit should also comment on the steps taken by the management to rectify the weaknesses pointed out by them in their previous reports for reducing the level of risk.
7. Banks/DFIs are encouraged to consider the feasibility of adopting the tiered mark-up rates or risk-based pricing according to the credit worthiness of individual borrowers. For instance, banks/DFIs may, inter alia, consider credit history, purchase patterns & month-on book in credit cards, payment behaviour, loyalty, cost of borrowings and product profitability in assessing feasibility of tired mark-up rates. However, banks/DFIs having a regular consumer finance portfolio of more than Rs1.0 billion (outstanding amount) should prepare and present such a feasibility report to the Board Risk Management Committee for review and information; and update the same every year thereafter.
8. The banks/DFIs shall ensure that their accounting and computer systems are well equipped to avoid charging mark-up on mark-up. For this purpose, it should be ensured that the mark-up/profit charged on the outstanding amount is kept separate from the principal.
9. The banks/DFIs shall ensure that any repayment (full or partial) made by the borrower is accounted for, as per agreed terms and conditions, before applying mark-up/profit on the outstanding amount.
10. To bring uniformity in calculation and reporting of Days Past Due (DPDs), Banks/DFIs shall ensure that counting of DPDs for all consumer financing products starts from payment due date. For a missed payment, or payment less than minimum due amount, first DPD shall be the very next day of payment due date.

11. Banks/DFIs shall not increase a borrower's aggregate credit limit, for revolving facilities (credit card/overdraft/finance facilities of similar product structure), unless the borrower has specifically requested for the limit enhancement.
12. Banks/DFIs, with last four quarters consumer finance outstanding portfolio in excess of Rs.5 billion, are encouraged to perform affordability assessment tests on (reasonably representative) samples of consumer finance portfolio with variable mark-up/profit rate. Affordability assessment test may include the shock to customer's ability to repay (e.g., DBRs) the financing facility based on plausible changes in interest rates as observed during the last business cycle. The results of the affordability test will be presented to the Board Risk Management Committee for review and analysis at least once a year.

4.3.3 Disclosures

1. The banks/DFIs must clearly disclose, all the important terms, conditions, fees, charges, and penalties, which inter alia include Annualized Percentage Rate, prepayment penalties and the conditions under which they apply. For ease of reference and guidance of their customers, banks/DFIs are encouraged to publish brochures regarding frequently asked questions.
2. Minimum Payment Due (MPD) of the credit card or of any other product of revolving credit nature shall be sufficient, so as to avoid the negative amortization. Banks/DFIs shall also specify in their relevant approved policies, minimum percentage of principal repayment included in minimum payment due and disclose the same in Key Fact Sheet.

4.3.4 Part C: Regulation

4.3.4.1 Regulation R-1 Facilities to Related Persons and Proper Utilization of Clean Financing Facilities

The consumer finance facilities extended by banks/DFIs to their directors, major shareholders, employees, and family members of these persons shall be at arm's length basis and on normal terms and conditions applicable for other customers of the banks/DFIs

4.3.4.2 Regulation R-2 Limit on Exposure against total consumer financing

Banks/DFIs shall ensure that the aggregate exposure under all consumer financing facilities at the end of first year and second year of the start of their consumer financing does not exceed 2 times and 4 times of their equity respectively. For subsequent years, following limits are placed on the total consumer financing facilities:

Percentage of Classified Consumer Financing to Total Consumer Financing	Maximum Limit
a) Below 3%	10 times of the equity
b) Below 5%	6 times of the equity
c) Below 10%	4 times of the equity
d) 10% & above	2 times of the equity

4.3.4.3 Regulation R-3 Total Financing Facilities to be Commensurate with the Income

While extending financing facilities to their customers, the banks/DFIs should ensure that the total instalment of the financing facilities extended by the financial institutions is commensurate with monthly income and repayment capacity of the borrower. In this regard, while determining the creditworthiness and repayment capacity of the prospective borrower, the banks/DFIs shall ensure that the total monthly amortization payments of consumer financing facilities should not exceed 50% of the net disposable income of the prospective borrower.

4.3.4.5 Regulation R-4 General Reserve against Consumer Finance

The banks/DFIs shall maintain a general reserve at least equivalent to the percentages given below of both secured and unsecured consumer finance portfolio (net of cash collateral, govt. securities and gold), to protect them from the risks associated with the economic cyclical nature of this business.

The above reserve requirement will, however, be maintained for the performing portion only of the consumer portfolio.

Category of Financing	NPL / Gross Loans	Rate of General Provision
Un-secured portfolio	Ratio ≤ 5%	4.0%
	5% < Ratio ≤ 10%	5.0%
	10% < Ratio ≤ 20%	6.0%
	Ratio > 20%	7.0%
Secured Portfolio	Ratio ≤ 5%	1.0%
	5% < Ratio ≤ 10%	1.5%
	10% < Ratio ≤ 20%	2.0%
	Ratio > 20%	2.5%

4.3.4.6 Regulation R-5 Rescheduling/Restructuring of Performing/Non-performing Consumer Finance Facilities

Banks/DFIs should frame policy for rescheduling/ restructuring of consumer financing facilities including non-performing financing facilities. The Policy should inter-alia include definition and types of rescheduling/restructuring, criteria to assess the financial distress or income impairment warranting the rescheduling / restructuring, the reduced mark-up/profit rates applicable on restructured accounts and specify the limits on the amount of rescheduled / restructured performing financing facilities as percentage of total outstanding consumer financing.

4.3.4.7 Regulation R-6 Classification & Provisioning of Receivables

Receivables outstanding in other assets or any other head of balance sheet, on account of, insurance or takaful / recovery charges / or any other item (other than those amounts which are already transferred to memorandum account) against the non-performing loans/financing facilities shall also be classified with 100% provisions maintained their against.

4.3.4.8 Regulation R-7 Margin Requirements

Banks/DFIs are free to determine the margin requirements on consumer facilities provided by them to their clients taking into account the risk profile of the borrower(s) in order to secure their interests. However, this relaxation shall not apply in case of items, import of which is

banned by the Government. Banks/DFIs will continue to observe margin restrictions on shares/TFCs as per existing instructions under Prudential Regulations for Corporate/Commercial Banking.

4.3.4.9 Regulation R-8 Maximum Clean Limit for Credit Card and Personal Loan/Financing from All Banks/DFIs

Banks/DFIs may take total clean exposure on a customer under Credit Card and Personal loan/financing up to PKR2,000,000 in aggregate from all banks/DFIs. Further, banks/DFIs shall also ensure that overall credit card and personal loan/financing limits, both on secured as well as on unsecured basis, availed by one person from all banks/DFIs in aggregate should not exceed PKR5,000,000, at any point in time.

4.4 NEEDS AND ADVANTAGE OF REGULATIONS

The need for banking regulations premised on protecting the banking sector can be outlined in a number of ways: first the need is based on the reason that the banking sector is a crucial area in the economic development of a country and further this sector is interconnected with the entire financial sector such as capital markets, insurance, real estate, etc.[627] The importance of the banking system is also seen in the way which can adversely affect the entire markets globally.[628]

The first and second chapter contains detailed discussion explaining the major role that a banking sector plays in any economy; a banking systemic failure can cause the state to use taxpayers' money in bail outs. The principal reason for regulating the banking sector is prevention of economic risks which may arise due to failing of the banking sector. Further, the regulation of the banking sector has a major role in the economy and also in facilitating the other markets like insurance, real estate, fund management, and even capital markets. Hence it is in the best interest that for these markets to perform to their peak the banking sector must be kept under proper supervisions and free of risks.

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[627] Demirgüç-Kunt, Asli, and Enrica Detragiache. "The determinants of banking crises in developing and developed countries." Staff Papers 45, no. 1 (1998): 81-109. http://policydialogue.org/files/publications/Determinants_of_Banking_Crises.pdf> accessed 2 August 2019

[628] Mishkin, Frederic S. The economics of money, banking, and Banking markets. Pearson education, 2007; Pagano, https://ojs.uniroma1.it/index.php/PSLQuarterlyReview/article/view/10195> accessed 20 July 2020 Marco. "Banking markets and growth: an overview." European economic review 37, no. 2-3 (1993): 613-622. http://www.csef.it/pagano/eer-1993.pdf> accessed 20 June 2020

Thus, for a banking sector to be kept sound and to protect the entire sector, there is a need for a regulator and regulations containing stringent rules for corporate governance, banking conduct and practices. The advantage of regulation is that the banking sector can be set to operate at a level which is beneficial to itself in terms of having a return on Investments which is desirable to attract investment and at the same time caution the sector from systemic risks, predatory practices, and liquidity problems.[629] Regulations are to ensure that there is better equity and liquidity leading to less crises and bursts.[630] Apart from creating sound banking shielding the banking sector, the need for regulating the banking sector is to create a level of accountability on the part of the management and the board to the shareholders and investors ensuring that there is faith and confidence whereby more investments in the sector will take place.[631]

4.5 Regulations & Basel Accord

The Basel Committee - initially named the Committee of Banking Regulations and Supervisory Practices - was established by the central bank governors of the group of ten countries at the end of 1974 in the aftermath of serious disturbances in international currency and banking markets, notably the failure of Bankhaus Herstatt in West Germany.[632] The Committee meets three to four times a year, since its formation in February 1975 at its headquarter at the Bank for International Settlements in Basel, to enhance Banking stability by improving the quality of banking supervision worldwide and to serve as a forum for regular cooperation between its member countries on banking supervisory matters.

Since its inception, the Basel Committee has expanded its membership from the G10 to 45 institutions from 28 Countries. The Committee has established a series of international standards for bank regulation, most notably its landmark publications of the accords on capital adequacy which are commonly known as Basel I, Basel II and, most recently, Basel III.

[629] Ju, Xiaosheng, and Dic Lo. "The cost and benefit of banking regulations and controls, Chinese style." PSL Quarterly Review 65, no. 263 (2012).
[630] Admati, Anat R. "The compelling case for stronger and more effective leverage regulation in banking." The Journal of Legal Studies 43, no. S2 (2014): S35-S61 https://www.journals.uchicago.edu/doi/abs/10.1086/677557?mobileUi=0> accessed 20 July 2020
[631] Morrison, Alan D., and Lucy White. "Reputational contagion and optimal regulatory forbearance." Journal of Banking Economics 110, no. 3 (2013): 642-658 Working Paper < https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1196.pdf> accessed o2 August 2020.
[632] http://www.bis.org/bcbs/history.htm>

The preamble to the Basel framework makes clear that it is to be applied on a consolidated basis to internationally active banks. The extent to which individual supervisors will apply the Basel requirements to individual banking subsidiaries, particularly if these are in the same jurisdiction as the holding company, depends on local rules, but within the European Economic Area this is expected to be the case.[633]

4.5.1 Basel I: the Basel Capital Accord

In the early 1980s, the onset of the Latin American debt crisis heightened the Committee's concerns that the capital ratios of the main international banks were deteriorating at a time of growing international risks. There was strong recognition within the Committee of the overriding need for a multinational accord to strengthen the stability of the international banking system and to remove a source of competitive inequality arising from differences in national capital requirements. Following comments on a consultative paper published in December 1987, a capital measurement system commonly referred to as the Basel Capital Accord was approved by the G10 Governors and released to banks in July 1988.

The 1988 Accord called for a minimum ratio of capital to risk-weighted assets of 8% to be implemented by the end of 1992. Ultimately, this framework was introduced not only in member countries but also in virtually all countries with active international banks.

4.5.2 Basel II: The New Capital Framework

In June 1999, the Committee issued a proposal for a new capital adequacy framework to replace the 1988 Accord. This led to the release of a revised capital framework in June 2004. Generally known as "Basel II", the revised framework comprised three pillars:

1) the First Pillar - the determination of eligible capital and minimum capital requirements in relation to the credit risk, operational risk and market risk taken by the bank;
2) the Second Pillar - the supervisory review process, designed to ensure that other risks are taken into account in supervisory interaction with banks; and
3) the Third Pillar - market discipline, achieved through disclosure of information to its peers in respect of the risks taken by a bank.

[633] Basel II: a briefing for practitioners, C.O.B. 2004, 21(Nov), 1-41

4.5.2.1 The objectives of Basel II

According to Professor Douglas W. Arner, Basel II was intended to provide an overall system of risk-based supervision and risk management (internal and market) for banks. In attempting to do so, Basel II focused on five categories of risk: (1) credit; (2) market; (3) operational; (4) liquidity; and (5) legal. To that end, Basel II framework involved four levels of banking supervisory mandates as well as banks' internal functions: (i) identification of risk; (2) risk management; (3) risk disclosure; and (4) internal risk management.[634]

The Basel Committee has stated that its fundamental objective in revising the 1988 Accord was: …. "to develop a framework that would further strengthen the soundness and stability of the international banking system while maintaining sufficient consistency that capital adequacy regulation will not be a significant source of competitive inequality among internationally active banks."

Basel II was not intended to increase the overall requirements for capital in the banking system, but rather to ensure that capital requirements better reflected the risks inherent in that system. More detailed objectives included[635]:

(i) the promotion of stronger risk management practices by the banking industry;

(ii) the development of "more risk-sensitive capital requirements that are conceptually sound" while at the same time having regard to particular features of the present supervisory and accounting systems in individual countries;

(iii) a desire in particular to develop a more risk-sensitive and prudent approach to exposures arising from securitisations, both those of the originating lender and those exposures created by investment in securitisations originated by other banks;

(iv) greater reliance on assessments of risk provided by banks' internal systems as

[634] Douglas W. Arner, Financial Stability, Economic Growth, and the Role of Law (New York: Cambridge University Press, 2007), at p. 212

[635] Basel II: a briefing for practitioners, C.O.B. 2004, 21(Nov), 1-41

inputs to capital calculations; and

(v) inclusion of a range of options to allow banks to select approaches to determining capital requirements that are most appropriate for their operations and their financial market infrastructure, as well as a limited degree of national discretion to adapt the standards to different national markets.

4.5.2.2 Eligible regulatory capital

This comprises both equity shareholders' funds and subordinated debt, and also in some circumstances includes general loan loss provisions of up to 1.25 percent of risk-weighted assets. It is subject to deductions of significant minority and majority investments in commercial investments which exceed materiality levels, and also to deductions for goodwill and other intangible assets.

4.5.2.2.1 Tier 1 capital

The principle was established in the 1988 Basel Accord that 50 percent of eligible regulatory capital should comprise equity capital and published reserves (including minority interests subject to certain constraints). This represents what is conventionally regarded as equity shareholders' funds, though excluding revaluation reserves. Certain forms of innovative hybrid capital instruments can also be included within Tier 1, as explained further below. The key criterion for inclusion within Tier 1 is the ability of the capital instruments to absorb losses (before they impact creditors of the bank).

4.5.2.2 Tier 2 capital

Supplementary capital, now more generally known as Tier 2, includes unpublished or hidden reserves, revaluation reserves, general loan loss provisions subject to the limitations described above, hybrid capital instruments and subordinated term debt with an original maturity of more than five years, suitably amortised, and with an upper limit for subordinated debt of 50 percent of Tier 1 capital. Certain innovative capital instruments can also be included in Tier 1 subject to stringent conditions and a maximum of 15 percent of Tier 1 capital.

4.5.2.3 **Tier 3 capital**

In addition, short-term subordinated debt can be used as Tier 3 capital. Such short-term debt because of its short-term nature is not regarded as so well able to absorb losses, but Tier 3 capital is regarded as regulatory capital solely to meet part of the eligible capital requirements in respect of market risk. Such capital will be limited to 250 per cent of a bank's Tier 1 capital that is required to support market risks. In addition, such capital must:

(a) be unsecured, subordinated and fully paid up;
(b) have an original maturity of at least two years;
(c) not be repayable before the agreed repayment date unless the supervisor agrees; and
(d) be subject to a lock-in clause which stipulates that neither interest nor principal may be paid (even at maturity) if such payment means that the bank falls below or remains below its minimum capital requirement.

4.5.3 Risk-weighted assets

The determination of risk-weighted assets (" RWAs") involves more complex calculations. These require first the computation of capital requirements for market risk and operational risk, which are multiplied by 12.5 (the reciprocal of the minimum capital ratio of 8 per cent). This amount is then added to the sum of risk-weighted assets determined by the approach to credit risk which has been adopted, for comparison with eligible regulatory capital. This calculation lies at the heart of the Basal approach: the desire for more risk-sensitive capital requirements is principally satisfied by the greater sophistication of the approach to credit risk and to operational risk.[636]

4.5.4 The approach to credit risk in Basel

There is an increased risk sensitivity in respect of credit risk which can be seen in what is described by Basel as "the Standardised Approach": an approach which involves the measurement of credit risk in a standardised manner, supported by external credit assessments.

[636] Basel II: a briefing for practitioners (n 635) p.5

There is also a "Simplified Standardised Approach" to credit risk within the Basel framework, which provides for a simpler means of calculating minimum capital requirements without compromising capital strength. This is contained in Annex 9 to the Basel framework.[637]

4.5.4.1 The internal ratings-based approach

The alternative internal ratings-based approach (" IRB") is introduced by Basel in its revised framework as follows: "Subject to certain minimum conditions and disclosure requirements, banks that have received supervisory approval to use the IRB approach may rely on their own internal estimates of risk components in determining the capital requirement for a given exposure. The risk components include measures of the probability of default (PD), loss given default (LGD), the exposure at default (EAD), and effective maturity (M). In some cases, banks may be required to use a supervisory value as opposed to an internal estimate for one or more of the risk components."

4.5.4.2 Securitisations

One of the objectives stated by several Basel Committee members was that of addressing anomalies created since the 1988 Accord by the rapid development of securitisations, and the complexity of the exposures taken by banks to securitisation vehicles both as originators (and sellers) of loans, and as investors in other banks' securitisation vehicles. The approach in the revised Basel framework goes some way to reflecting the economic substance of such exposures rather than their legal form. Securitisation was not specifically covered in the 1988 Basel Accord and its subsequent amendments and therefore the development of capital requirements for securitisation was seen by the Basel Committee as an important priority. The reasoning for separate capital treatments for securitisation is derived from: (1) the specific credit nature of the exposures which is dependent on the credit standing of the underlying securitised assets; and (2) the supervisors' objective to curb opportunities for capital arbitrage where banks avoid (through securitisation) maintaining regulatory capital relevant to the residual risks to which they are exposed.[638]

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[637] Basel II: a briefing for practitioners (n 635) p.5
[638] Basel II: a briefing for practitioners (n 635) p. 11

4.5.4.3 Operational risk

Operational risk is defined as “the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events. This definition includes legal risk but excludes strategic and reputational risk.” Basel permits them to choose one of four methodologies for the computation of a capital requirement for operational risk:

(a) the Basic Indicator approach;
(b) the Standardised approach;
(c) the Alternative Standardised approach; and
(d) the Advanced Measurement approach.[639]

4.5.4.4 Market risk

The final input to the minimum capital requirements under the First Pillar is market risk. Market risk covers the various market risks run by a bank’s trading books interest rate, equity, foreign exchange, and commodity risk.

4.5.5 The Second Pillar

The Second Pillar, “Supervisory Review”, is intended not only to ensure that banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing their risks. It is inevitably a far more subjective aspect of the revised framework than the First Pillar, and is one that will present a greater challenge to supervisors in resourcing it and to the Basel Accord Implementation Group in ensuring consistency of approach across countries Section 3 of this issue explains something of the way in which the Second Pillar is expected to be applied and the matters that banks are expected to take into account in considering their own capital requirements. Section 5 comments further on the techniques which banks might use to model “economic capital” requirements, as a basis for showing that management is adequately addressing the capital needs generated by their activities and positions, and also to inform the debate with the bank’s supervisor on its capital requirements. It also explores whether

[639] Basel II: a briefing for practitioners (n 635) p.6

economic capital models will, in effect, be mandatory for larger institutions.[640]

4.5.6 The Third Pillar

The purpose of Pillar 3, market discipline, is to complement the minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2). The Committee aims to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and hence the capital adequacy of the institution. The intent is for such disclosures to reflect the way in which senior management assesses risk, rather than to amount to a "boiler plate" type of disclosure. Inevitably, the interaction of such requirements with financial reporting standards, particularly International Financial Reporting Standards and United States Generally Accepted Accounting Practices, is important. Basel makes clear that the inclusion of disclosure requirements in Pillar 3 does not mean that they must be included within the audited section of a bank's financial statements, nor indeed in the documents attached to the audited financial statements, which are normally required to be at least reviewed by external auditors for consistency with the audited financial statements. Basel-required disclosures may be disclosed to market participants by other means, though there are attractions in allowing external scrutiny of the information and, in the case of banks whose shares are publicly traded, potential problems if certain information is made available only to some shareholders. Section 4 provides further details of the required disclosures.[641]

4.5.7 Basel III

Even before Lehman Brothers collapsed in September 2008, the need for a fundamental strengthening of the Basel II framework had become apparent. The banking sector entered the Banking crisis with too much leverage and inadequate liquidity buffers. These weaknesses were accompanied by poor governance and risk management as well as inappropriate incentive structures. The dangerous combination of these factors was demonstrated by the mispricing of credit and liquidity risks, and excess credit growth.

In December 2010, the Basel Committee released Basel III which raised the levels for capital

[640] Basel II: a briefing for practitioners (n 635) p.6
[641] Basel II: a briefing for practitioners (n 635) p.7

requirements and introduced a new global liquidity framework. The Basel Committee's 27 member jurisdictions agreed to implement Basel III from January 1, 2013, subject to transitional and phase-in arrangements. The Bank for International Settlements (BIS) confirmed that the subject of regulation under Basel III is banks which includes a "bank, banking group or other entities (e.g. holding company) whose capital is being measured."[642] In November 2011, the G-20 leaders' summit in Cannes, France called on the Basel Committee's member jurisdictions to meet their commitment to implement fully and consistently Basel II and Basel 2.5 by end 2011 and Basel III starting in 2013.[643] The Basel Committee's report issued in April 2013 titled Progress Report on Implementation of the Basel Regulatory Framework stressed that the Basel Committee intends to expand the adoption monitoring to other Basel III components, including the Liquidity Coverage Ratio, capital charges for global and domestically systemically important banks and the leverage ratio.[644]

Basel III continues to use Basel II framework which built on three pillars (Pillar 1: Capital Requirement; Pillar 2: Supervisory Review; and Pillar 3: Market Discipline) to improve banks' risk management and governance as well as to strengthen their transparency and disclosure, with changes made to the supervisory management framework and new requirements for market disclosure. Compliance with the capital requirement will be assessed now by the so-called minimum capital coefficient, which must amount to at least 8 per cent.[645]

Basel III maintains the same capital adequacy ratio as Basel II and no change is envisaged at present for the minimum capital coefficient (of 8 per cent). Under Basel II, in performing the risk-weighting exercise, banks could choose to do so by applying external credit rating agencies' risk assessments, known as the "standardised approach" or by using the internal risk model, known as the "internal ratings-based approach", (IRB Approach) which is banks' own internally generated assessments of risks.[646]

Regulatory Elements	Proposed Requirement
Higher Minimum Tier 1 Capital Requirement	(1) Tier 1 Capital Ratio is increased from 4% to

[642] http://www.bis.org/publ/bcbs164.htm
[643] E Lee, Basel III: post-financial crisis international financial regulatory reforms, J.I.B.L.R. 2013, 28(11) 433-447 at p. 433
[644] Basel Committee on Banking Supervision, "Progress Report on Implementation of the Basel Regulatory Framework"
[645] E Lee, Basel III: post-financial crisis international financial regulatory reforms, J.I.B.L.R. 2013, 28(11) 433-447 at p. 434
[646] E Lee, Basel III: post-financial crisis international financial regulatory reforms, J.I.B.L.R. 2013, 28(11) 433-447 at p. 435

	6% (2) The ratio will be set at 4.5% from 1 Jan 2013, 5.5% from 1 Jan 2014 and 6% from 1 Jan 2015 (3) Predominance of common equity will now reach 82.3% of Tier 1 capital, inclusive of capital conservation buffer
New Capital Conservation Buffer	(1) Consists of 2.5% of bank's capital (2) Used to absorb losses during periods of financial and economic stress (3) Must be met exclusively with common equity (4) Banks are required to hold capital conservation buffer to withstand future periods of stress, bringing the total common equity requirement to 7% (i.e., 4.5% common equity requirement + 2.5% capital conservation buffer) (5) Banks that do not maintain the capital conservation buffer will face restrictions on pay-outs of dividends, bonuses and share buybacks
Countercyclical Capital Buffer	(1) Within a range of 0% to 2.5% of common equity or other fully loss-absorbing capital, will be implemented according to national circumstances (2) An extension to the conservation buffer, when in effect
Higher Minimum Tier 1 Common Equity Requirement	(1) Increased from 2% to 4.5%
	(2) The ratio will be set at 3.5% from 1 Jan 2013, 4% from 1 Jan 2014 and 4.5% from 1 Jan 2015
Liquidity Standard	(1) Liquidity Coverage Ratio (LCR): used to ensure that sufficient high quality liquid resources are available on a short-term basis (30 days), in

	case of a stress scenario. Introduced from 1 Jan 2015
	(2) Net Stable Funding Ratio (NSFR):
	(a) used to promote more medium- and long-term funding of assets and activities of banking organisations, over a one-year time horizon; (b) aimed to limit over-reliance on short-term wholesale funding during times of buoyant market liquidity
	(3) Additional liquidity monitoring metrics: focused on maturity mismatch, concentration of funding and available unencumbered assets
Leverage Ratio	(1) A supplemental 3% non-risk-based leverage ratio, serving as a backstop to the measures outlined above (2) Parallel run between 2013-2017; migration to Pillar 1 from 2018
Minimum Total Capital Ratio	(1) Remains at 8%, unchanged (2) The addition of the capital conservation buffer increases the total amount of capital a bank must hold to 10.5% of risk-weighted assets, of which 8.5% must be Tier 1 capital (3) Required features for Tier 2 capital instruments will be harmonised (4) Tier 3 capital will be phased out (5) Tier 2 capital cannot exceed Tier 1 capital [647]

[647] E Lee Basel III: post-financial crisis international financial regulatory reforms, J.I.B.L.R. 2013, 28(11) 433-447 at p. 436

4.5.7.1 Capital requirements

Basel III contains a comprehensive set of micro-prudential regulations to strengthen the regulation and supervision that the banking authority is responsible for, and to improve the banking sector's risk management ability. To achieve this goal, Basel III starts with capital regulation as regulation forces banks to internalize the externality of the social cost of bank failures by requiring them to hold more equity than they would if they only considered the private costs of insolvency. This had a significant impact on the banking industry. The European banking sector for example by 2019 the industry required about €1.1trillion of additional Tier 1 capital, €1.3 trillion of short-term liquidity, and about €2.3 trillion of long-term funding, absent any mitigating actions and US banking sector, it is shortfall of [US] $870 billion (€600 billion) in the Tier 1 capital and the gap in short-term liquidity at [US] $800 billion (€570 billion), and the gap in long-term funding at [US] $3.2 trillion (€2.2 trillion).[648]

To complement capital regulation, the Basel Committee also requires banks to strengthen accounting transparency and disclosure. That is because under the old definition of capital, a bank could report an apparently strong Tier 1 capital ratio while at the same time having a weak tangible common equity ratio, owing to the fact that under Basel II, banks had to carry 4 per cent in Tier 1 capital relative to risk-weighted assets but only half of that 4 per cent had to be tangible common equity (TCE). Note that common equity is recognised as the highest quality component of (a bank's) capital; it is used to absorb losses as and when they occur because it has full flexibility of dividend payments and has no maturity date. Designed to dampen rather than amplify any risk contagion, Basel III was developed to reduce the frequency and intensity of any future financial crisis by substantially raising the quality and quantity of capital with a greater focus on common equity.[649]

As observed in the global financial crisis of 2007–2009, credit losses and write-downs came directly out of banks' retained earnings and common equity; therefore, in order to make banks more robust in combating any future financial storms, Basel III substantially raises the quality, quantity, consistency and transparency of the Tier 1 capital base. The new minimum is 6

[648]http://www.mckinsey.com/clientservice/Financial_Services/Knowledge_Highlights/~/media/Reports/Financial_Services/Basel%20III%20and%20European%20banking%20FINAL.ashx
[649] E Lee Basel III: post-financial crisis international financial regulatory reforms, J.I.B.L.R. 2013, 28(11) 433-447 at p. 438

percent of risk-weighted assets, at least 75 per cent (or 4.5 per cent of risk-weighted assets) must be tangible common equity and the balance of which must be true loss-absorbing capital. The new capital definition and requirement also places more focus on common equity and sets stricter criteria for Tier 1 capital. That is because prior to the global financial crisis of 2007–2009, the amount of tangible common equity of many banks, when measured against risk-weighted assets, was as low as 1 to 3 per cent, net of regulatory deductions. This translates into a risk-based leverage of between 33 to 1 and 100 to 1.[650]

4.5.7.2 Pro-cyclicality and systemic risk through leverage ratio

Basel III addresses systemic risk in its two dimensions: the time dimension, mitigating pro-cyclicality; and the cross-sectional dimension, mitigating interconnection and contagion risk. Bank supervisors are able to impose a countercyclical buffer on their banking system when credit growth seems to be getting out of control. Basel III's impositions of countercyclical buffer and leverage ratio have gained some academic support.[651] This was supported by Professor Douglas Arner stating that "leverage standards are often easier to implement than the usual capital requirements, as they are both simpler and more transparent."[652]

Basel III's three elements—constraining risk-weighted assets build-ups, lowering leverage ratio and improving capital equity—work concertedly together to help minimise financial shocks for banks. In more precise terms, while risk-weighted capital requirements potentially have the greatest impact in improving financial institutions' risk management practices, leverage combined with clear requirements for higher levels of equity capital will likely contribute to financial stability."[653]

Basel III tries to address all these deficiencies of Basel II, by introducing both the LCR and NSFR. The LCR is a ratio based on short-term (i.e., within 30 days) capital calibration while the NSFR, for long-term (within one year) capital calibration. The LCR and the NSFR were two new measurements created for Basel III, to provide regulators with internationally comparable standards for bank liquidity. LCR and NSFR were introduced by the Basel

[650] E Lee Basel III: post-financial crisis international financial regulatory reforms, J.I.B.L.R. 2013, 28(11) 433-447 at p. 439
[651] E Lee Basel III: post-financial crisis international financial regulatory reforms, J.I.B.L.R. 2013, 28(11) 433-447 at p. 440
[652] Douglas W. Arner and Cyn-young Park, "Developing Asia and the Global Financial Regulatory Agenda" (2011) 12(2) Journal of Banking Regulation 119
[653] Arner and Park (n 652)

Committee through its publication of a consultation paper in December 2009. After the consultation period, an amended liquidity proposal was published in December 2010. Regulators are due to begin measuring the LCR and NSFR in 2013, but banks will not need to comply with the minimum ratio for LCR until 2015 and the minimum ratio for NSFR until 2018.

LCR requires banks to hold a deep pool of liquid assets to meet cash flow needs for up to 30 days under a high-stress scenario though it has been suggested there should be less severe tests (less than 30 days) that banks would have to meet to meet the liquidity requirement. During that 30-day period, regulators want to ensure that outflows (of capitals) are matched by inflows in the event of a run on the banks, as banks are required to comply with the minimum LCR standards starting in 2015.[654]

In summary, the enhanced Basel framework revised and strengthened the three pillars established by Basel II. It also extended the framework with several innovations:

- an additional layer of common equity and the capital conservation buffer that, when breached, restricts pay outs to help meet the minimum common equity requirement
- a countercyclical capital buffer, which places restrictions on participation by banks in system-wide credit booms with the aim of reducing their losses in credit busts
- a leverage ratio: a minimum amount of loss-absorbing capital relative to all of a bank's assets and off-balance sheet exposures regardless of risk weighting
- liquidity requirements: a minimum liquidity ratio, the Liquidity Coverage Ratio (LCR), intended to provide enough cash to cover funding needs over a 30-day period of stress; and a longer-term ratio, the Net Stable Funding Ratio (NSFR), intended to address maturity mismatches over the entire balance sheet additional proposals for systemically important banks, including requirements for supplementary capital, augmented contingent capital, and strengthened arrangements for cross-border supervision and resolution.

[654] " Annex 2: Phase-in Arrangements", a Basel Committee press release, September 12, 2010.

4.5.8 Regulatory Approach adopted by Basel III

There is no specific model of regulations which Basel III ties the banking sector to. In fact, as long as the main goal of creating a sound banking system is achieved and proper prudential together with proper regulation of multinational banks is conducted then the Basel III would have been complied with. Basel III proposes a number of amendments to the regulation of standards in banking. The main goal of Basel III is to ensure that proper reforms are undertaken and the system of banking regulation is stable nationally and internationally. Apart from prudential guidelines and principles, Basel III is very clear on what needs to be done when creating new rules and new regulatory frameworks.[655] There should be effective institutional framework, co-operation[656], coordination[657], capacity and lack of political interference.[658]

It has, however, been argued that the Twin Peaks attention is in compliance with Basel III and hence more effective in ensuring the prudential regulation of the banking sector. In fact, international financial agencies like the IMF, the Basel Committee and the G20 have endorsed this regulatory framework indicating that this system is more effective in separating prudential guidelines and regulations from conduct regulation.

In the eyes of the Basel Committee a better regulatory framework should address two key functions: First, the macro prudential policies and structure should be able to both a time dimension of system risks. In this way, the development of systemic risk over time must be addressed properly in order to ensure that there is proper resilience and stability in the banking market even in times of economic downtime by the limitation of pro-cyclization, an occurrence

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[655] Laeven, Luc, and Ross Levine. "Bank governance, regulation and risk taking." Journal of Banking economics 93, no. 2 (2009): 259-275

[656] Lai, Alexandra, and Adi Mordel. "the Resolution of Systemically important Banking institutions." Banking System Review (2012): 37; Fratangelo, Pierpaolo. "International and European Co-operation for Prudential Supervision." (2003): 1-25; Goodman, Radford. "Cross-Border Bank Insolvency, Rosa Lastra." (2011): 40 < www.bankofcanada.ca/wp-content/uploads/2012/06/fsr-0612-lai.pdf> accessed 29 January 2020.; Pierpaolo Fratangelo, 'International and European Co-operation for Prudential Supervision' (2003) Munich Personal RePEc Archive MPRA Paper 5539 1-25 < https://mpra.ub.uni-muenchen.de/5539/> accessed 29 January 2020.
; Radford Goodman,' 'Cross-Border Bank Insolvency 'Rosa Lastra(2011)40 OUP Oxford (17 Feb. 2011) ISBN-10: 019957707273 BAZEKON 9-17 < http://bazekon.icm.edu.pl/bazekon/element/bwmeta1.element.ekon-element-000171319559> accessed 29 January 2020.

[657] Zaleska, Małgorzata. "Supervision of the Banking Market–evaluation of the Proposed Models of Integration of Supervision, in the Context of Global Experiences." STUDIES AND WORKS (2006): 9

[658] Caprio, Gerard, and Patrick Honohan. "Restoring banking stability: beyond supervised capital requirements." The Journal of Economic Perspectives 13, no. 4 (1999): 43-64; Caprio, Gerard, and Daniela Klingebiel. "Bank insolvency: bad luck, bad policy, or bad banking?." In Annual World Bank conference on development economics, vol. 79. 1996; Jayasuriya, Kanishka. "Globalization and the changing architecture of the state: the regulatory state and the politics of negative co-ordicountry." Journal of European Public Policy 8, no. 1 (2001): 101-123. State and the Politics of Negative Co-Ordination' (2001)8(1) Journal of European Public Policy 101,123 <https://doi.org/10.1080/1350176001001859> accessed 29 January 2020

which has the ability of increasing the impact of systemic risks. Secondly, there is an issue of cross-sectional dimension which is highly encouraged by Basel III. This entails the distribution of risks in the banking system in any particular time. The aim of the Basel prudential guidelines is thus to make sure that there is no concentration systemic risk in one area which could cause catastrophic failure. It has been argued by several commentators that the FSA in the UK failed because there was less focus on prudential regulation: "Not only did the FSA never get around to the prudential regulation of banks which in any event had been abandoned to the failed Basel II, the FSA was manifestly ignorant of prudential reduction of banks. Pandering to public opinion the FSA had morphed into a market conduct regulator. The 2008 crisis made it clear that it was a mistake to remove the banks from the Bank of England."[659]

Basel III stresses the need to ensure reduced risk for not only the whole banking system but also for individual banks. The term "banking macro-prudential policies" refers to the set of policies mainly of a prudential nature adopted and to implement the limit the banking system's exposure to the "systemic risk" ensuing from factors that do not concern individual banking service providers or individual markets individual banking service providers or individual markets and structures of the financial system but are more general in and structures of the financial system in character.

A "systemic risk" is the risk of a malfunction in the supply of banking services (and/or failure to supply), due to supply of banking services (and/or failure to supply), due to the weakening of a sector or the weakening of a sector or of the entire financial system, potentially leading to serious negative consequences in the real sector of the economy.[660]

Even though Basel III is not expressly clear about Conduct Regulations and most of the guidelines are geared to ensuring that there are better and improved macro prudential guidelines, conduct cannot be left to chance. Apart from being categorical that the existing banking frameworks should be improved, and more additional innovative ways included to cover grey areas of regulation, the committee recommended that there should be provisions in

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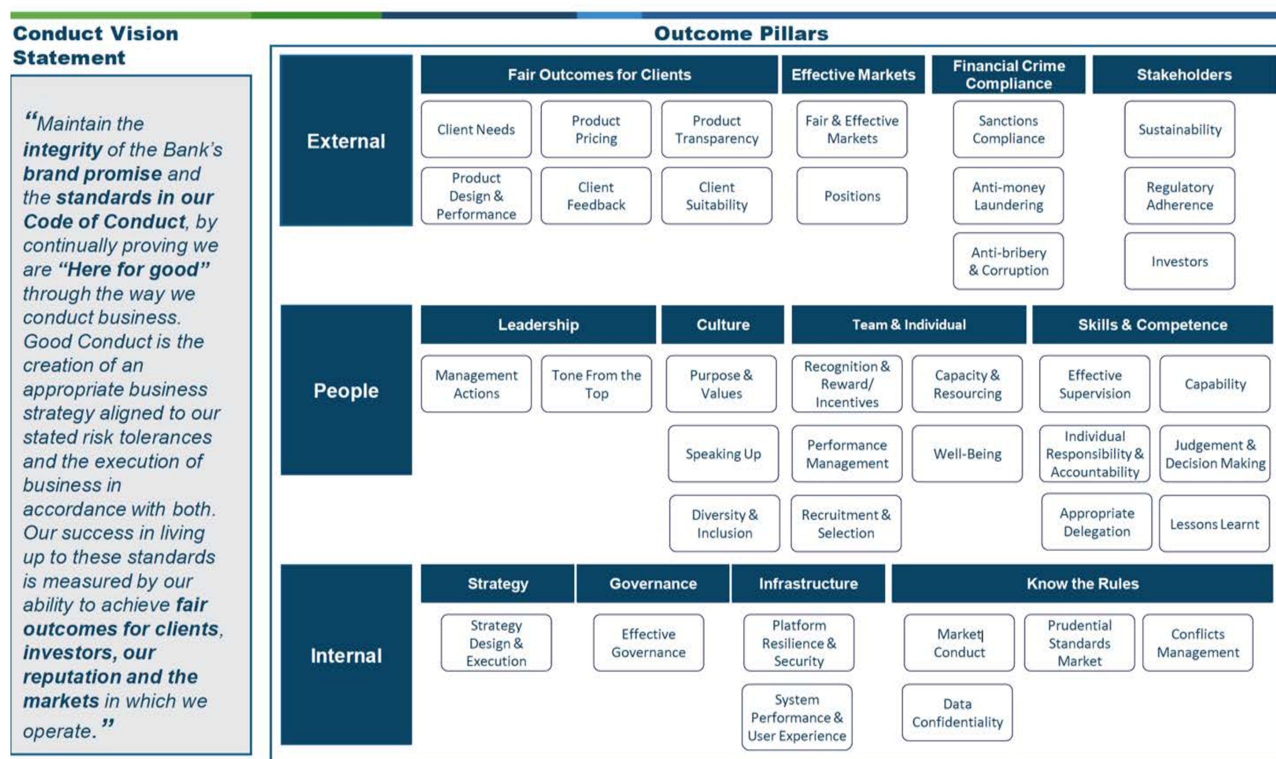
[659] Free Market Foundation, The Case Against Introducing the Twin Peaks Regulatory System (August 2016), http://www.freemarketfoundation.com/article-view/case-against-introducing-the-twin-peaks-regulatory-system accessed 02 September 2017

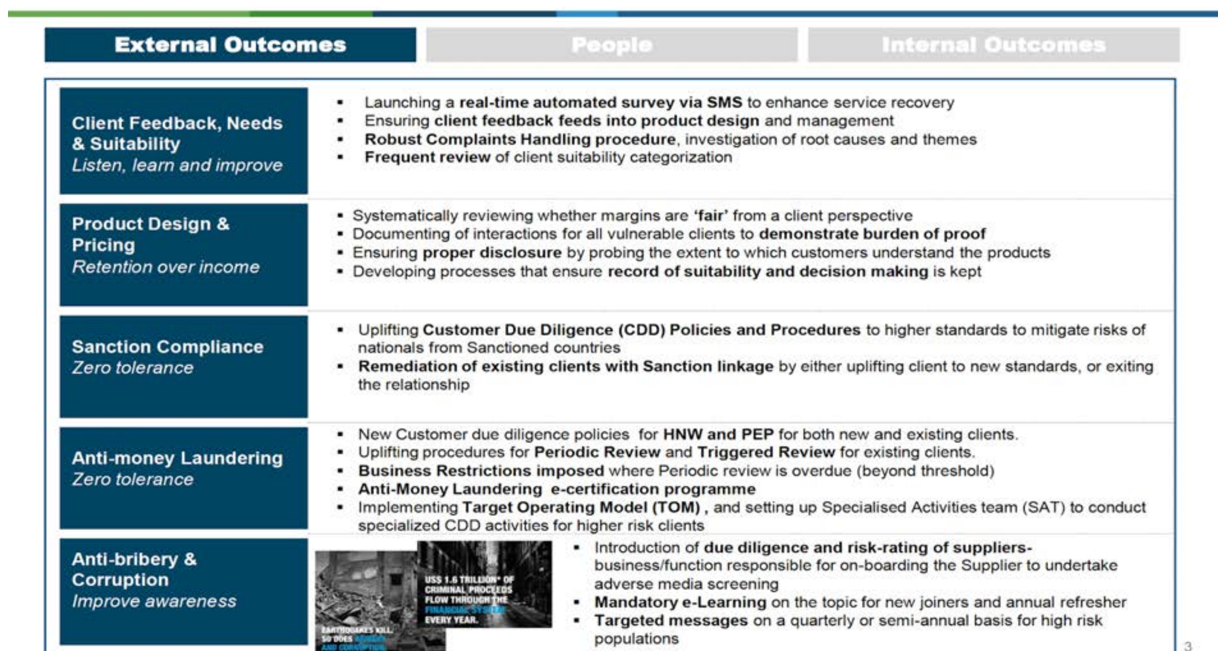
[660] Christos VI. Gortsos, "Basel III": the reform of the existing regulatory framework of the Basel Committee on Banking Supervision for strengthening the stability of the international banking system (2011) http://www.hba.gr/Events/UplFiles/parousiaseis/secgen/2_Gortsos_Basel%20III.pdf accessed 02 September 2017

the regulatory framework and adequate structures to ensure that there are less risks in the banking sector in the name of credit risks. From a banker's point of view the following table helpfully demonstrates the benefits of conduct regulations not only for banks but also for the banking system as a whole and the mechanism that is designed for the banks in Pakistan to adopt and apply in order to follow the conduct regulations and achieve the potential benefits:



Source: The State Bank[661]

[661] www.sbp.org.pk/events/2016/Naseer.pdf



Source: The State Bank[662]

4.6 A Critical Analysis of Basel III Approach: Safeguards and Weaknesses

4.6.1 Safeguards

Basel III came in to ensure that the weaknesses that existed in Basel II and the challenges which were experienced in the 2008 banking crisis are not repeated. The Accord came with various safeguards which upon being implemented are supposed to create a better banking sector globally as it proposed national guidelines with an international perspective hence having a proper way of strengthening the global banking market.

The main safeguard which Basel III seeks to put in place is the enhancement of risk coverage in the banking sector. Basel III proposes a framework through the strengthening of the regulation and regulatory framework of the banking sector in terms of resilience. This comes in the form of quality and quantity of capital framework and capital base. This guideline entails transparency in the regulatory institutions and framework and allows better quality and

[662] www.sbp.org.pk/events/2016/Naseer.pdf

consistency in Prudential Regulations.[663] In addition, this safeguard entails the creation of a supplemented risk-based capital requirement using a leverage ratio. The reason for such a measure is because the crisis of 2008 was grounded on the built-up of leverage ratio.[664] One of the underlying features of the crisis was the built-up of excessive on- and off-balance sheet leverage in the banking system. The built-up of leverage also has been a feature of previous banking crises, for example leading up to September 1998. During the most severe part of the crisis, the banking sector was forced by the market to reduce its leverage in a manner that amplified downward pressure on asset prices, further exacerbating the positive feedback loop between losses, declines in bank capital, and the contraction in credit availability.

The reduction of pro-cyclisation and promotion of countercyclical buffers is also a major element of this safeguard. Regulation which must make sure that their promotion of forward-looking guidelines, protection from excessive credit growth, there is proper capital conservation.[665] The other safeguard relates to an introduction of global standards in the liquidity regulation of banking institutions and the banking sector. Here Basel is specific on the core issues which have to be implemented for stable banking, these include, use of monitoring tools, net stable funding ratio, and liquidity coverage ratio. The use of these tools is supposed to ensure that there is a strong capital requirement in the banking sector.

Additionally, safeguard is placed on capital requirements for banking institutions, disclosure requirements for transparency, market disciplined and detailed transitional requirements to ensure that there is efficient implementation of the safeguards. Resilience banking institutions is core to Basel III, the understanding is that even when there is a crisis, banking institutions should be able to recover fast. This guideline and measures are supposed to make banks raise the capital ratios in order to be more resilient. The success of the Basel III safeguards has been seen in various countries especially in the Tier 1.[666]

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[663] Basel Committee "Basel III: A global regulatory framework for more resilient banks and banking systems." Basel Committee on Banking Supervision, Basel (2010)
[664] Basel Committee, (n. 663) p. 4
[665] Eubanks, Walter W. Status of the Basel III Capital Adequacy Accord. DIANE Publishing, 2010
[666] Basel Committee on Banking Supervision (BCBS). Basel Committee on Banking Supervision (BCBS). 2014a. “Basel III Monitoring Report.” Bank for International Settlements (March). 2014a. “Basel III Monitoring Report.” Bank for International Settlements (March); Basel Committee on Banking Supervision (BCBS). Basel Committee on Banking Supervision (BCBS). 2014b. “Progress Report on Implementation of the Basel Regulatory Framework.” Bank for International Settlements (April).

4.6.2 Weaknesses of the Basel III

As much as Basel III is an improved framework for banking regulation, it comes inherently with some weaknesses, some of which are the same as those of Basel II. The problem which faced Basel II was the fact that it was a bold experiment which took decades of research and analysis of the banking sector, and never really got to be fully implemented or experimented upon.[667] Therefore, the main weakness of the Base III is the fact that it is just a bold new layering over the structure of Basel II architecture.

It has a backward-looking approach as it reckons that securities that have been so risky in the past years are the same as those securities which will be risky in the future. This argument received support from Millman: The consequence of this Basel II reform was to discourage banks from lending to risky enterprises, and to encourage the accumulation of apparently risk-free assets. This was a primary contributor to the structured finance craze, as securitization was a way to "manufacture" apparently risk-free assets out of risky pools. What brought banks like Citigroup and Bank of America to their knees was not direct exposure to subprime loans, but exposure to triple-A-rated debt backed by pools of such loans, debt which turned out not to be risk-free at all. Banks will need to hold more common equity than ever against their risk-weighted assets. That massively increases the incentive to find low-risk-weighted assets with some return, since these assets can be leveraged much more highly than risky assets. Lending to AA-rated sovereigns still carries a risk-weight of zero. So, one result of Basel III could be to encourage banks to increase their lending to sovereigns at the margins of zero-risk-weight status. If that happens, anyone wants to guess where the next crisis will crop up.[668]

There are other risks which affect the banking sector without even emanating from the banking sector. For instance, a sovereign default will definitely and always affect the banking crisis, even if there are very effective capital-adequacy rules as proposed by Basel III. Even central banks cannot protect the banking sector from a sovereign default, and neither can the banks themselves. Millman's point is broad but on-point: Since taking any additional measurable risk is now stigmatized, the game becomes how to increase returns without increasing measurable risk.[669] Basel II assumed that banks are in the best position to measure

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[667] Felix Salmon, the biggest weakness of Basel III (Sep 2010) http://blogs.reuters.com/felix-salmon/2010/09/15/the-biggest-weakness-of-basel-iii/
[668] The Economists, Basel III - Third time's the charm? (Sep 13 2016) https://www.economist.com/blogs/freeexchange/
[669] The Economists, Basel III - Third time's the charm? (n.668)

their own risks, and that a regulatory framework that aligns regulatory capital requirements with risks being taken is to be desired. In other words, the regulatory framework was pushing banks hard in the direction they were already going towards avoiding measurable risks and hence into risks you cannot easily measure or don't know exist.[670]

The same challenge facing the Basel II is outlined by Joe Nocera[671] who explains that the whole value-at-risk structure gives banking institutions all the incentives needed to push all the risks to the end. The impact of this is that end risks are more often ignored. The banks will then embrace other mechanism such as the Gaussian Copula Function[672] that basically has the effect of making the end expanded, and thus embracing more risks which eventually may cause adverse impacts. There is hardly any provision in Basel III which seeks to address this challenge directly or indirectly.

Another criticism is that Basel III reminded the banking sector that the booms are fuelled by an underestimation of market risks, and in particular times of the boom. The behaviour is that it is self-feeding as lending is able to raise the asset prices which in turn justify further leverage. It was fuelled by market-sensitive risk management approach and the use of fair value accounting which was promoted by Basel II. The fact that Basel III reminds banking institutions that the crisis was caused and fuelled by underestimation of risks from their perspectives is not entirely correct as the same banks were busy using the so-called Nobel-prize-winning sophisticated approach. As such it looks really odd that Basel III did not propose any harmonization in the accounting area.[673]

Another challenge of Basel III is that the banking regulation cannot be used to a fifth excessive credit cycle alone on the understanding that both fiscal and monetary policies have to play a role in the use of sustainable business models. The importance of fiscal policy has always been disregarded. In the US, it has been revealed that an overly loose fiscal policy played a major role after the dotcom-bubble burst and contributed to high consumption and an overvaluation of the dollar which fed the boom more as compared to the monetary policy. Regulations should not amplify the credit cycle, and that is what Basel II achieved.

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[670] The Economists, Basel III - Third time's the charm? (n.668)

[671] Joe Nocera, Risk Management (Jan 2009) The New York Times, http://www.nytimes.com/2009/01/04/magazine/04risk-t.html?pagewanted=all

[672] Felix Salmon, Recipe for disaster: the formula that killed wall street (2009), https://www.wired.com/2009/02/wp-quant/?currentPage=all

[673] Pascal March T vander Strataeten, Basel III: Five Substantive Problems That Still Need To Be Solved https://www.linkedin.com/pulse/20140725222958-4628733-basel-iii-five-substantive-problems-that-need-to-be-solved

4.7 SUITABLE REGULATORY MODEL FOR DEVELOPING COUNTRIES

It is not possible to make a sweeping statement, with confirmation, which would be the most appropriate regulatory model considering that the banking sector is of dynamic nature. Having in mind that adopting a framework that does not correspond to the existing banking system then it can cause over regulation or under-regulation for the banking sector. In fact, that will be the least of any stakeholder's concern, the major challenge would be the inconsistencies in the banking sector in terms of overlapping roles of supervisors and regulators. If, for instance, a banking model from the developed world is arbitrarily imposed on a banking system of a country which is still developing, then the most predictable result would be over-regulation and over-restriction of the smaller banking institutions which may not have the capacity to adhere to the banking regulations without incurring substantial expenditures, hence reducing the profitability of these smaller banks[674] or pushing them out of the market as it is evident, as seen in the second chapter, from Pakistan where many small banks merged with one other in order to comply with capital requirements that the State Bank had imposed on banks in order to comply with obligations to adopt Basel as imposed by the IMF.

Secondly, there exists no universally acceptable model that is considered most suitable for a developing country therefore it is an uphill task to determine which system of banking should be adopted by a developing country. The diversity of research in this area demonstrates the difficulty of choosing a best model of institutional framework and regulation for developing countries.[675] The works of Llewellyn and Healey and other researchers supports this preposition that there is no single model for regulation of banking institutions which would be optimal for banking. Both developing and developed countries have shown diverging banking models which make it very hard to determine which one would be optimal for the developing countries. The existence of advantages and disadvantages in most of the banking regulation models and institutional framework for regulation cuts across all the banking regulation models. However, the emerging trend all over the world has been on reducing the number of regulatory agencies and ensuring cooperation between the existing ones.[676]

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[674] Carmichael, J, Fleming, A and Llewellyn, D T, (2004), Aligning Banking Supervisory Structures with Country Needs, World Bank Institute, Washington.

[675] Llewellyn, D.T. (1999b), "Introduction: the Institutional Structure of Regulatory Agencies", in N. Courtis, ed. How Countries Supervise their Banks, Insurers and Securities Markets, Central Bank Publications, London; Healey, J (2001), "Banking Stability and the Central Bank: International Evidence", in Richard A Brealey, et.al. al., Banking Stability and Central Banks, Routledge, London.

[676] Llewellyn, David T. "Institutional structure of Banking regulation and supervision: The basic issues." In Paper dipresentasikan pada World Bank seminar "Aligning Supervision Structures with Country Needs" tanggal, vol. 6. 2006, 7

There are a number of reasons why this raging debate on the proper banking regulatory structure keeps going on. These reasons shake the very nature and belief of a superior system of regulation and dictate that supervision and regulation in a specific country most likely reflect key factors and challenges which are evident in those markets. Firstly, in many countries the issue of banking innovation and the change in structure challenge the very thought of universality of banking regulations. Even if regulatory structures mirror the evolution and the development of the banking system, it has to be realised that banking markets are not a replica of another. They develop at different rates, making it very hard to assume that the regulatory framework should be imposed.[677]

In both developing and developed markets, the institutional changes are based on market demands. To anticipate a challenge based on existing data from a particular market; the reforms in banking institutions usually follow banking failures, hurdles in the institutional level such as proper cooperation between the supervisor and regulator, and very often piece-meal structure has developed making sure that the regulatory structure and model are not necessarily created from the beginning without taking into account the failures and successes of the existing ones.[678]

As developing markets expand their banking sector, they also experience complexities in regulation and supervision, for example, the conduct of business in banking has recently become more crucial. That being said, we have seen that there can be more regulatory agencies which are in charge of monitoring the banking sector. This issue raises the challenge of excessive or even an additional institution which could end up adding uncertainties, risks, and costs of regulation.[679] Should such a system be implemented for a developing market then justice will not have been done to that banking system since the last thing the developing markets require is the complications of multiple agencies in the regulatory institutional framework as was seen in the UK in 1997.

[677] EP Ellinger, E Lomnicka and RJA Hooley, Ellinger's Modern Banking Law (4th edn, OUP, Oxford, 2006)
[678] M Andenas and L Panourgias, "Applied Monetary Policy and Bank Supervision by the ECB' in JJ Norton and M Andenas (eds), International Monetary and Financial Law Upon Entering the New Millennium (BIICL, London, 2003) 119-70
[679] Carmichael, Jeffrey, Alexander Fleming, and David T. Llewellyn, eds. Aligning Banking supervisory structures with country needs. World Bank Publications, 2004.

Just like in other developed markets the challenges which face the banking sector are more or less the same but with some inherent realities of the sector. This issue such as a determination of the proper number of the regulatory bodies, and which should be the primary one, should there be an integrated model where the regulator handles more than one banking sector, or a single sector or should there be a super regulator for the entire banking sector?[680] Additionally, there is the challenge on the role of the central bank in supervision and regulation,[681] the issue of separating conduct of business and prudential regulation or should they be combined and the mandate handed to one agency in the absence of one single regulator for instance in case of a Twin Peaks Model, there is a challenge of unified regulatory issues and their relation with the central bank.[682] There is the challenge of institutional and functional dimension and how the objectives of the institutions are defined. To mount these challenges, even when adopting a single regulator model which covers both conduct and prudential aspects, there is the element of political independence which may not be guaranteed in most developing countries.[683]

4.7.1 Integrated vs Multiple Agencies – A case of Integration

Even though there is no ideal banking regulation framework or model, there has been various research which have favoured the integration of regulations.[684] There are two schools of thoughts each with different views on whether to adopt a single agency for Prudential and Conduct Regulations. There are several arguments which favour the creation of a single integrated agency. Since there has been a trend for stable banking in countries which have separated prudential guidelines and conduct by creating a Twin Peaks Model the argument is that all prudential guidelines in banking should be handled by one integrated agency.[685] The need for integration has been seen to be important in a number of ways:

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[680] Masciandaro, Donato. "Unification in Banking sector supervision: The trade-off between central bank and single authority." Journal of Banking Regulation and Compliance 12, no. 2 (2004): 151-169. Journal of Financial Regulation and Compliance 151,169 accessed 29 January 2020

[681] Llewellyn, David T. "Integrated Agencies and the Role of Central Banks." Chapters (2005).

[682] Abrams, Richard K., and Michael Taylor. Issues in the unification of Banking sector supervision. International Monetary Fund, 2000 IMF WP/00/213 < www.imf.org/external/pubs/ft/wp/2000/wp00213.pdf> accessed 29 January 2020

[683] Alpanda, Sami, and Adam Honig. "The impact of central bank independence on political monetary cycles in advanced and developing Countries." Journal of Money, Credit and Banking 41, no. 7 (2009): 1365-1389 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1433403> accessed 29 January 2020

[684] Cihák, Martin, and Richard Podpiera. "Experience with integrated supervisors: governance and quality of supervision." Designing Banking Supervision Institutions: Independence, Accountability and Governance, Edward Elgar, Cheltenham (2007): 309-341

[685] Masciandaro, Donato. "E Pluribus Unum? Authorities' design in Banking supervision: Trends and determinants." Open Economies Review 17, no. 1 (2006): 73-102; Abrams, Richard K., Michael W. Taylor, and London School of Economics (United Kingdom). Banking Markets Group;. "Assessing the case for unified Banking Sector Supervision." Current Developments in Monetary and Banking Law 2 (2003): 463; Masciandaro, Donato. "Unification in Banking sector supervision: The trade-off between central bank and single authority." Journal of Banking Regulation and Compliance 12, no. 2 (2004): 151-169

a. The separation of institutional and functional regulation is made up of a single specialist banking body. In addition, when handling the regulation of banking conglomerates, an integrated body provides a group-wide picture of banking risk more effectively. Even though there exists a number of ways which may be used to undertake prudential supervision for diversified institutions which are steadily on the rise in developing banking markets, a single, and integrated agency is more suitable to monitor such institutions better; and hence better equipped to detect the soundless of the banking sector and the risks that emanate from the sector. It has been recognised that there are no perfect models since 1966 and this is supported by researchers[686] and each model has challenges even in developing countries;[687] Hence the reason that even though an integrated model is not perfect, it has less functional and institutional hurdles making it more suitable for risk identification and mitigation. More precisely, Taylor made it clear decades ago that: "A regulatory system which presupposes a clear separation between banking, securities and insurance is no longer the best way to regulate a Banking system in which these distinctions are increasingly irrelevant".[688] Having in mind that this system is not perfect but better, Taylor recognised that there are some grey areas which have to be constantly improved within the existing overall integrated model and believes that: "any system is bound to have its anomalies and illogical ties; it is sufficient that the Twin Peaks model has fewer than the alternatives".[689]
b. There is the issue of economies of scale within the banking regulatory agencies and more specifically with respect to the recruitment of staff and skills requirement. If it is so determined, then few agencies create lower institutional costs. For developing countries this is an advantage. A single regulator could also be more effective because of shared resources, and particularly the sharing of information, and the sharing of support services and IT infrastructure. Furthermore, an integrated regulator reduces the time taken to make decisions as compared to multiple agencies since the delays inherent in consultation, cooperation, and regulatory compliance is reduced to a departmental

[686] Michael W Taylor, ' Twin Peaks: A Regulatory Structure for the New Century' London, Centre for Study of Banking Innovation, December (1995)20 CSFI ; Michael W Taylor, 'Peak Practice: How to Reform the UK's regulatory System' London, Centre for Study of Banking Innovation, October 1996. ASIN: B0018TOE2W.
[687] David T Llewellyn, 'Institutional Structure of Financial Regulation and Supervision: The Basic Issues' (2006) 6 & 7 World Bank seminar "Aligning Supervision Structures with Country Needs" < http://siteresources.worldbank.org/INTTOPCONF6/Resources/2057292-1162909660809/F2FlemmingLlewellyn.pdf> accessed 29 January 2020.; Kremers JJM, Schoenmaker D, Wierts PJ, 'Cross-Sector Supervision: Which Model?' (2003)1 Brookings-Wharton Papers on Financial Services 225,243 < https://www.researchgate.net/publication/236798262_Cross-Sector_Supervision_Which_Model> accessed 22 January 2020; Clive Briault, 'The Rationale for a Single National Banking Services Regulator' (1999)211 Opportunities and Risks in Central European Finances ..
[688] Ibid
[689] Ibid

level making information easy to share and consultation easy to undertake. In the same vein, the issue of optimal deployment of staff is much easier within the same agency as compared to multiple agencies.

c. The issue of synergies is also crucial and easily achievable within an integrated banking regulatory framework. The various areas of prudential regulation can easily be learned. In addition, since there is clarity on which agency undertakes which function as compared to multiple agencies where there may be more grey areas and lacunae, there is less incomplete coverage and hence less institutions and lines of banking business slipping the eyes of the regulator.

d. One another reason is the interest of neutrality in terms of competition in supervision and regulation between the various kinds of entities involved in the same business may be much easier to sustain while using an integrated regime of supervision. In principle, a single agency would try to avoid the challenges of inconsistencies, inequalities, overlaps, duplications, and other gaps that would arise with a regulatory regime which is characterised by multiple agencies. This merit supports the argument that it is much simpler to have a regime of supervision which is simple for the banking sector, and one that is easily understood and recognised by the regulated institutions and consumers alike. This is what the developing banking markets may need; it is simple and easily understood given that a single and integrated regulatory scheme allows for the challenge of double compliance to be eradicated, the costs of compliance are low and there is symmetry in the flow of information.[690]

e. The issue of regulatory arbitrage comes into play in the regulatory institution created by banking laws. Through the adoption of an integrated model, this can be minimized properly. Multiplicity of regulatory bodies create a potential regulatory arbitrage. This can cause impairments in the overall efficiency of the agencies which take part in the supervision and regulation. This problem has been discussed by Abrams and Taylor:[691] regulatory arbitrage "can involve the placement of a particular Banking service or product in that part of a given Banking conglomerate where the supervisory costs are the lowest or where supervisory oversight is the least intrusive. It may also lead firms to design new Banking institutions or redesign existing ones strictly to minimise or avoid supervisory oversight."

[690] M Yokoi-Arai, "The Balance of Market Discipline in Bank Regulation' in L Gorton (ed), Breakdown of Public & Private Dichotomy in Commercial and Financial Law (Studentlitteratur, Lund, Stockholm, 2003)

[691] Abrams RK, Taylor M, 'Issues in the Unification of Financial Sector Supervision' (2000) IMF WP/00/213 < www.imf.org/external/pubs/ft/wp/2000/wp00213.pdf> accessed 29 January 2020

f. The issues of expertise are also crucial and a major strength for having an integrated agency kind of framework. In developing countries, there could be a shortage in supply of highly skilled and technical experts. Spreading the available experts in different agencies is not desirable and effective.[692] The implication of having multiple agencies is that each will have few expertise. Concentrating this workforce in one agency is more advantageous and also creates a better career prospect.
g. The level of accountability in the integrated structure is more certain and can easily be put to question and held accountable by the public and other stakeholders. Because of its simple nature and since its roles are usually clearly stipulated with less grey areas as compared to having many agencies.
h. The issue of costs as mentioned above is also important especially for the banking institutions that need to comply. Since one agency will be conducting prudential regulation, the standards set will be the same in terms of information, banking structure, technological integrity and operation integrity, the management, the board, and accounting standards; this is advantageous for banking institutions as less costs will be spent on complying with regulations. The cost is also reduced in terms of budgetary allocations to the supervisory body. An integrated system will require a single budgetary allocation as compared to allocating several agencies. Since most developing countries have budgetary constraints, an integrated approach is thus more desirable for these young markets. The issue of costs is very crucial and cannot be taken lightly, even developed countries have faced this challenge with multiple agencies. Prior to the creation of the defunct FSA, a banking conglomerate in the UK could be required to report to more than nine (9) regulatory agencies, indicating that a banking conglomerate was required to comply that many times.[693]

This does not mean that integrated models can be applied uniformly to all developing Countries. But it has been revealed by a survey of eight countries that the main reason why these countries adopted the integrated supervision model is because there was a need to create an effective supervision system of the banking sector and to maximise the economies of scale.[694]

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692 http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2007/0213_cm. shtml> accessed March 2017

693 http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2007/0213_cm. shtml> accessed March 2017

694 Luna Martinez, Jose, and Rose, Thomas, A., (2003), "International Survey of Integrated Banking Sector Supervision", World Bank Policy Research Working Paper 3096, Washington, July. <https://openknowledge.worldbank.org/handle/10986/18144> accessed 20 September 2019

Even though there is enough evidence to favour this model. It is bound to face a number of potential hazards. One of the arguments which can probably end up affecting the developing banking markets is the diversification of the banking sector and the differences which this creates. Credit risks in banking can be transferred to other banking sectors and hence creating challenges of proper risk regulation. However, this does not mean that this is the case for all countries, but many developing markets have been experiencing a banking boom.[695]

Another moral hazard of having a single institution is the fact that there could be a misguided perception that by creating a single regulator, the risk spectrum disappears, this could water down the efforts made in risk identification and evaluation. In another case, creating a single agency may lead to a situation where information that is valuable for prudential governance is lost. The effect of such a move would be to the merit of different approaches in preventing banking risks and the diversity in regulation is lost. In many cases particularly where there is political interference. Additionally, there are other risks such as the hazard of the 'Christmas tree[696]' and the 'x-inefficiencies'. It follows that a single banking agency is more likely to have a very wide list of miscellaneous functions which may make it overburdened.

In addition, there are serious costs to take into account when making major institutional changes, which include the cost of change itself. It is agreed that there is a high degree of unpredictability of the change and the change process itself and this could end up causing imbalances in the banking sector. The notes by Abrams and Taylor[697] show that there are a number of dimensions to the 'Pandora's Box' effect; a bargaining process that is available and open to the various interest groups in the banking sector to make sure that banking legislation process includes the various interests, the very low personnel in the banking business, and the managerial diversion from the primary activity of supervision and regulation. The study by Luna Martinez and Rose in 2003 also revealed that there are a number of challenges which are associated with the creation of an integrated banking agency. In particular, the challenges can

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[695] Masciandaro, Donato. "Politicians and Banking supervision unification outside the central bank: Why do they do it?." Journal of Banking Stability5, no. 2 (2009): 124-146. < http://isiarticles.com/bundles/Article/pre/pdf/24679.pdf> accessed 29 January 2020

[696] Taylor, M and Fleming, A, (1999), "Integrated Banking Supervision: Lessons from Northern European Experience", Policy Research Working Paper 2223, World Bank, Washington

[697] Abrams RK, Taylor M, 'Issues in the Unification of Financial Sector Supervision' (2000) IMF WP/00/213 < www.imf.org/external/pubs/ft/wp/2000/wp00213.pdf> accessed 29 January 2020ly

be summarised as the legal constraints which cover the problem of defining the power, scope of the agency, objective, and mission as well.[698]

4.7.2 Unified Supervisory Agency vs. Twin Peaks

There are also various arguments on the combination of conduct regulation and prudential regulation. In a unified model, both conduct regulation and prudential regulation are unified and undertaken by a singular agency.[699] This was the model which was adopted by the UK in 1997 which brought all the functions of monitoring conduct of business in banks and prudential functions under one agency which was the Financial Services Authority.[700] The UK adoption of this model was however changed, and the country recently adopted a Twin Peaks Model, one body handling conducts regulation and the other prudential regulation.[701] Taylor argued that the adoption of multiple agencies to handle conduct supervision and prudential governance has the impact of creating problems which are associated with overlap of regulation, duplication of rule books, potential arbitrage of regulation, bureaucratic wrangles, the lack of proper coordination within and between the regulating bodies, and finally a lack of clarity and transparency within the banking regulatory framework.[702]

This does not mean that the unified agency model is free from problems. Briault has revealed that the unified approach has additional advantages and hence should be implemented as compared to the Twin Peaks Model which separates conduct and prudential governance within different agencies. There is a benefit of harmonisation which is brought about by unifying models. The rationalisation and consolidation of rules, principles, and guidance which have

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698 De Luna-Martinez, José, and Thomas A. Rose. International survey of integrated Banking sector supervision. Vol. 3096. World Bank Publications, 2003. <https://openknowledge.worldbank.org/handle/10986/18144> accessed 20 September 2019.
699 Briault, Clive. "The Rationale for a Single National Banking Services Regulator" (1999) 2 (211)Opportunities and Risks in Central European Finances< http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.468.6859&rep=rep1&type=pdf> accessed 1 August 2019.
700 Abrams, Richard K., and Michael Taylor. Issues in the unification of Banking sector supervision. International Monetary Fund, 2000. IMF WP/00/213 < www.imf.org/external/pubs/ft/wp/2000/wp00213.pdf> accessed 29 January 2020.
701 Abrams, Richard K., Michael W. Taylor, and London School of Economics (United Kingdom). Banking Markets Group;. "Assessing the case for unified Banking Sector Supervision." Current Developments in Monetary and Banking Law 2 (2003): 463; Arnone, Marco, and Alessandro Gambini. "Architecture of supervisory authorities and banking supervision." Designing Banking Supervision Institutions: Independence, Accountability and Governance, Edward Elgar, Cheltenham (2007): 262-308;
https://static1.squarespace.com/static/54d620fce4b049bf4cd5be9b/t/55241159e4b0c8f3afe1d11e/1428427097907/Twin+Peaks+A+regulatory+structure+for+the+new+century.pdf> 1 August 2017.
702 Taylor, M. (1995), Twin Peaks: A Regulatory Structure for the New Century, London, Centre for Study of Banking Innovation, December; Taylor, M. (1996), Peak Practice: How to Reform the UK's regulatory System, London, Centre for Study of Banking Innovation, October; Masciandaro, Donato. "Unification in Banking sector supervision: The trade-off between central bank and single authority." Journal of Banking Regulation and Compliance 12, no. 2 (2004): 151-169; <https://www.researchgate.net/publication/315366898_Twin_Peaks_A_Theoretical_Analysis> accessed 1 August 2017

been issued by the regulator and when embedded in the prevailing legislative framework can easily be implemented.[703] Briault also argues that since the system uses a single process in terms of authorisation of banking processes, approval, and compliance, then the standards which are put in place are easy to follow. Further the fact that a single database is used for compliance, data and information sharing makes the system to have more consistencies. In addition, the single regulator makes use of a single scheme in terms of handling conduct of business-related issues like compensation, consumer complaints and has a single independent dispute settlement scheme or Tribunal making the system more reliable and the decision more consistent as compared to having more agencies. The reasoning that conducts and prudential issues may and even most of the time be connected makes a unified regulator more desirable.[704]

Furthermore, there exists other factors which can also cause a country to merge conduct of business and prudential regulation. One reason is an unclear demarcation between conduct of business issues and prudential issues when handled by one agency but makes more sense as a wider scope of analysis can be achieved as compared to a single view which may not seek to resolve the underlying risks.[705] The issue of multiple accountabilities and blame shifting is avoided as there is only one regulator who handles both. In that case there can be no confusion on whether a risk was a prudential one or conduct one and hence apportioned to a particular agency.[706]

It should be noted that none of the academic experts and researchers have argued that these rationales make the unification of conduct and prudential regulation to one supervisor advantageous and better for the developing markets. In fact, the system has faced a number of criticisms from a number of authors.[707] The main argument is the reasoning that the two dimensions of the conduct of business and prudential regulation need fundamentally different cultures and approaches and thus it creates doubt if a single agency has the power to affect this requirement. Even in practice, the combination of the two elements into the hands of one single regulator is most likely to adversely affect the efficiency in which one concept is undertaken

[703] C Goodhart, P Hartmann, D Llewellyn, L Rojas-Suarez, and S Weisbrod, Financial Regulation: Why, How and Where Now? (Routledge, London, 1998) 5

[704] Briault, C. (1998), 'A Single Regulator for the UK Banking Services Industry', Banking Stability Review, November 1998. <https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/1998/autumn-1998.pdf> accessed 1 August 2019

[705] Di Noia, Carmine, and Giorgio Di Giorgio. "Should banking supervision and monetary policy tasks be given to different agencies?." International Finance2, no. 3 (1999): 361-378.

[706] Goodhart, Charles AE. "The organizational structure of banking supervision." Economic Notes 31, no. 1 (2002): 1-32.

[707] Masciandaro, Donato. "Divide et impera: Banking supervision unification and central bank fragmentation effect." European Journal of Political Economy 23, no. 2 (2007): 285-315.

which may overshadow the other when handled by the same agency. The degree of care and importance which the two concepts need will not be covered properly by a single supervisor. This is recorded in the words of Michael Taylor: “There are already profound differences between the style and techniques appropriate to prudential and conduct of business regulation, and these are likely to become more pronounced as prudential regulation moves further in the direction of assessment of firms' own internal risk control systems. It would be difficult to combine two such different cultures within a single organisation.”[708]

A single and unified agency which is tasked with all regulatory and supervisory aspects would most likely be taken to be excessively overpowered. The chances that such an agency may be unresponsive, unwieldy, have excess bureaucratic processes due to many powers and many compliance processes. Abrams and Taylor also noted that the possibility that there may be a potential conflict of interests between conduct of business and prudential regulation is very high in terms of supervision and regulation owing to the different nature in their objective of prudential regulation and conduct regulation. While the former is more aligned to solvency in the banking sector, the latter is more inclined to consumer protection and interests. It thus can be put forward that separate agencies which are responsible for undertaking conduct and prudential regulations could be more effective than a unified agency since the objectives of each will be handled with the uniqueness and effectiveness they deserve.[709] The implication of this is an integrated regulator, a unified one will also lack a clear focus on the rationales and objectives of supervision and regulation.

The emergence of significant culture conflict may be seen within a unified structure if a single agency is given the mandate to handle all aspects of regulations, and this can be a challenge when other banking institutions are allocated to the same regulator. It will be hard for a single regulator to undertake adequate reflection of the fundamental diverging requirements, approach, rationale, and perspectives that are required for the various banking institutions to approach each without compromising the objectives of the other. The challenge is that the unified institution will be very difficult to manage and will most likely have an unclear focus. According to the Reserve Bank of Australia: “The differences in objectives and cultures would

[708] Llewellyn, David T. "Institutional structure of Banking regulation and supervision: The basic issues." In Paper dipresentasikan pada World Bank seminar “Aligning Supervision Structures with Country Needs” tanggal, vol. 6. 2006
[709] Abrams, R. K. and Taylor, M (2000), “Issues in the Unification of Banking Sector Supervision”, MAE Operational Paper, International Monetary Fund, Washington, IMF WP/00/213 < www.imf.org/external/pubs/ft/wp/2000/wp00213.pdf> accessed 29 January 2020

produce an institution which was difficult to manage and unlikely to be clearly focused on the various tasks for which it had responsibility."[710] The unified regulatory model, just like the integrated approach, is more likely to be faced with the so-called Christmas-tree effect whereby a large list of responsibilities will cast upon the agency in wide area of finance, and this can be accumulated over time hence making the agency lose the focus on both conduct regulation and prudential oversight.

For any developed country which seeks to adopt the unified model, it is clear that there may arise genuine conflict concerning the objectives and the balance between conduct and prudential aspects of regulation. A major issue that has to be taken into account is the institution which is the best to solve these challenges. It should be noted that in a unified agency, the resolution of conflicts is always internalised unlike multiple agencies, and hence advantageous. However, this has been revealed to be undesirable since in the conflict resolution the judgement is premised on key issues such as shareholders and stakeholders' participation, then such decisions should be undertaken at a political level and in a process that includes accountability to the public. This can only be achieved by having separate agencies which handle conduct and prudential aspects separately hence allowing a better framework for consultation at a political level.[711]

4.7.3 The Twin Peaks

The Twin Peaks has been supported by Taylor, Goodhart and others who have discussed that it is better to use a model and an approach which are based on objectives of banking regulations. The approach entails the creation of two separate and integrated agencies for conduct and prudential regulation and supervision. The author distinguishes the objectives of regulation, that of consumer protection and soundness and safety in banking and argue that the systemic considerations cover not only banking sectors but also extend to the wider range of other banking sectors.[712]

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[710] Thompson, G. (1996), 'Regulatory Policy Issues in Australia', in Edey, M. (ed.), Future of Banking System, Sydney, Reserve Bank of Australia.

[711] Taylor, M. (1995), Twin Peaks: A Regulatory Structure for the New Century, London, Centre for Study of Banking Innovation, December; Taylor, M. (1996), Peak Practice: How to Reform the UK's regulatory System, London, Centre for Study of Banking Innovation, October

[712] Goodhart, C.A., Hartmann, P, Llewellyn, D. T., Rojas-Suarez, M, and Weisbrod, S (1999) Banking Regulation: Why, How and Where Now?, London, Routledge; Goodhart, C.A.E. (1996), 'Some Regulatory Concerns', Swiss Journal of Economics and Statistics.

Even though the key issue which faces the Twin Peaks is the role of the central banks in the supervision and regulation, the system has worked in many jurisdictions. In 1997, the Wallis Committee of Australia made recommendations to the government of changing the role of the Reserve Bank of Australia which was primarily the prudential regulator. Australia became the first jurisdiction to establish the Twin Peaks model, creating the Australian Prudential Regulatory Authority (APRA) and the Australian Securities and Investments Commission (ASIC). Systemic stability remained the role of the Reserve Bank of Australia (RBA) and competition was the responsibility of the Australian Competition and Consumer Commission (ACCC). Many other countries like the UK and South Africa have adopted the Twin Peaks. In the Middle East, Qatar adopted this model of regulatory structure. This model has been considered to be a leading one in the world and since its adoption in 1997 by the Australian government it has been linked to its better performance during the banking crisis. Australia was the only country in the G20 which recorded better performance and was not largely affected by the crisis.

This model consists of the main regulator which is tasked with the maintenance of banking stability of ensuring that banking institutions do not end up collapsing, and another agency charged with regulation of the banking business to ensure that there is consumer protection in that the banking sector does not fail their customers. In as much as there are debates on the naming of the system, whether it is a 'Three Peaks' system or a Twin Peaks the systems' success has attracted a number of countries which are willing and even started making necessary preparations to adopt it. Hong Kong, South Korea, and the Euro Federal zone have intimated on adopting this structure.[713]

It would be a misnomer to argue any system including Twin Peak is a perfect system. In fact, the way in which this system has been adopted in the various countries suggests that there is no uniformity in the adoption of this structure. In the Netherlands, the central bank is the primary body which conducts prudential regulation, while in Australia the system is different from the central bank which is left with handling of the systemic risks on payment processes and the lender of last resort. It can be argued that since prudential regulation concerns market stability; hence the prudential regulator would most likely be the lead regulator. However, this notion is discredited by the Twin Peaks supporters who have argued that each element is crucial

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[713] Andy Shmulov, Doing it the Australian Way, 'Twin Peaks' and the Pitfall in Between (March 2016) http://clsbluesky.law.columbia.edu/2016/03/31/doing-it-the-australian-way-twin-peaks-and-the-pitfalls-in-between-2/

and hence the conduct regulator ought not to be disregarded or created as a weakling compared to the sister prudential regulator. This is because even though it appears that conduct regulations apply on a smaller scale, there is a higher chance that consumer abuse and market conduct can end up affecting the system stability of banking institutions and hence the importance of empowering both bodies. Notwithstanding, it has been easy for countries with developed banking markets like the UK and Netherlands to adopt it. The same has been the case with South Africa which is a developing banking market.[714]

4.8 CONCLUSION

It can be argued that developing Countries require a much simpler banking regulation model that has less bureaucratic processes and hard locks. The Basel Committee has recommended the adoption of the Twin Peaks which has been regarded as one of the best regulatory models. The reason that it arguably separates conduct regulation and prudential regulation creates a clear outline or roles and responsibilities. Of course, in adopting it, there are issues such as political control, the prevailing banking conditions, and the existing framework etc. It is not a perfect system as it is most likely to be faced with a number of challenges but with proper implementation and development the Twin Peaks model is a more desirable regulatory structure for banking.

We have also discussed in this chapter that the Central Bank in Pakistan protects the interests of investors and consumers by exercising "prudential supervision and control" over its banking system.[715] These Prudential regulations impose minimum requirements to strengthen the risk management processes through establishing comprehensive credit risk management systems appropriate to their type, scope, sophistication, and scale of operations and require the Board of Directors of the banks/DFIs to establish policies, procedures and practices to define risks, stipulate responsibilities, specify security requirements, design internal controls and then ensure strict compliance with them. These prudential supervision and control impose an obligation to protect the interest of investors and consumers by establishing separate Risk Management capacity even before a bank becomes operational and before embarking upon or undertaking consumer financing.

[714] Andy Schmulov, Finanial Regulation Is Australia's 'twin peaks' model a successful export? (2016) https://www.lowyinstitute.org/the-interpreter/Banking-regulation-australias-twin-peaks-model-successful-export
[715] This confirms one of hypothesis of this thesis

The State Bank has been encouraging banks to follow international best practices and instil sound risk management and corporate governance culture. In this regard, SBP has been issuing instructions from time to time which include the following main circulars: i. Risk Management guidelines were issued vide BSD circular 7 of August 15, 2003, to provide broad level guidance on various risks (including operational risk) faced by the banks. ii. Guidelines on Internal Controls were issued vide BSD Circular 7 of May 27, 2004, to ensure existence of an effective internal control systems. iii. Business Continuity Planning guidelines were issued vide BSD circular 13 of September 4, 2004, in which the banks were advised to develop effective contingency and security plans. Iv. The State Bank Implementation of Basel II guidelines issued vide BSD circular 8 of June 27, 2006, which in addition to credit and market risks also require banks to allocate capital for operational risk based on prescribed approaches.[716]

The Basel Committee's proposal on an updated Capital Accord, Basel II,[717] includes market discipline as a core element. The principle-based method sets out the principles of regulation, allowing flexibility towards new products and systems. It aims to promote innovation of financial institutions through greater freedom of management. This enhances financial institutions' ability to make improvements on management, risk control and compliance, without being hampered by regulatory barriers. A more flexible approach to new products and transactions is also an important part of this approach.[718] Principle-based regulation is often considered to be counter to rule-based regulation. However, this is not an accurate description of rule-based regulation. Rule-based regulation prescribes detailed rules related to the operational scope and activity of financial institutions.[719]

The risk-based method expects each financial institution to improve their risk-management capacity. This would enable financial institutions to understand their various risks faster and more accurately. It is closely related to the subsequent market discipline. Market discipline envisages that stakeholders of the financial institution will monitor the financial institution. If issues are not resolved quickly, the stakeholder may decide to withdraw his investment, or sell

[716] www.sbp.org.pk/bprd/2014/c4-annexure-1.pdf
[717] Basel Committee, "A New Capital Adequacy Framework' (June 1999) and Basel Committee, "International Convergence of Capital Measurements and Capital Standards: A Revised Framework' (June 2004).
[718] http://www.fsa.go.jp/singi/singi_kinyu/s_group/siryou/20070301.html
[719] C. Goodhart, "The Free Banking Challenge to Central Banks" (1994) Critical Review 411

the shares of the financial institution. This is a real threat to the financial institution, as it may lead to insolvency if they are withdrawn quickly.[720]

Self-regulation is considered to be complementary to principle-based regulation, shaping the specifics of regulation.[721] Penalties have been used as a way of imposing sanctions against wrongdoing of financial institutions, in tandem with greater personal liability of the management. Both of these moves are to impose greater self-discipline on financial institutions' activity and to limit the desire to make illegal or inappropriate transactions. This heightens the reputational risk of financial institutions taking such actions.

It is generally considered by many academics e.g., Llewellyn[722], Mwenda and Flemming,[723] and others, that there is no ideal one size fits all structure for a jurisdictional regulatory regime. Tirole and Dewatripont find the rationale for banking regulation in "the need to protect the small depositors." Deposits are primarily made by small unsophisticated depositors who are, in practice, unable to monitor the soundness of the banks they lend money too, as well as it being economically wasteful for all to try.[724] The general correctness of this seems borne out by the US experience of wildcat or free banking after the dissolution of the Second Bank of the United States, and possibly also by the instability of the Scottish model of free banking (although this has been vigorously contested). This view was given the name, by Tirole and Dewatripont, of "representation hypothesis", with the function of regulation to exercise the type of control depositors would like to exert if they were sophisticated and fully coordinated.

As developing markets expand their banking sector, they also experience complexities in regulation and supervision; we have seen that there can be more regulatory agencies which are in charge of monitoring the banking sector. This issue raises the challenge of excessive or even an additional institution which could end up adding uncertainties, risks, and costs of regulation.[725] Should such a system be implemented for a developing market then justice will

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[720] M Yokoi-Arai, "The Balance of Market Discipline in Bank Regulation' in L Gorton (ed), Breakdown of Public & Private Dichotomy in Commercial and Financial Law (Studentlitteratur, Lund, Stockholm, 2003) 81-105

[721] L.H. White, Free Banking in Britain, 2nd edn (London: IEA, 2008)

[722] D.T. Llewellyn, "Institutional Structure of Financial Regulation and Supervision: The Basic Issues" Paper presented to a World Bank seminar (June 2006)

[723] Kenneth K. Mwenda and Alex Fleming, "International developments in the organizational structure of financial services supervision", Paper presented at a seminar hosted by the World Bank Financial Sector Vice-Presidency (September 20, 2001).

[724] Tirole and Dewatripont, The Prudential Regulation of Banks ((Cambridge: MIT Press, 1995).), p.31.

[725] Carmichael, Jeffrey, Alexander Fleming, and David T. Llewellyn, eds. Aligning Banking supervisory structures with country needs. World Bank Publications, 2004.

not have been done to that banking system since the last thing the developed markets require is the complications of multiple agencies in the regulatory institutional framework in, as was seen in the UK in 1997, colluded in a self-defeating spiral of complexity.[726] No capitalist economy can prosper without sufficient certainty about the way that rights and obligations will be interpreted and enforced. Arbitrary regulatory judgements also impose a high tax on all investments and savings."[727]

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[726] M. King, The End of Alchemy (London: Little, Brown, 2016).
[727] King (n 726)

CHAPTER 5:
SHOULD BANKING REFORMS BE ACHIEVED BY LEGISLATION ONLY OR IN COMBINATION WITH CODES OF CONDUCT FOR ATTAINING GOOD CORPORATE GOVERNANCE?

5.1 INTRODUCTION

The role of legislation and codes of conduct is very crucial in a banking sector. It is through the use of regulations and codes of conduct that the banking sector can be kept sound and dynamic to be forced to comply with all macroprudential policies and macroeconomic policies. The legislation not only provides the framework for banking regulations but also gives legitimacy to the issuance of codes of conduct and practice in the banking sector through the supervisory and regulatory bodies. Corporate Governance has always been an interdisciplinary research issue in management, law, and economics. In theory and practice of corporate governance there is a rise of broad discussion of “best practice model.” The countries are learning from the successful experiences of other countries and applying the corporate governance mutatis mutandis according to their own national conditions to improve and develop their systems.

The study of corporate governance in banking has gained increasing attention over the past two decades due to the experiences of banking crises. Corporate governance is meant to play a critical role in maintaining banking market stability. Effective corporate governance helps to obtain and maintain public trust and faith in the banking system, which is essential to a steady operation of the banking industry as well as the whole economy. Ineffective and inefficient corporate governance in commercial banks may lead to banks’ liquidation impacting the deposit insurance system; which may in turn spread its influence into the macroeconomic system with heavy public costs and serious consequences. Furthermore, it can also reduce the market confidence in banks' ability to manage assets and liabilities appropriately, which may trigger liquidity crises. Corporate governance, bank regulation, and market competition are complemented to each other and are essential for the maintenance of banking stability. The improvement of bank governance is to be made on the basis of a dynamic and healthy industrial environment, which includes efficient banking regulations regarding information disclosure

and risk control, as well as introduction of more competition in the banking industry in view of their positive effects on bank's governance.[728]

The best mode of supervising and regulating the banking sector is subject to finding the answer, whether it is through secondary regulation or code of conduct or through the use of primary legislation. There are also a number of regulatory tools such as Ministerial Decrees and Central bank guidelines which can be prescribed on the basis of power emanating from the parent acts i.e., the central bank legislations or the banking legislation. The best ways to look at and determine the manner in which banking reforms can be introduced is by looking at each reform on a case-by-case basis. Major underlying reforms such as corporate governance, statutory compliance mandates like disclosure, registration, and constitution of banks should be contained in a statute. This is indisputable since these are tested principles which have withstood the test of time.

Delegated legislation is another way to introduce banking reforms; it has been argued that the use of delegated legislation issued in banking can only be desirable if done in line with the existing legal framework. Some of the benefits which attach to the use of delegated legislation also attach to use of code of conducts. The benefit includes saving time, in introducing and implementing reforms, that a legislative procedure may take.[729]

In this chapter it is discussed and explored if sound corporate governance can be applied to Pakistan Banking system; [730] its effectiveness and what steps Pakistan Banking System must take in making corporate governance applicable or effectively applicable in Pakistan Banking System.

5.2 Limits of legislation to bringing a reform

[728] Arnone, Marco, and Alessandro Gambini. "Architecture of supervisory authorities and banking supervision." Designing Banking Supervision Institutions: Independence, Accountability and Governance, Edward Elgar, Cheltenham (2007): 262-308

[729] Edward C Page, Governing by Numbers: Delegated Legislation and Everyday Policy-Making (2001) Bloomsbury Publishing ISBN 1-84113-207-1; Mads Andenæs and Alexander Türk (eds) Delegated Legislation and the Role of Committees in the EC (2000) 4 Kluwer law international IBSN-9789041112750. Maureen O'hara, 'A Dynamic Theory of the Banking Firm' (1983)38(1) The Journal of Finance Wiley 127,140 <https://doi.org/10.1111/j.1540-6261.1983.tb03630.x> accessed 14 January 2020

[730] This questions also one of hypothesis of this thesis

The role of legislation being the principal source of law in reforms can be seen in many jurisdictions. It is through legislation that makes the banking sector transparent and that allows the banking sector to be held responsible and put into account. Macro prudential guidelines can be injected into the banking sector through legislations as well.[731]

In contemporary legislation theory, legislation is approached from roughly two different models: law as symbol vs. law as instrument. Each model offers its own specific perspective from which in concrete cases legislation can be described and evaluated. In the Law As Symbol (LAS) model legislation is seen as an ongoing communicative and interactive process in which various actors in society – the legislator, officials, and citizens – work together on an equal level to create and implement legislation. In the Law As Instrument (LAI) model legislation is conceived, on the other hand, as a command that is issued by the legislature, from a position above or outside society, in order to achieve a specific policy goal.[732]

Applied to legislation, several claims follow from the LAS model:

(1) Legislation has value: because legislation is the outcome of special, democratic procedure it has, 'dignity': "(...) the dignity of legislation, the ground for its authority, and its claim to be respected by us, have a lot to do with the sort of achievement it is.

(2) Legislation is an expression of values: it contains aspirational norms which reflect generally shared moral values. It symbolises what we, as a community, stand for.

(3) Legislation requires interpretation: law consisting of general clauses have to be interpreted. The legislature cannot and does not intend to determine the meaning of the law; in its application to concrete cases, the law acquires its provisional meaning. There is no strict division of power: in some cases, other instances than the legislature (for instance the court) can take the initiative to create legal norms or give new meanings to existing norms. The law's interpretation is a collective enterprise in which both legal officials and citizens participate and cooperate.

(4) Legislation requires communication: the legislative process does not stop with the promulgation of the law; the legal norms have to be communicated to the norm addressees. People cannot reasonably be expected to comply with the law if they do not know its content.

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[731] Helen Xanthaki, Misconceptions in Legislative Quality: An Enlightened Approach to the Drafting of Legislation https://www.researchgate.net/publication/329585655_Misconceptions_in_Legislative_Quality_An_Enlightened_Approach_to_the_Drafting_of_Legislation [accessed Dec 28, 2022] at pg. 20

[732] Bart van Klink, Misconceptions in Legislative Quality: How to Account for the Bindingness of Law? https://www.researchgate.net/publication/329585655_Misconceptions_in_Legislative_Quality_An_Enlightened_Approach_to_the_Drafting_of_Legislation [accessed Dec 28, 2022] at pg.78

It is the legislature's duty to actively disseminate its message, not only via the official channels but also via other media. In the process of communication, the meaning of the law inevitably changes.[733]

Whereas the application of LAI model states that Legislation has an instrumental value; the meaning of legislation is its use or usefulness. If it helps solve the social problem it is meant to solve, it serves its purpose as legislation; if not, it has to be repaired in order to improve its functioning or it has to be replaced or supplemented by some other instrument or instruments.[734]

Legislative quality has been discussed and debated in great length, now more than ever before, with the recent EU focus on better regulation. The concept is commonly taken up by many disciplines, all with a different focus: lawyers talk about good and bad laws, linguists debate good and bad expressions, economists discuss legislative efficiency, and political scientists seek good regulation. All angles are welcome but there still is one piece missing from the debate: the definition of legislative quality. What is it? How can it be achieved? Actually, can it be achieved? Without agreeing on the semantic field of the concept and its constituent referents, academic doctrine and professional praxis cannot benefit or advance.[735]

Legislation is simply a tool for regulation, namely a tool in the process of putting government policies into effect to the degree and extent intended by the government. In other words, legislation is one of the many weapons in the arsenal of governments for the achievement of their desired regulatory results, which in turn is the prevalent measure of policy success. The regulatory tools available to the government vary from flexible forms of traditional regulation (such as performance-based and incentive approaches) to co-regulation and self-regulation schemes, incentive, and market-based instruments (such as tax breaks and tradable permits) and information approaches. But legislation remains one of the most popular regulatory tools.

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[733] Klink (n 732) p79
[734] Klink (n 732) p 73
[735] Helen Xanthaki, Misconceptions in Legislative Quality: An Enlightened Approach to the Drafting of Legislation https://www.researchgate.net/publication/329585655_Misconceptions_in_Legislative_Quality_An_Enlightened_Approach_to_the_Drafting_of_Legislation [accessed Dec 28, 2022] at pg. 20

So, what is legislation attempting to achieve and by what means? This diagram visualises these goals and their hierarchy.[736]

Fig. 1. Hierarchy of legislative goals

The first and main inherent limit of legislation is a mere expression of the regulatory agenda, i.e., legislation inevitably relies on the soundness of the policy goals and regulatory aims set by regulators. Legislation requires a constitutionally, legally, ethically, and democratically justified policy aim pursued by equally constitutional, legal, ethical, democratic, and cost-efficient means to achieve it. Moreover, it relies on the intent of users and interpreters to comply with it. Of course, this interdependence of policy, regulation, legislation, and implementation works both ways: good legislative expression can accentuate the logic of the policy, clarify the choice of regulatory tools, and can ultimately incite implementation. But in the same way that efficacy requires legislative facilitation of regulatory success, it also requires the synergistic contribution of all parts and actors of the drafting process as part of the legislative process.[737]

Added to the lack of its ultimate control over efficacy, legislation is further limited by the means by which it can pursue efficacy. The diagram above expresses that effectiveness can be achieved by means of clarity, precision, and unambiguity. And that these can be enhanced by the use of plain language and gender-neutral language. Legislation aims to communicate the regulatory message to its users as a means of imposing and inciting implementation.[738]

It is this inherent limit of legislation that has led to the supplementing of the legislative text by parliamentary interpretation, policy guidance, explanatory materials, and annotations. What this fails to take into account though is the change in user attitudes: at a time where users are used to using the internet to receive direct answers from the original sources of communication instead of relying on intermediary professionals, legislation is used as a direct source of

[736] Xanthaki (n 735) p29
[737] Xanthaki (n 735) p 30
[738] Xanthaki (n 735) p 32

answers to questions related to the text. This is proven by the 2,000,000 users per month of the UK government's free electronic legal database. The second limit of legislation is its presentation in the form of written communication.[739]

Another limit of legislation relates to a phenomenon observed and recorded by the Office of Parliamentary Counsel: users' aversion to legislation. In other words, users of diverse legal sophistication are overwhelmed by the volume and complexity of legislation. They find it difficult to understand the terminology used with the text, the structure of the Act itself, and the interconnection of the Act with other primary and secondary legislative texts and the statute book as a whole. What users find intimidating is not just the words themselves (one could argue that the simplification of words has come a very long way) but the context of the legislative message within the many provisions of the same Act, and within the labyrinth of relevant primary and secondary sources of law. Negative perception of legislation describes the phenomenon of citizens' attribution of more complexity to legislation than it actually is. Navigation between pieces of legislation is often the problem. Users also appear to find it difficult to find reliable explanatory information and relevant guidance.[740]

Another inherent limit of legislation as a product are legislation's interconnection and reliance on regulation, the limits of legislation as written communication, and the intrinsic aversion of users to legislative texts.[741]

Another limitation is found in delegated legislation which authorises the regulators to bring regulations. In the banking sector, the use of regulations can only bring banking reforms to some extent. There is inherent danger of over-legislation when the regulator is delegated the authority to bring changes to regulations. The impact of such an occurrence is a negative impact on the banking sector because it will restrict the efficiency of the regulatory and supervisory bodies such as the central banks and other financial agencies. The other rationale for which the legislation cannot be entirely relied upon as any overreliance on the same has the impact of changing a legislator into a regulator.

[739] Xanthaki (n 735) p 33
[740] Xanthaki (n 735) p 33
[741] Xanthaki (n 735) p 33

Lastly the inherent limit on legislation in bringing reforms is in the legislative process itself which is not only lengthy but also subject to social and political approvals. An example can be quoted from “the issue of penalties on account of violations of Foreign Exchange Regulations in Pakistan:” due to contradictory legislations it had become difficult for the Central Bank to effectively monitor and supervise foreign exchange activities as PERA 1992 has an overriding effect over FERA 1947 and all other laws. Under FERA 1947, an individual cannot take out of the country an amount more than US$ 10,000/- in cash whereas PERA 1992 provides complete freedom in this respect. Accordingly, the only option available with The State Bank was to go through a complex and lengthy adjudication process. This issue became graver where immediate action was required against the Banks and Exchange Companies particularly when evidence was found on rising speculative activities in forex markets. Under such circumstances, the only recourse available with The State Bank was to suspend / cancel licences of the banks/Exchange Companies which often became more severe than the violation warrants. In the light of the above two factors, SBP had time and again proposed to the Government to make two amendments in FERA, 1947 (for giving powers to The State Bank to impose direct monetary penalties) and PERA, 1992 (excluding FERA 1947 from PERA 1992’s overriding effect). However, in response to such requests no development on requisite amendments in legislation had taken place.[742]

The other reason why trusting legislation so much may be counterproductive is the fact that there are always conflicts among legislators and an interplay of roles which may cause a hard lock between various banking stakeholders. This is even true in major and developed banking markets like the Netherlands, for instance, the role of regulation is between three agencies: the De Nederlandsche Bank (DNB), the Ministry of Finance (MoF) and the Authority for the Banking Markets. The Ministry of Finance can issue decrees which have the impact of affecting the functions of the DNB. These in themselves show that there are some challenges in banking legislations and hence there can be some non-enforcement issues.[743]

5.3 Why the contributions of Codes of Conduct may not be disregarded?

[742] www.sbp.org.pk/press/2008/SBP-Clarification-19-Oct-2008.pdf
[743] Jeroen J M Kremers, Dirk Schoenmaker and Peter J Wierts, ‘Cross-Sector Supervision: Which Model?’ (2003)1 Brookings-Wharton Papers on Banking Services 225,243 < https://www.researchgate.net/publication/236798262_Cross-Sector_Supervision_Which_Model> accessed 22 January 2020.

The role of codes of conduct is not to be taken lightly in the banking sector. The codes of conduct have been defined to be a set of rules that outline the social norms and acceptable duties and responsibilities, or prescribing proper practices in a sector, for an organization or a person. The concept of codes of conduct is closely connected to that of ethical standards and moral codes. The Merriam Webster Dictionary defines it as “a set of rules about good and bad behaviour.” The powers given to the supervisory and regulatory body are primarily creation of a sound banking system which is only achievable by practising a number of acceptable conducts which are generally acceptable both internationally and nationally as being good practice.

It is true that the development of banking has caused significant legal development in terms of creating a range of macro prudential policies and economic monetary policies and seeing from the working of the Basel Committee on banking supervision, the Council, the Commission, and the European Parliament have undertaken broad mandates to reform the banking system. This is creating trust and transparency in the system.[744] It is argued that there is a need for deeper action to be taken so that: the underlying ethical behaviour in the banking sector has to improve as well. This underlines the importance of creating trust in the banking sector since banking is all about perception.[745]

The corporate scandals in the banking sector have eroded public trust even if the relevant authorities in the EU and the US took adequate measures. They offered guidelines for creating good governance which is essentially a term which goes hand in hand with a good code of conduct in the banking sector.[746] The role of codes of conduct in the banking sector is rather wide, codes of conduct vary and may be general or specific. The specific ones offer guidance on specific areas such as disclosure of information and compliance with the law, such as the Dutch banking code under rule 5(4) & (5)[747] respectively. This means, among other things, that in your work you comply with the law, regulations, and rules of conduct and instructions that apply to your work for the bank. This means, among other things, that you do not disclose

[744] Ignazio Angeloni, ‘Ethics in Finance: A Banking Supervisory Perspective’, (26 September 2014) ECB Conference on “The New Banking Regulatory System: Challenges and Consequences for the Banking Sector” Venice <www.bankingsupervision.europa.eu/press/speeches/date/2014/html/se140926.en.html> accessed 23 January 2020.
[745] Sinkey Joseph, ‘Identifying" Problem" Banks: How Do the Banking Authorities Measure A Bank's Risk Exposure?’ (1978)10(2) Journal of Money, Credit and Banking Blackwell 184,193 < https://ideas.repec.org/a/mcb/jmoncb/v10y1978i2p184-93.html> accessed 23 January 2020.
[746] Ravid Rivka, ‘Standard Operating Procedures, Ethical and Legal Regulations in BTB (Brain/Tissue/Bio) Banking: What is Still Missing?’ (2008) Cell and Tissue Banking 121,137 < 10.1007/s10561-007-9055-y> accessed 23 January 2020
[747] The Netherlands Social Charter-Banking Code- and Rules of Conduct.

confidential information about customers to third parties without their permission. You only disclose information about customers to others if you are required to do so under the law, a court order, or the regulator. Neither do you misuse information available to you.

The codes of conduct and guidelines issued by the central banks can be used in conjunction with others. Although they do not create any binding laws, failure to adhere to them may lead to very serious consequences in terms of regulatory violations and the central banks can take appropriate action as per the enabling legislations. In a way, these codes of conduct are able to break down the requirements of legislation and create a framework in which the banking institution can have a clear way in which legislation trickles down to the specific banking sector.

One of the primary functions of codes of conduct is to emphasise the stipulations of the statute in an effort to create a culture where the law is adhered to, and malpractices are avoided; it is more like a training exercise with a view to allowing the banking sector to perfect the good conduct. For instance, the Federal Deposit Insurance Corporation (USA) has on various occasions called for the banking sector to implement effective internal corporate codes of conduct which are in tandem with the regulators' codes and guidelines for the promotion of ethical and fair actions that are crucial for good banking practice.[748] Therefore, one of the critical roles of these codes of conduct issued by the banking institution and the banking supervisor is that it allows and expressly reminds the Board of Directors or Trustees, the employees, and all stakeholders of the need for and importance of maintaining high standards in all banking undertakings.[749]

The working of the codes of conduct, unlike the legislations, allow for detailed guidelines to be issued in terms of special obligation to the banking institution officers, employees and directors. Further, since legislation offers umbrella protection to the banking sector in terms of corporate governance, risk management and liquidity and transparency, the code of conduct goes into detailed guidance in writing the entire organization, inclusive of the subsidiaries, all officers, employees, agents, and directors.

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[748] Federal Deposit Insurance Corporation, 'Banking Institution Letters, Corporate Codes Of Conduct Guidance on Implementing an Effective Ethics Program' (2015) <www.fdic.gov/news/news/Banking/index.html> accessed 23 January 2020.
[749] Rhys Jenkins, 'Corporate Codes of Conduct: Self-Regulation in a Global Economy' (2001)

In the UK, the FCA retains a High-Level Standards block within its Handbook structure. The FCA's High Level Standards comprise:[750]

- Principles for Businesses ("PRIN");
- Senior Management Arrangements, Systems and Controls ("SYSC");
- Code of Conduct ("COCON");
- Threshold Conditions ("COND");
- Statements of Principle and Code of Practice for Approved Persons ("APER");
- The Fit and Proper Test for Approved Persons ("FIT");
- Financial Stability and Market Confidence sourcebook ("FINMAR");
- Training and Competence ("TC");
- General Provisions ("GEN"); and
- Fees ("FEES").

In the UK, when the PRA restructured its rules, it also streamlined the content it had inherited and aligned it to PRA's general objective of promoting the safety and soundness of regulated firms and, for insurers, ensuring that policyholders are appropriately protected. The 11 Principles for Businesses were replaced with eight Fundamental Rules, while FINMAR was replaced by a Statement of Policy on the Exercise of the PRA's Financial Stability Powers. When it finalised its new Rulebook, the PRA explained that its Approach documents, the statutory Threshold Conditions ("TCs") and the Fundamental Rules are core to its supervisory approach and underpin the PRA Rulebook.[751]

Underscoring the importance of the principles are the remarks made by Mark Steward, FCA Executive Director of Enforcement and Market Oversight, in February 2020: "The principles are the foundations of good conduct and should be an integral part of the operational process of planning or decision-making at all levels and as a way of overseeing and assessing whether the firm's conduct remains appropriate. If firms and senior management approach a business activity from the outset using the Principles as a foundational guide, as part of the organisation of activities and as a way of monitoring execution of activities, I am sure we would see considerably less unintended harm caused by misconduct."[752]

[750] Hywel Jenkins and Cat Dankos, Journal Article Compliance Officer Bulletin, C.O.B. 2021, 183(Feb), 1-31 p.2
[751] Jenkins and Dankos (n 750) p.2
[752] Jenkins and Dankos (n 750) p.3

The FCA expects firms to consider notifications under principle 11 as part of their internal strategic and operational decision-making processes as well as in respect of instances where a firm may have fallen below the expectations of the relevant Handbook rules. It is advisable, therefore, that firms consider Principle 11 within their wider corporate governance policies and firms should be aware of the potential requirement to notify the regulators at the time of making a strategic decision with regulatory consequences rather than solely upon completion of implementation.[753]

There are numerous examples of fines for breaches of Principle 11. In 2016, a firm was fined over £3.25m and had a restriction imposed preventing it from accepting deposits for 168 days by the FCA for serious anti-money laundering systems failures. During the course of the FCA's investigation, the firm failed to notify the regulator of an allegation of fraud; the Final Notice explains that the breach of Principle 11 was determined to account for £140,000 of the financial penalty (a 30% settlement discount was applied to the original determination of £200,000). Providing false or misleading information to the regulator is also likely to be a breach of Principle 11, as is illustrated in an enforcement action which the FCA took against a UK insurance company in early 2016. In this case, the firm in question provided inaccurate information in response to requests from the FCA, and also failed to disclose information to the regulator that was material to the questions and issues it raised with the firm. The FCA noted that the effect of the breaches was to hinder the FCA's ability to take timely action to protect consumers; it imposed a £1,137,500 financial penalty on the firm (in administration). The PRA has also taken action against firms under Fundamental Rule 7. In 2017, the PRA imposed a fine of £17.85 million on a firm and £8.925m on its subsidiary for delaying disclosure of enforcement action being taken by a US state regulator to the PRA.[754]

A majority of the codes have an internal requirement for staffs and employees to be trained, and that a banking institution has to ensure that sufficient resources are put to this area; further the fact that the institution has its own disciplinary measures which can be included in the codes of conduct either adopted or issued by the regulator, it creates a sense of internal mechanism

[753] Jenkins and Dankos (n 750) p.10
[754] Jenkins and Dankos (n 750) p.11

in which a bank can comply with banking rules by ensuring that employees are properly educated and deterred from conducting any malpractice.[755]

The effectiveness of code of practice in a banking institution does not only have an advantage in the relation of outward performance, but also ensures that there is a system where the banking institution can have a way of benchmarking its performance. For instance, the management of the banking institution can review its performance on a regular basis or review its internal code of practice with the view of updating the same to be aligned to the new business activities, banking risks, regulators guidelines and the existing legal framework. Additionally, the code of practice for banking guides the banking institutions on how to coordinate with these banking stakeholders. One of the best examples of this internal control measures and bank governance is that of France.[756]

The call for accountability in this area and other areas of banking are important enough and ensure that malpractices such as insider lending and money laundering are prevented.[757] As much as codes of conduct can take the form of separate documentation outlining standards of behaviour and ethical guidelines for affected people, they are mainly supplemented by several attachments showing how an organization can best achieve the guidelines and standards. Further, it is only through the use of these codes of conduct that cross-reference can be done with other related and relevant procedures and policies hence ensuring that better decisions are made in any given situation taking into account all the relevant factors as guided by the codes of conduct. The codes of conduct are fluid and fit into an organization structure allowing broad corporate governance principles to be broken down into digestible bits for the banking institutions office. For instance, the code mandates the banking institutions to have at least more than two personnel responsible for the effective management of a banking institution.

The scope and nature of duties that are performed by these managers must be in line with the global approach and best practice and even so such management of the bank must be proper and fit for their professional duties. This entails proper training of legal officers, internal officers, and risk officers of the bank to keep them up to date with the prevailing and future

[755] J.C. Coffee, Gatekeepers: The Professions and Corporate Governance (OUP, 2006),
[756] The France Banking Regulation 2017
[757] Handbook of transnational governance (Polity, 2011); Wright Christopher and Alexis Rwabizambuga, ‘Institutional pressures, corporate reputation, and voluntary codes of conduct: An examicountry of the equator principles’ (2006) Business and Society Review 111 no. 1, 89-117.

banking trends.[758] The directors, managers, and other members of the board, and any such person who are exercising similar duties and powers, as well as personnel who oversee internal compliance and procedures, have to comply with key requirements, that is, their experience, professional skills, and honourability. This requirement is higher for larger credit facilities, which must comply with specific rules which prevent the accumulation of supervisory mandate and executive powers. The bigger banks are thus required to make sure that certain specific committees are set up within the organization personnel with proper skills based on the role which the committee plays in the institution. These committees dealing with specific matters like remuneration, appointments and risks have to adhere to specific thresholds.

This reveals that the role of the codes of conducts in banking is essential not only for bringing life to the stipulation of law but to also allowing the Banking institution to have an internal control mechanism which is owned by them and can be fluid enough to allow and recognise the dynamic nature of banking business and banking institutions.

5.4 What role may Good Governance play in establishing a Sound Banking System: a Qualitative and Empirical Study

5.4.1 Definition of Corporate Governance & its Application on Banking System

Corporate governance has been defined as a "system by which companies are controlled and directed."[759] For a more economic definition, it has been defined "to deal with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment."[760] In corporate law the major interest of corporate governance has been on the interest of the shareholders as members of a company. The other interest, that of the stakeholders, creditors and debtholders, the public interest, and the government together with other stakeholders with various social and environmental dimensions are not included and are left to other parts of the law, this is the classical shareholding approach of corporate governance. In contrast, most economists have decided to go with a broader approach to

[758] Part 4(a) of the France Banking Regulation 2017
[759] A. Cadbury, Report of the Committee on the Banking Aspects of Corporate Governance, London, December 1992
[760] A. Shleifer & R. W. Vishny, "A Survey of Corporate Governance," 52 Journal of Finance 737 (1997) 737

corporate governance and have made sure that it includes all the stakeholders including the shareholders.[761]

The Banking Sector is the liquidity risk because banking institutions are constantly borrowing on short term basis and long-term lending and when amalgamated with other consequential risks like the case of reputational risk and systemic risks, the sector becomes a very volatile and fragile one.[762] By allowing the banking institutions' officers to be trained in relevant areas such as finance, law and accounting, codes of conduct will be the guide to ensuring that there is acknowledgement of proper corporate governance.[763]

The confidence from the public and trust are at the heart of a successful banking system. This kind of importance makes it necessary for both strong internal and external corporate governance. Control within the banking institution focuses on the conflicts between the principal and the agent which is between shareholders and directors of a banking institution. This also covers instances of control between majority shareholders and minority shareholders. The shareholders have to play their role in keeping in check the director such that they do not act arbitrarily and hence help to maintain the risk profile of the bank. Of course, there are stakeholders like debtholders who also have to take part in the governance of the banking sector. This kind of governance is primarily contained in corporate law.

Gualandri et al.[764] argues that banks in particular are financed dominantly by borrowing from depositors and other creditors, less so by equity finance. The significantly heavier reliance on leverage means that depositors and creditors share a substantial amount of residual risk which in conventional corporate governance models would fall upon shareholders. Corporate governance here as elsewhere covers the way in which the board sets out the bank's strategy, objectives, its risk appetite and management of risk, has the oversight of the bank's business, protects the interests of depositors, and shareholders, taking into account the interests of other stakeholders, and "align corporate culture, activities, and behaviours with the expectation that the bank will operate, in a safe and sound manner, with integrity, and complying with

[761] K.J. Hopt/G. Wohlmannstetter (eds.) Handbuch Corporate Governance von Banken (Vahlen, C.H. Beck Munich 2011), 31, 33; A. v. Werder, "Ökonomische Grundfragen der Corporate Governance," in P. Hommelhoff/K. J. Hopt/A. v. Werder, eds., Handbuch Corporate Governance (Schäffer-Poeschel Stuttgart/Dr Otto Schmidt KG Cologne 2d ed 2009) 3 ff, 9;
[762] OECD, Corporate Governance and the Banking Crisis: Key Findings and Main Messages, Paris, June 2009., 9, 32;
[763] Rammal Hussain and Lee Parker, 'Audit and governance in Islamic banks: selection and training of Shari'ah advisors' (2010) PhD diss., University of Sydney
[764] E. Gualandri, A. Stanziale, and E. Mangone, "Internal Corporate Governance and the Financial Crisis: Lessons for Banks, Regulators and Supervisors" (December 13, 2011), SSRN, http://ssrn.com/abstract=1971659 accessed November 2022

applicable laws and regulations". The board works together with senior management to achieve these objectives but is also responsible for the oversight of the bank's strategy and the way in which the bank manages its risks.[765]

White[766] argues that given the highly leveraged nature of banks and financial institutions, the risk-bearing capacity of residual losses is extended to debt holders (such as bondholders and depositors) to a greater extent than shareholders in the conventional paradigm of corporate governance. It can also be argued that the residual rights over the net earnings of a bank or financial institution are distributed among shareholders, bondholders, and depositors (such as savings depositors who may be paid a higher interest rate). Further, bondholders and uninsured depositors may take the residual losses if the bank or financial institution should fail. If there is a potential for state bailout of a failing financial institution, the state could even arguably fall within the class of residual risk bearer, though not as a residual owner of rights over net earnings.[767]

The control from outside has now become a crucial aspect of the banking system. The external corporate governance has been developed and expanded greatly after the 2008 banking crisis and covers various elements of governance like control by the auditors, rating agencies, disclosure to the banking market, the market of corporate control, etc.[768] These kinds of disclosures are necessary under corporate governance in banks to enable the stakeholders and the principal (shareholders) to have a clear understanding of the current situation of the banking sector and to enable the stakeholders and the shareholders in taking necessary measures and prevent the board and the management from undertaking risky banking investments and operations. Ciancanelli and Gonzalez[769] also argue that the agency paradigm is much more complex in the banking sector, in that the main issue is risk-shifting between shareholders and debt holders such as depositors and bondholders. Further, the potential of state bailout puts the state in the position of stakeholder, mitigating shareholder and creditor risk.[770]

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[765] OCC, Corporate and Risk Governance, Comptroller's Handbook, Version 2.0, p.3.

[766] L. J. White, "Corporate Governance and Prudential Regulation of Banks: Is There Any Connection?" in J. R. Barth, C. Lin, and C. Wihlborg (eds), Research Handbook on International Banking and Governance (Cheltenham: Edward Elgar, 2012

[767] D. Bugeja, Reforming Corporate Retail Investor Protection (Hart, 2019

[768] M.J. Roe and R. Shipra, "The Power of Narrative in Corporate Lawmaking" (2020), ECGI Working Paper No.554, p.32.

[769] P. Ciancanelli and J. A. R. Gonzalez, "Corporate Governance in Banking: A Conceptual Framework" (2000), http://papers.ssrn.com/paper.taf?abstract_id=253714 [Accessed September 2022].

[770] I. H.-Y. Chiu, "Institutional Shareholders as Stewards: Toward a New Conception of Corporate Governance" (2012) 6 Brooklyn Journal of Corporate, Financial and Commercial Law 387.

The special nature of banking institutions and sectors enable the special auditors for these institutions which are mandatory under the supervisory authority. The level of control which is created by external and internal control play a crucial role in ensuring that the sector is not hit by unnecessary systemic risks.

The lack of proper internal and external control measures in other words is poor corporate governance which has been associated with collapse of banking institutions and banking shocks. Many researchers have intimated that a high deficit in proper governance in banking is responsible or rather a disposing factor for failings. This is also recognised by the Basel Committee report and are equally given weight: risk management is higher in ranking than the board and the management.[771] After the crisis, it was clear that for a better banking system, a new system had to be adopted. Further a vast amount of data, reports and research indicated that more risk management and internal control measures had to be initiated.[772] The 2010 report recognised the role of corporate governance and suggested 14 principles of corporate governance which upon implementation and including the same to compliment the regulatory framework, would go a long way in preventing the 2008 crisis.[773]

The importance of corporate governance in banking is one which has been tried and tested. Effective corporate governance has been seen to be very crucial for the effective working of the banking system and a country's economy. Because banks conduct the function of creating and intermediating funds from savers to the depositors and to the activities which support business and enterprise, they are central to the economic drive. Thus, banking safety and soundness is very essential to Banking stability and thus the way in which these banks perform their functions and businesses, therefore, is critical to the economic health of a country. It is thus clear that any governance weaknesses at a banking level could end up playing a major role in the weakening of a Banking system and can result in transmission of the problem not only to the entire banking system but also to the economy as a whole.[774]

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[771] Basel Committee on Banking Supervision, Principles for enhancing corporate governance, October 2010
[772] Ibid, Basel Committee 2010
[773] The paper recommended fout (4) principles which touched on the working of the board of directors, one (1) on senior management of the banks, four (4) on internal control and risk management for banks, two (2) on the remuneration and compensation of the management and the board, two (2) on the structure of banking institutions, and one (1) covered transparency and disclosure for the banking companies
[774] Bank for International Settlement, Basel Committee on Banking Supervision Guidelines Corporate governance principles for banks, http://www.bis.org/bcbs/publ/d328.pdf

The major role of the goal of corporate governance is pegged on safeguarding the interest of the shareholders conforming to sustainability of the banking sector and public interest. This aspect of corporate governance makes sure that all the stakeholders in the banking system play a role in ensuring that there is a sound banking system. The allocation of responsibility and authority, which is one of the main goals of governance, ensures that the banking affairs and banking business are conducted in a manner which is prudent, and that the banking institution board and the top management undertakes decision making in a manner which is lawful.

The importance of corporate governance goes to the root of setting the objectives and strategies of the banking business; oversee and select personnel; daily operation of the banking business; meet the shareholders' interests and obligations, protect the interests of the banking depositors, and take into account the interests of other recognised stakeholders such as the creditors; align all the corporate activities, corporate culture and behaviour with the anticipated sound practices and make sure that the banking institution operates in a sound and safe manner, with integrity and further in compliance with regulations and applicable law; and establish control functions.[775]

Therefore, corporate governance is an all-rounded tool; it does not only cover the legal aspects but also encompass the management, the stakeholders, and good practices. One of the main advantages of corporate governance is that it works well with other banking tools such as compliance and supervision. It is no wonder that mostly all supervisors have insisted on the need for sound corporate governance in banking institutions. BIS argues that sound corporate governance, "…. is an essential element in the safe and sound functioning of a bank and may adversely affect the bank's risk profile if not operating effectively. Well governed banks contribute to the maintenance of an efficient and cost-effective supervisory process, as there is less need for supervisory intervention…"[776]

The introduction of the Basel Committee Principles for Enhancing Corporate Governance in October 2010 has shown to be a major step in the long-standing efforts of increasing Banking stability, accountability, responsibility and further promoting overall sound banking and Banking practices. The importance of these principles is that they have true representation and

[775] Bank for International Settlement (n 774)
[776] Bank for International Settlement (n 774)

experience which marred the global Banking crisis which started in 2007. These principles have been adopted by many national supervisors.

5.4.2 Theoretical Basis of Corporate Governance

The major theoretical basis of corporate governance is enshrined in the assumption which exists in the agency and in the stakeholder theory. Emanating from the work of Berle and Means who propound the argument that in modern firms has a distinct separation between management and finance and hence culminating into a separation of control and ownership, thereby making it hard for the professional management (agent) to be held accountable by the shareholders (principal).[777] Therefore, in order to balance this problem, the agency theory proceeds to suggest mechanisms which can be used. The use of managerial incentive mechanism; dividend mechanism; and bonding mechanism help to ensure that there is a balance. Further, it has been argued that the direct intervention of the shareholders, the threat of takeover, and threat of firing help in reducing the imbalance caused by modern firms.[778]

The stakeholder theory also comes into play in the banking system. There is a detailed discussion entailing how the banking sector is an area of public interest and the success of the sector is a key concern not only to the public but also to the government.[779] Therefore, making the government a stakeholder among other stakeholders like creditors and shareholders is advised. The reasoning of the shareholder theory is premised on the fact that activities of any corporate body, in this case banks, impact on the external environment and thus requiring the accountability to a wider audience apart from the shareholders of the bank. From a theoretical point, the Board of Directors of a bank plays a crucial role in managing the institution and has become one critical body in the banking sector in terms of governance mechanisms by making the board to be held responsible for the performance of the banking institution. The diverse ways in which the role of a board is viewed can only imply that the sector is crucial and when the board functions properly it is highly unlikely a bank can fail.[780] The role of the board has

[777] Berle Adolf Augustus and Gardiner Gardiner Coit Means, The modern corporation and private property (Transaction publishers, 1991)
[778] Sanda Ahmadu, Aminu Mikailu and Tukur Garba, 'Corporate governance mechanisms and firms' Banking performance in Nigeria' (2010) Afro-Asian Journal of Finance and Accounting 2 no. 1, 22-39.
[779] Stiglitz Joseph and Marilou Uy, 'Banking markets, public policy, and the East Asian miracle' (1996) The World Bank Research Observer 11, no. 2, 249-276
[780] Kiel Geoffrey and Gavin Nicholson, 'Board composition and corporate performance: How the Australian experience informs contrasting theories of corporate governance' (2003) Corporate Governance: An International Review 11, no. 3, 189-205

been shown to be very important and diverse and hence affecting all sectors and almost all operations in banking[781] and having the power to influence the performance of an organization whose success is pegged on the roles that the board undertakes.[782]

5.4.3 Empirical Basis of Corporate Governance

The research by Dedu and other[783] has revealed the connection between good governance and a reliable banking system. The investigation is based on an empirical analysis, the influence of internal corporate governance and the impact it has on banking performance in the Romanian banking sector. This includes the ownership structure, the management body, and the internal corporate governance index. The research managed to develop an internal corporate governance index to show the structure of committees, the corporate structure, internal control framework, risk management and institutional transparency. It is argued that corporate governance impacts on the personnel of the bank, and especially the management of the bank, to have clearly defined responsibilities and roles.

Other researchers have also used empirical evidence from the implications of corporate governance in the Chinese banking sector to demonstrate that China has developed an effective corporate governance structure to the point of improving the performance of the banking sector, creating transparency in the interest of the public and shareholders.[784] Another research as carried out by Gompers and others[785] also discusses that corporate governance practices have played a crucial role in shaping the behaviour and influence on accounting performance; it is also noted that a reduction of state interference and involvement in the banking sector shows that the corporate governance had increased efficiency in the banking sector once government involvement was reduced and corporate governance was emphasised.[786] Black[787] found very strong evidence that weaker corporate governance would most likely lead to weaker

[781] Finkelstein Sydney and Ann Mooney, 'Not the usual suspects: How to use board process to make boards better' (2003) The Academy of Management Executive 17 no. 2, 101-113.
[782] Jacob O, 'The Effect of corporate governance on a Firm's Banking Performance: A case study of companies listed on the Nairobi Stock Exchange' (2011) Unpublished MBA project. School of Business, University of Nairobi
[783] Dedu Vasile and Gheorghe Chitan, 'The influence of internal corporate governance on bank performance-an empirical analysis for Romania' (2013) Procedia-Social and Behavioral Sciences 99, 1114-1123.
[784] Liu Qiao, 'Corporate governance in China: Current practices, economic effects and institutional determinants' (2006) CESifo Economic Studies 52 no. 2, 415-453.
[785] Gompers Paul, Joy Ishii and Andrew Metrick, 'Corporate governance and equity prices' (2003) The quarterly journal of economics 118 no. 1, 107-156
[786] Abor Joshua and Charles KD Adjasi, 'Corporate governance and the small and medium enterprises sector: theory and implications, (2007) Corporate Governance: The international journal of business in society 7 no. 2, 111-122
[787] Black Bernard, 'The corporate governance behavior and market value of Russian firms' (2001) Emerging Markets Review 2 no. 2, 89-108

performance in management and thorough performance will most definitely cause an increase in their performance. The market research, however, notes that performance of a banking sector is a dynamic element as such it depends on other macro prudential factors and the strategies of the banking business; Black referred to the stock market performance to establish this connection.[788]

Another set of researchers such as Choi and Hasan have gone ahead and shown this connection by examining the impact which the ownership of a banking institution and corporate governance have on performance of bank. This study was conducted in Korea between 1998 and 2002 using a simple and ordinary model. They reported that an existence on the board of directors of one foreign director translated into a significant improvement in the performance of the banking institution. However, it was shocking that multiple foreign directors on the board did not translate into a better performance of the banking institutions.[789] The study also revealed that the large shareholders of a bank have the active voices which monitors the performance of a banking company; it also revealed that direct shareholders monitoring plays a bigger role in monitoring of the company and help in the boosting of the overall performance and profit making of the banking firm.[790]

Other researchers, Franks, and Mayer[791] conducted a study on turnover and shareholding: they managed to find a connection between the involvement of large shareholders of a company and the monitoring of directors. The results indicated that larger shareholding is always related to active monitoring of the directors of the banks and further that there was a slightly higher turnover when a banking institution was defined by having a large shareholder.

Roe[792] revealed that the low ownership of concentration in the USA as compared to other countries is the reason why controlling managers have initiated policies which discourage large bank holding like anti-takeover devices. The implications of these are that it weakens corporate governance itself and has the result of making the managers of these institutions very strong relative to the shareholders. Roe continues to argue that these management entrenchments are

[788] Bernard (n 787)
[789] Otieno Miseda Fred, 'The effect of corporate governance on Banking performance of Commercial Banks in Kenya' (2012) PhD diss
[790] Fred (n 789)
[791] Franks Julian and Colin Mayer, 'Ownership and control of German corporations' (2001) The Review of Banking Studies 14 no. 4, 43-977
[792] Roe Mark, Strong managers, weak owners: The political roots of American corporate finance. (Princeton University Press, 1996)

a very serious corporate governance problem and described the same as bad governance which according to him has the effect of causing less accountability measures and making the management hold the shareholders at a peril. Since it is undoubtedly clear that a proper banking system is where all the stakeholders have their role which they play in the banking sector and the shareholders are respected, watering down the role of the shareholders by the management is a blow to the performance of the banking sector and hence a blow to good banking too.[793]

Another empirical survey of corporate governance, conducted by Tandelilin and others, examined the existing correlation between corporate governance, bank performance and the risk management of the banking institution by the use of a sample of 51 banks. The study was primarily based in Indonesia covering the Indonesian banking sector between the years 1999-2004. The study employed the use of the Triangle Gap Model with both secondary data analysis and primary data analysis. They concluded that the ownership of a bank had an impact on the relationship that existed between corporate governance and risk management and bank performance and corporate governance. However, their research model could not establish any connection between bank performance and corporate governance in a linear manner, but an indirect connection was established by the research.[794]

Love and Rachinsky in their research, consisted of 50 banks from Ukraine and 197 other banks from Russia, managed to established connection between operational performance and corporate governance.[795] In the Danish market, Rose's[796] research on the listed companies excluding banking firms and insurance companies, in the Copenhagen Stock Exchange from 1998 to 2001, showed that there were no significant correlations between increased ownership of the investors of an institution and their performance.

Similar research was conducted in Kenya. This empirical study, by Barako and Tower,[797] examined all the banking institutions that were operational in the country with a view to investigating a connection between the ownership structure of a bank and the bank's

[793] Ibid
[794] Tandelilin Eduardus, Hermeindito Kaaro, Putu Anom Mahadwartha and S. Supriyatna, 'Corporate governance, risk management and bank performance: Does type of ownership matter' (2007) EADN individual research grant project 34, 115-118
[795] Love Inessa and Andrei Rachinsky, 'Corporate Governance and Bank Performance in Emerging Markets: Evidence from Russia and Ukraine' (2015) Emerging Markets Finance and Trade 51 no. sup2, S101-S121
[796] Rose Caspar, 'Can institutional investors fix the corporate governance problem? Some Danish evidence' (2007) Manage Governance 405 – 428
[797] Barako Dulacha and Tower Greg, 'Corporate Governance and bank performance: Does ownership matter? Evidence from the Kenyan banking sector' (2007) Corporate Ownership and Control Journal 4 (2), 23-50

performance. Their results showed a stronger support of the ownership model of a bank influenced the performance of the banks in the country. To go into the specific of their findings, it was clear that board ownership can also negatively impact on banking performance. The findings also revealed that institutional shareholders have no major influence on performance of a bank and that foreign bank's ownership was associated with a significant positive effect on a banking institution's performance.

The research by Nam and others[798] has been able to analyse the interconnection between performance and corporate governance. They revealed that better corporate governance should lead to a situation where there is improved performance due to the implication that the management of the bank is better supervised and that agency operational costs are significantly lower. On the other hand, they found out that where there was poor governance in the banking institution, there were more chances of corruption. Another empirical study showing positive connection is that of Brown and his colleague[799] who demonstrated that banking firms which have weak corporate governance policies and framework showed a poor performance as compared to those firms which could be said to have developed stronger corporate governance.

One issue which is a derivative of corporate governance is the reliability of financial reporting. This is core to transparency and high standards of auditing and accounting.[800] Otieno argues that reliability and accuracy of banking reports that are provided by the managers of a bank affects the perception in the eyes of all prospective investors and stakeholders alike.

On auditing committees and its implication in commercial banks performance, there are conflicting empirical studies in the area and hence very hard to determine whether this corporate governance tool impacts the performance of the bank. The research, by Anderson, Mansi and Reeb[801] and that by Klein,[802] revealed that there is a strong connection between a commercial bank's performance and the audit committee. Four years later another author

[798] Nam Sang-wo, Milkailu A.S and Garba T, 'Linkage between Corporate Governance and Firm Performance' (2005) ADB Institute
[799] Brown L.D and Marches L.C, 'Correlation between Corporate Governance and Corporate Performance' (2003) Research Study Commissioned by Institutional Shareholders Services
[800] DeZoort Todd and Steven Salterio, 'The effects of corporate governance experience and Banking-reporting and audit knowledge on audit committee members' judgments' (2001) Auditing: A Journal of Practice & Theory 20 no. 2, 31-47
[801] Anderson Ronald, Sattar Mansi and David Reeb, 'Board characteristics, accounting report integrity, and the cost of debt' (2004) Journal of accounting and economics 37 no. 3, 315-342
[802] Klein April, 'Audit committee, board of director characteristics, and earnings management' (2002) Journal of accounting and economics 33 no. 3, 375-400

Kajola[803] declared that there was no significant connection between performance and audit committees.

There have also been a number of empirical studies conducted in the area of the board size of the bank. Most notably research has revealed that there is a linear association of banking performance and the size of the board. Even so there still exist inconsistencies in the results which have emerged in terms of determining whether a large or small board would be more effective and achieve good performance. These findings were corroborated with the findings of Sanda and others[804] and Mak and Kusnadi,[805] a decade later. The results were that smaller boards had a positive effect on performance.

The separation of offices of the Chief Executive Officer and the board chair is another way in which corporate governance can be determined.[806] This separation of offices is designed to generally reduce the agency costs of companies. Empirical results have shown that there is a positive and further statistical correlation between the separation of the office of the Chief Executive Officer and chair and performance.

One researcher Yermack[807] also demonstrated the same by pointing out that those banking firms are more valuable when separate personnel sit in the office of the Chief Executive Officer and the Chair of the board. Other studies have also shown that for an organization in banking to be effective the separation must be distinct. For instance, Kyereboah-Coleman has been able to show that independent and large boards have the capacity to enhance the value of a bank, and that the merging of the two bodies has a negative influence on the performance of the banking institution as it causes it to have lesser access to debt finance.[808]

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[803] Kajola Sunday, 'Corporate governance and firm performance: The case of Nigerian listed firms' (2008) European journal of economics, finance and administrative sciences 14 no. 14, 16-28
[804] Sanda Ahmadu, Aminu Mikailu and Tukur Garba, 'Corporate governance mechanisms and firms' Banking performance in Nigeria' (2010) Afro-Asian Journal of Finance and Accounting 2 no. 1, 22-39
[805] Mak Yuen Teen and Yuanto Kusnadi. 'Size really matters: Further evidence on the negative relationship between board size and firm value' (2005) Pacific-Basin Finance Journal 13 no. 3, 301-318
[806] Kyereboah-Coleman Anthony and Nicholas Biekpe, 'Do boards and CEOs matter for bank performance? A comparative analysis of banks in Ghana' (2006) Journal of Corporate Ownership and Control 4, no. 1, 119-126
[807] Yermack David, 'Higher market valuation of companies with a small board of directors' (1996) Journal of Banking economics 40 no. 2, 185-211
[808] Kyereboah-Coleman A, 'Relationship between corporate governance and firm performance : an African perspective' (2007) Ph.D Thesis, University of Stellenbosch, South Africa) <https://scholar.sun.ac.za/handle/10019.1/1348> accessed on 15 Aug. 17

The results of a study by Klein also pointed out that boards which are structured in a manner that is independent of the firm's CEO are better equipped and more effective in the monitoring of the corporate banking and accounting processes and hence more valuable than the reverse. Evidence in terms of debt ratio was investigated by Fosberg[809] whose study revealed that in those firms where the functioning of the CEO and the board were separated the debt ratios were smaller than when there was no separation.

5.4.4 The role of Corporate Governance in establishing a sound banking system

The main question which many regulators ponder on is why do banks fail? After every crisis, this is the question which the politicians, customers, investors, academics, managers, and supervisors ask in order to improve on the stability of the banking and the Banking institutions; and hence prevent any future Banking crisis. However, it is clear that even with all that knowledge gained it is still not enough to guarantee that the banking sector will remain sound and prevent failures. In as much as many studies have focussed on the accounting variables like capital ratios, the empirical analysis has not been left behind as outlined in the section above.[810]

The role of corporate governance in establishing sound banking has experienced exponential research on the link between corporate governance[811] even in the recent Banking crisis, in 2007-2008, when the impact of bank ownership and management structures on the possibility of default was analysed. It has now been clearly established that the influence of corporate governance elements like the management structure, ownership structures, and the board have

[809] Fosberg Richard, 'Agency problems and debt financing: leadership structure effects' (2004) Corporate Governance: The international journal of business in society 4 no. 1, 31-38.
[810] Martin, Daniel, 1977, Early warning of bank failure: A logit regression approach, Journal of Banking & Finance 1(3), 249-276; Pettway, Richard H. and Joseph F. Sinkey, Jr., 1980, Establishing on-site bank examicountry priorities: an early-warning system using accounting and market information, The Journal of Finance 35(1), 137-150; Lane, William R., Stephen W. Looney, and James W. Wansley, 1986, An application of the Cox Proportional Hazards Model to bank failure, Journal of Banking & Finance 10(4), 511- 531; Espahbodi, Pouran, 1991, Identification of problem banks and binary choice models, Journal of Banking & Finance 15(1), 53-71; Cole, Rebel A. and George W. Fenn, 1995, The role of commercial real estate investments in the banking crisis of 1985-92, Working Paper; Cole, Rebel A. and Jeffery W. Gunther, 1998, Predicting bank failures: A comparison of on- and off-site monitoring systems, Journal of Banking Services Research 13(2), 103-117; Helwege, Jean, 1996, Determinants of Savings and Loan failures: Estimates of a time-varying proportional hazard function, Journal of Banking Services Research 10(4), 373-39; Schaeck, Klaus, 2008, Bank liability structure, FDIC loss, and time to failure: A quantile regression approach, Journal of Banking Services Research 33(3), 163-179; Schaeck, Klaus, Martin Cihák, and Simon Wolfe, 2009, Are more competitive banking systems more stable?, Journal of Money, Credit, and Banking 41(4), 711-734; Cole, Rebel A. and Lawrence J. White, 2012, Déjà Vu all over again: The causes of US commercial bank failures this time around, Journal of Banking Services Research, forthcoming.
[811] Berger, Allen N., Björn Imbierowicz, and Christian Rauch. "The roles of corporate governance in bank failures during the recent Banking crisis." Journal of Money, Credit and Banking 48, no. 4 (2016): 729-770

a role to play in sound banking. The call for governance-based frameworks in controlling banking risks after the recent banking crisis has gone further to cover several aspects like restrictions on compensation, the disclosure of director compensation, the alignment of compensation with risk and performance, ban on directors of collapsed banking institutions.

The published literature shows that there is a very strong affinity between sound banking systems and proper corporate governance. The existence of strong corporate governance measures and practice in a banking system has been linked to better performance and avoidance of risks.[812] In order to see the role in which corporate governance plays in bringing sound banking, it is necessary to look at the negatives first then inferences may be drawn whether corporate governance has a role in banking. These authors analysed 249 US commercial banks in terms of default just before the 2008- 2009 Banking crisis. Their research was done on defaults on the period of the first quarter of 2007 to third quarter of 2010 and compared those results with those of 4,021 no default US commercial banks. The research also made use of five sets of explanatory variables in a multi-dimensional logit progression model of default. The effect of accounting as a variable on the banking institutions' probability of default was analysed. Since there is a list of accounting variables researched well established, these created a background to the research. Secondly, the researchers made use of corporate governance indicators so as to measure the ownership of banking institutions in terms of banking management and ownership structure. In ownership, the researchers used the shareholding of the various categories of the banking institutions management, for instance whether the bank's chief executive officer also doubles up as the major shareholder, or whether the banking institution's parent or holding company is a publicly traded company, and whether the banking institution is a multibank holding firm. On the part of the management structures, the researchers made use of the number of outside directors, chief officers which were all normalized by the size of the board and management, the size of the board of directors itself, if the CEO of the banking institution is also the chair.[813]

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[812] Saunders, Anthony, Elizabeth Strock, and Nickolaos G. Travlos, 1990, Ownership structure, deregulation, and bank risk taking, The Journal of Finance 45(2), 643-654; Laeven, Luc and Ross Levine, 2009, Bank governance, regulation and risk taking, Journal of Banking Economics 93(2), 259-275; Caprio, Gerard, Luc Laeven, and Ross Levine, 2003, Governance and bank valuation, NBER Working Paper 10158; Beltratti, Andrea and René M. Stulz, 2012, The credit crisis around the globe: why did some banks perform better? Forthcoming, Journal of Banking Economics; Pathan, Shams, 2009, Strong boards, CEO power and bank risk-taking, Journal of Banking & Finance 33(7), 1340-1350

[813] Saunders, Anthony, Elizabeth Strock, and Nickolaos G. Travlos, (n 812)

The results of these researchers corroborates other researchers which were based on accounting variables, such as return on assets, capital ratios, the amount and portion of a banking institution's non-performing loans and that these variables can be used to predict a banking institution's default. They went on to say that these were: "…the shareholdings of outside directors (directors without other direct management executive functions within the bank), the shareholdings of chief officers, and the shareholdings of other corporate insiders (lower-level management, such as vice presidents)".[814]

The research further showed that when a banking institution is characterized by a large shareholding of outside directors and further chief officers in the management then there is a reduced probability of risks. Banking risk taking is one of the important aspects which is supposed to be cured by proper governance. It is not a surprise that even before the 2008-2009 banking crisis it had already been established that corporate governance had major implications on the stability of the banks. Studies dating back have outlined that the composition of shareholders, and the other governance characteristics possess greater power to influence the banking systems' overall stability.[815]

These kinds of findings have been instrumental in supporting corporate governance and showing that even before the occurrence of the Banking crisis, evidence overwhelmingly showed that corporate governance is necessary for sound banking. Ownership of the bank has been shown to have a significant impact on how a bank handles risks in terms of investments, operations, and practices. The overall findings of many researchers have led to the conclusion that a higher shareholding of directors and chief officers inevitably induce a corresponding higher risk-taking practice in the banking institutions. The study by Saunders and his colleagues[816] show this phenomenon in 1987-1992, and that of Anderson and his friend[817] confirmed the same findings for the period of 1987-1989, this was the time before the Banking crisis of 2008 -2009 and hence post crisis studies reveals this importance reflects that governance plays a major role in sound banking. The data up to the late 2004 have shown that in the US banking system, banking holding companies assumed greater risks if the board had

[814] Saunders, Anthony, Elizabeth Strock, and Nickolaos G. Travlos, (n 812)
[815] Saunders, Anthony, Elizabeth Strock, and Nickolaos G. Travlos, (n 812)
[816] Saunders, Anthony, Elizabeth Strock, and Nickolaos G. Travlos, (n 812)
[817] Anderson, Ronald C. and Donald R. Fraser, 2000, Corporate control, bank risk taking and the health of the banking industry, Journal of Banking & Finance 24(8), 1383-1398

a strong shareholder representation. Based on these findings, it is clear that bad corporate governance plays a major role in the collapse of banking institutions.[818]

Various studies, done by Beltratti and Stulz and Erkens and others,[819] have analysed the concept of corporate governance after the 2008-2009 Banking crisis. This research also concentrated on the ownership structure of banks in respect to the risks which attach.[820] Beltratti and Stulz found out that banking institutions which had better governance, in the form of board structure and chief management which were shareholder friendly, performed relatively worse during the 2008 Banking crisis as compared to other banks and had a higher overall stability risk before the crisis hit the Banking market. It is also not shocking that the two found out that banking institutions with a higher controlling shareholder ownership were riskier than others. The same result was extrapolated by Gropp and Kohler.[821]

In 2012, Erkens, Hung and Matos[822] established a connection between the independence of the board and institutional ownership and stock performance. Laeven and Levine also revealed the importance of corporate governance by showing that banking institutions which were more diversified and had outsider-controlled shareholder base were on average linked to lower structural risks as compared to one which had a highly concentrated shareholder base whereby most of the cash-flow rights related to a single (insider or outsider) ownership.[823] Weak corporate governance breeds high risks in banking by causing inadequate risk management. This is revealed by Kirkpatrick's research which has shown that weak corporate governance in banks causes insufficient risk monitoring of the board, an issue which has the result of contributing largely to banking instability during a crisis as was witnessed in 2008.

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[818] Beltratti, Andrea and René M. Stulz, 2012, The credit crisis around the globe: why did some banks perform better? Forthcoming, Journal of Banking Economics

[819] Erkens, David H., Mingyi Hung, and Pedro Matos, 2012, Corporate governance in the 2007-2008 Banking crisis: Evidence from Banking institutions worldwide, Journal of Corporate Finance 18(1), 389-411

[820] There are other researchers who have also looked at corporate governance post the 2008 Banking crisis. There are also a number of them which have concentrated on the structure of the senior management and the board of directors and how this affects the risk of the banking isntitutions. On the list of some of the most relevant researches which have been done in this area are the works of: Kirkpatrick, Grant, 2009, The corporate governance lessons from the Banking crisis, OECD Banking Market Trends 2009/1, 1-30; Bebchuk, Lucian A. and Holger Spamann, 2010, Regulating bankers' pay, Georgetown Law Journal 98(2), 247-287; DeYoung, Robert, Emma Y. Peng, and Meng Yan, 2010, Executive compensation and business policy choices at US commercial banks, Research Working Paper Federal Reserve Bank of Kansas City 10-02, 1-56; Fahlenbrach, Rüdiger and René M. Stulz, 2011, Bank CEO incentives and the credit crisis, Journal of Banking Economics 99(1), 11-26; and Bhattacharyya, Sugato and Amiyatosh Purnanandam, 2012, Risk-taking by banks: What did we know and when did we know it? Working Paper

[821] Gropp, Reint and Matthias Köhler, 2010, Bank owners or bank managers: Who is keen on risk? Evidence from the Banking crisis, Centre for European Economic Research Discussion Paper No. 10-013, 1-36

[822] Erkens, David H., Mingyi Hung, and Pedro Matos, 2012, Corporate governance in the 2007-2008 Banking crisis: Evidence from Banking institutions worldwide, Journal of Corporate Finance 18(1), 389-411

[823] Laeven, Luc and Ross Levine, 2009, Bank governance, regulation and risk taking, Journal of Banking Economics 93(2), 259-275

5.4.5 Evolution of Corporate Governance in UK & its Role

In the UK, the role of corporate governance was enshrined in the system even before the 2008 banking crisis. The government placed more reliance on soft law and voluntary schemes to make sure that there are sound banking practices in the UK. The foundation of corporate governance was laid by the Institutional Shareholder's Committee's statement on the 'Responsibilities of Institutional Shareholders in the UK'[824] providing guiding principles which enabled banking institutions' investors a framework for undertaking various actions and hence ensure sound banking. This made it possible for the introduction of the 'comply or explain' system This was however not enough as the role of governance was not fully exploited. The implications of corporate governance are allowing the shareholder and investors to hold the directors and the management accountable for their actions hence making sure that there is no mischief on the part of the board and chief management.[825]

Following a series of high-profile corporate failures in the UK in the late 1980s and early 1990s, the private sector initiated a series of reforms to improve transparency and accountability in corporate governance. The first was the Cadbury Committee on the Financial Aspects of Corporate Governance set up by the London Stock Exchange, the Financial Reporting Council and accountancy professions to report on financial aspects of corporate governance. Commonly cited reasons for corporate failure include fraud,[826] mismanagement, accounting irregularities, failure of the board to anticipate or address the risks facing the company,[827] economic distress[828] and excessive remuneration of corporate executives. The corporate governance principles are also supplemented by legislation such as the Companies Act 2006. For example, directors' general duties are covered in Pt 10, Ch.2. This is in addition to directors' specific duties which pervades much of the Act. Accounts and reports are covered in Pt 15, while Pt 15, Ch.6 of the Act imposes a duty on directors of quoted and traded companies to prepare a directors' remuneration report, a breach of which is a criminal offence.

[824] Institutional Shareholders' Committee, 'The Responsibilities of Institutional Shareholders in the UK' (London, ISC 1991).
[825] O'Dwyer, Aidan. "Corporate Governance after the Banking crisis: The role of shareholders in monitoring the activities of the board." Aberdeen Student L. Rev. 5 (2014): 112
[826] https://www.gov.uk/government/news/independent-commission-on-banking-final-report
[827] Financial Services (Banking Reform) Act 2013
[828] https://www.fca.org.uk/publication/corporate/pcbs-response.pdf

5.4.5.1 Cadbury report 1992, Greenbury Report 1995 and Hampel Report 1998

This good foundation was recognised by the Cadbury Committee which established that there was an explicit need for ensuring that this would be appropriate in improving better banking practices.[829] The starting point is, perhaps, the 1992 Cadbury report which reported on corporate governance generally and directors' responsibilities in relation to financial reporting in particular.[830] This was followed by Greenbury report in 1995,[831] and the Hampel report in 1998. The Hampel Report addressed a concern that the emphasis on accountability in the work of the previous committees had, to an extent, neglected to take into account that a board's primary responsibility is to act in the best interests of the shareholders by promoting the long-term success of the company.

5.4.5.2 The Turnbull Report and FRC Guidance

In 1999, guidance for directors on compliance with the Corporate Governance Code was issued in the Turnbull Report. This was replaced by the FRC's 2014 Guidance on Risk Management, Internal Control and Related Financial and Business Reporting. The guidance was the result of recommendations made by Lord Sharman in his 2012 final report into going concern and liquidity risk. The guidance was designed to prompt boards to consider how to discharge their responsibilities in relation to the existing and emerging principal risks faced by the company.[832]

5.4.5.3 The Higgs Report 2003

In 2003, the conclusions of Sir Derek Higgs's review of the role, independence and recruitment of non-executive directors were published and incorporated into a revised version of the Corporate Governance Code issued the same year. Higgs expanded the Corporate Governance Code's recommendation that the board should comprise of at least one-third non-executive directors, the majority of whom should be independent, into a detailed set of tests of independence, such as length of tenure. Higgs also recommended that all listed companies

[829] Adrian Cadbury, 'Report of the Committee on the Banking Aspects of Corporate Governance' (London, Gee Publishing Ltd 1992) para 6.10.
[830] The Committee on the Financial Aspects of Corporate Governance Cadbury Report, 1992
[831] Study Group on Directors' Remuneration: Final Report (The Greenbury Report) 1995.
[832] https://www.frc.org.uk/getattachment/d672c107-b1fb-4051-84b0-f5b83a1b93f6/Guidance-on-Risk-Management-Internal-Control-and-Related-Reporting.pdf

should establish a nomination committee, chaired by an independent non-executive director and comprising a majority of independent non-executive directors.[833]

5.4.5.4 The Smith Report 2003

The Smith Report of 2003 comprised a set of recommendations in relation to the audit committee and the role of directors serving on the audit committee. These recommendations were incorporated into subsequent revisions of the Code.[834]

The FCA's approach to governance across the board is based on the simple statement "boards run businesses". In this regard, the board should drive the business, develop the strategy, manage the risks, and hold the executives to account for delivering on this agenda. In its Supervisory Statement, "Corporate Governance: Board responsibilities" (SS5/16), the PRA stated that an effective board: establishes a sustainable business model and a clear strategy consistent with that model; articulates and oversees a clear and measurable statement of risk appetite against which major business options are actively assessed; and meets its regulatory obligations, is open with the regulators and sets a culture that supports prudent management.[835] The Supervisory Statement also provides that the PRA's expectations of boards will also be influenced by the recovery and resolution strategies for the firm or the group "taking account of the extent to which the PRA would need to be satisfied that the board of a significant PRA-regulated subsidiary is constituted and performs in a way that shows that they are capable of independent action".

The FCA, the PRA and the UK Corporate Governance Code all require the separation of the roles of chief executive and chairman. For banks and other financial institutions, the chairman's role as a non-executive chairman extends far beyond simply chairing board meetings, and the chairman is expected to take up about two-thirds of his time, especially for large, complex banks. Under the PRA rules, the chairman is regarded as falling under their Senior Management Regime, along with the chairs of the Risk Committee, Audit Committee, Remuneration

[833] Derek Higgs, Review of the role and effectiveness of non-executive directors, 2003.
[834] Sir Robert Smith, Audit Committees, Combined Code Guidance, 2003; see http://www.ecgi.org/codes/documents/ac_report.pdf
[835] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisorystatement/2018/ss516update.pdf?la=en&hash=9FA09D82A6431745BBA95B3943C9AD13A5FB40A7

Committee, Nomination Committee, and the Senior Independent Director. They all have senior "oversight" functions, not executive functions under the senior management regime. Indeed, none of them can chair executive functions within the bank. These are all subject to pre-approval by the PRA apart from the Chair of the Nominations Committee and the Senior Independent Director, who are subject to pre-approval by the FCA. In addition, "all appointments to the board should be subject to a formal, rigorous, and transparent procedure and an effect should be maintained for board and senior management. Both appointments and succession plans should be based on merit and objective criteria and, within this context, should promote diversity of gender, social and ethnic backgrounds, cognitive and personal strengths".[836]

5.4.5.5 The Walker Review 2009

The Walker Review in 2009 was specifically addressed to banks and other financial institutions and considered those failures of corporate governance which contributed to the financial crisis. It contained 39 recommendations, along with details about how each recommendation was to be implemented in the related areas of: board size, composition, and qualification; functioning of the board and evaluation of performance; the role of institutional shareholders; governance of risk; and remuneration.

5.4.5.6 The Turner Review 2009

The Turner Review[837] highlighted the importance of high standards of risk management in outlining the FSA's policy approach to corporate governance in financial services firms. A key area of criticism was the existing decision-making capacity of boards and the role of non-executive directors in questioning decisions of boards. Turner recommended that non-executive directors should have appropriate technical expertise to understand all dimensions of the risks being taken and should have sufficient time to devote to enable them properly to oversee complex business (i.e., weeks, rather than days, per month).

5.4.5.7 Independent Commission on Banking published report 2011

[836] UK Corporate Governance Code 2018 Chs 2 and 3.
[837] http://www.fsa.gov.uk/pubs/other/turner_review.

The recommendations[838] made by this report was to promote long-term stability of UK banking by separating retail banking from wholesale/investment banking i.e., the ring-fencing regime. The report considered that an effective ring-fencing regime required certain governance structures, namely that the board of the UK retail subsidiary should have a majority of independent directors, one of whom is the chair. In response to the ICB's recommendations, the Financial Services (Banking Reform) Bill was published by the Government. It requires half of the board to be independent non-executives. The ring-fenced body will be required to have its own risk, audit, nomination, and remuneration non-executive board committees. There are also requirements in relation to risk management and internal audit as well as requirements in relation to the chair of the remuneration committee. The ring-fencing regime came into force on 1 January 2019.

5.4.5.8 The Kay Review 2012

Professor Kay's final report [839]on the review of UK equity markets and long-term decision making looked into the character and quality of shareholder engagement and accountability of companies to shareholders. It concluded that "short-termism" was a problem in UK equity markets and was caused by a breakdown of trust and misalignment of incentives. The report noted fragmentation in the shareholding of UK entities. Recommendations included following: (i) a proposal that companies consult with significant long-term investors overboard appointments; (ii) amending the Stewardship Code to incorporate a more expansive form of stewardship and establishing an Investor Forum; and (iii) structuring remuneration to relate incentives to sustainable long-term business performance. The Collective Engagement Framework was published in June 2016 and outlines a process whereby investors can initiate dialogue where they feel that the long-term value of the company is at risk.

5.4.5.9 Final Report 2013

Another report, published in 2013[840], contained over 100 recommendations, with 58 specifically relating to the FCA, including: (i) introducing a new Senior Persons Regime, to

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[838] https://www.gov.uk/government/news/independent-commission-on-banking-final-report.

[839] The Kay Review of UK Equity Markets and Long-Term Decision Making, Final Report; shttps://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf

[840] https://www.gov.uk/government/news/independent-commission-on-banking-final-

replace the existing Approved Persons Regime, governing the behaviour of senior bank staff, and a new framework for regulating individual standards of conduct in banking; (ii) amending remuneration for senior bank executives so that incentives more closely reflected the longer run balance between business risks and rewards; and (iii) a new criminal offence for reckless misconduct for senior bankers.

5.4.5.10 Professor Lambert Report 2014

In May 2014, Sir Richard Lambert published a report[841] containing recommendations made by the then Banking Standards Review Council, an organisation set up to promote high standards of behaviour and competence in UK banks in response to the recommendation contained in the PCBS report. The Lambert report followed a request from the Chairmen of the UK's seven largest banks and building societies.

5.4.5.11 Green Paper on Corporate Governance Reform 2016

In September 2017, the Government published a response[842] to the final report of the Business, Energy, and Industrial Strategy's Select Committee Corporate Governance Inquiry.[843] In August 2017, the Government published a response [844]to its November 2016 Green Paper on Corporate Governance Reform. The Green Paper response set out measures relating to addressing concerns over how companies respond to shareholder opposition concerning executive pay; strengthening the employee, customer, and supplier voice in companies; and improving corporate governance in large privately held businesses. Secondary legislation in the form of The Companies (Miscellaneous Reporting) Regulations 2018 was published to give effect to these measures.[845] The Regulations apply to company reporting on financial years beginning on or after 1 January 2019.

5.4.5.12 The UK Corporate Governance Code 2018

[841] Banking Standards (Lambert) Review; final report May 2014; see https://www.bankingstandardsboard.org.uk
[842] Corporate governance: Government Response to the Committee's Third Report of Session 2016-17, September 2017; see https://publications.parliament.uk/pa/cm201719/cmselect/cmbeis/338/338.pdf.
[843] The Business, Energy and Industrial Strategy Committee Fourth Report of Session 2016-17, Corporate governance (HC 702) April 2017; see https://publications.parliament.uk/pa/cm201617/cmselect/cmbeis/702/702.pdf.
[844] BEIS, Corporate Governance Reform, The Government response to green paper consultation (August 2017);
[845] The Companies (Miscellaneous Reporting) Regulations 2018

The UK Corporate Governance Code[846] was revamped in 2018 ("2018 Code"), introducing a new structure and layout. The 2018 Code contains fewer Provisions and no Supporting Principles. The 2018 Code applies to accounting periods beginning on or after 1 January 2019. The 2018 Code consists of 5 sections, 18 Principles, and 41 corresponding Provisions. The Principles set out high level standards of good corporate governance in the areas of leadership, effectiveness, accountability, remuneration and relations with shareholders.

5.4.6 Corporate and risk governance for banks in the USA

At about the time when the UK finalised its regulations for corporate governance for banks, the Office of the Comptroller of the Currency published, in USA, its "Corporate and Risk Governance", which provides "guidance relating to the roles and responsibilities of the board and senior management, as well as corporate and risk governance activities and risk management practices."[847] The Handbook applies to supervisions of national banks, federal savings associations, and federal banks and agencies of foreign banks. The focus is on corporate governance for large complex banks. The board should be aware not only of the type and management of the company's major risks, but also of the risks involved in any change of strategy, provision of new products and services, and any proposed mergers or acquisition, and, more importantly, the issue of cyber security. The directors are not bank employees and are regarded as "independent" if they are free of any family relationships or any other material business or professional relationship with the bank or its management. To "promote" director's independence, the board should have an "appropriate mix" of inside and outside directors. They are expected to be willing and able to exercise independent judgement and to have a "basic knowledge of the banking industry, financial regulatory system, and laws and regulations that govern the bank's operation." This requirement is hardly adequate for membership of the board of a large, complex bank. Knowledge, experience in business or another discipline that facilitates bank oversight is also acceptable, but this requirement is generally not as useful as it might appear, given that the role of a bank in the economy is so very different from that of a manufacturing or retail company. The outside director is also expected to accept the fiduciary duties of his position, avoid conflicts of interest and to have knowledge of the communities the bank serves. Other criteria for the selection of independent directors correspond to the usual standards: knowledge, skills, experience, availability of time, integrity, good reputation, and

[846] https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.PDF
[847] OCC, Corporate and Risk Governance, Comptroller's Handbook, Version 2.0, p.3.

the willingness to put the interests of the bank before their own. A candidate must declare any conflicts of interest. Rajgopal and his colleagues argue that, although it appears at first sight that directors' turnover of bank boards has increased since 2012, this is not in fact the case, as this is largely due to the disappearance of banks and nonbanks that failed after 2007. This suggests that the expectations set out in the OCC Handbook may require mandatory changes in addition.[848]

5.4.7 Corporate Governance in Pakistan

The Handbook[849] of Corporate Governance defines corporate governance as "Corporate Governance is the system by which business corporations are directed and controlled by structuring rights and responsibilities of different participants in the corporation, such as, the board, managers, shareholders and stakeholders. By doing this, it provides structure for setting corporate objectives and mustering resources to attain those goals without compromising fairness, ethics, transparency, and accountability". It is further stated that corporate governance may be taken as a mother-term dealing with issues arising out of the interaction among stakeholders. In any organization 'Board of Directors and Management' are the main decision-making bodies occupying the centre of decision-making process. Ideally, they cherish serving the interests of all stakeholders. Here, the notion of stakeholders includes sponsors, employees, customers, suppliers, regulators, government, and the society - an organization works for and lives within.

5.5 If sound corporate governance can be applied to the Pakistan Banking system?

In Pakistan, the Corporate Governance Regulatory Framework is required to be followed by all banks/DFIs. All banks are also required to follow 'Listed Companies (Code of Corporate Governance) Regulations' issued by the Securities & Exchange Commission of Pakistan (SECP) so long as any provision thereof does not conflict with any provision of the Banking Companies Ordinance 1962 or any Regulations and other instructions/guidelines issued by the State Bank from time to time.[850] Annexure A of The Corporate Governance Regulatory

[848] S. Rajgopal, S. Srinivasan, and F. Wong, "Bank Boards: What has changed since the financial crisis?" Harvard Business School, Working Paper 19-108 (January 2019),
[849] https://www.sbp.org.pk/about/corp_gov/index.htm
[850] https://www.sbp.org.pk/bprd/2021/C5-AnnexA.pdf

Framework contains disclosure and reporting requirements for Bank's Sponsor Shareholders, Board of Directors, President/CEO and Key Executives by filing Performa provided to satisfy the fit and proper test. The banks are also mandated Under Rule 4(1) (i-b) of the Banking Companies Rules, 1963 file list of Directors (the names, contact numbers and addresses of their board of directors within seven days of completion of each quarter) and contact details of following positions within seven (7) working days of completion of each quarter: (a) President/CEO/Managing Director/Country Manager (b) Group Head Operations/Chief Operating Officer (c) Group Head Compliance / Chief Compliance Officer (d) Group Head Human Resources (e) Company Secretary (f) Contact Persons in case of emergency (Name & Designation) vi) Reporting of minutes of board meetings and (g) shareholding related returns/information.

Dr Shamshad Akhtar, Governor The State Bank of Pakistan[851] Delivering her keynote address on 'Corporate Governance for Banks' at a convocation of the Institute of Bankers, has noted the relevance and importance of good corporate governance: "for the banking industry, with assets to GDP ratio of almost 59%, is critical in ensuring solvency and stability of the country's financial system. She said that the State Bank has been on the forefront in promoting good corporate governance in the country as a regulator and supervisor of banks and DFIs. "The State Bank has implemented a comprehensive corporate governance regime for banks, which is driven by a robust legal and regulatory framework, risk-based supervision and over-arching banking sector reforms, notably, privatization, liberalization and consolidation of banks."

She further added the major thrust of legal and regulatory requirements is to strengthen the functioning of the Boards of Directors of banks by separating the positions of chairman and CEO of banks and making it mandatory on banks to appoint on the Board at least 25% independent directors and not more than two executive directors. The State Bank has also strengthened the fit and proper criteria and approved appointment of directors and CEO of banks in line with the criteria. Banks must also follow the fit and proper criteria in appointing key executives although such appointments do not require The State Bank approval, she added. She said The State Bank has also issued guidelines on risk management, internal controls, IT security and business continuity planning besides detailed instructions on policy framework for banks, risk management framework including regulatory requirements that check banks'

[851] www.sbp.org.pk/press/2008/IBP-Convovation-13-Mar-08.pdf

exposure to group companies and other related parties, restrict exposure to single borrower, borrowing group or sector, as well as limit banks' investments in equity market. While giving details about current regulatory requirements for banks.

Dr Akhtar further said as a further step to strengthen governance of banks, they are required to undergo credit rating annually. The rating must be announced publicly and disclosed in the financial statements of the bank, she said and added The State Bank also requires banks to appoint auditors from a panel of pre-approved auditors maintained by it. "The objective is to ensure credibility of audited financial statements of banks," she added. Referring to monitoring and supervision mechanisms, she said that the State Bank has implemented a comprehensive framework, which is underpinned by regular on-site inspections of banks and DFIs under the regulatory ambit of The State Bank. Banks are inspected in accordance with a pre-approved annual inspection plan, following the CAMELS-S approach. The State Bank has also developed a comprehensive surveillance mechanism – the Institutional Risk Assessment Framework (IRAF) – to capture the host of risks facing individual banks based on the information gathered from on-site inspections, off-site supervision, market intelligence and self-assessment by banks, she added. "The objective is to obtain a composite rating for each bank for effective and proactive supervision by The State Bank," The State Bank is endeavouring to further strengthen its own governance processes in consultation with its Board of Directors. "An adequate and appropriate governance framework is crucial for the optimal functioning of any enterprise, but more so for a central bank because of its objectives of maintaining price stability and ensuring financial stability along with its crucial contribution to the overall economic policy framework."

Therefore, it can be suggested that sound corporate governance can be applied to Pakistan banking system. This is due to the reasons that the conditionality of international bodies on Pakistan banking system is a blessing in disguise that has not only revolutionised the banking system but also had a flip of coin to make the banking system fast growing and one of the principal sectors in contributing towards the country's GDP. Before the introduction of reformation to the banking system in Pakistan, due to political appointments, had four times[852] workforce with zero output that was an additional drain on the country's resources.

[852] Please see 6.7 in chapter 6 of this thesis for further discussions.

5.6 Conclusion

The acknowledgment of importance of role of corporate governance in banking is one which does not just emanate from the 2008 crisis but dates back decades ago where it had been shown that the structure of the board, the management and ownership of the banking institution have a major role in the performance of the banks. Even though the result has been converging and diverging at some point, perhaps because of the differences in the banking sectors, there is nevertheless consensus that corporate governance plays a crucial role in banking. This is why organizations like OECD, the World Bank and the Basel Committee have invested considerably in ensuring that there are international standards in banking regulations and prudential guidelines are harmonized.

The banking reforms can be introduced by both legislation and codes of conduct (delegated legislation). This chapter discusses that it is not only expedient but also expeditious to rely on codes of conduct in order to introducing reforms particularly in cases of dealing with certain circumstances, such as change in market behaviour, by way of code of conduct because legislation has its inherent inabilities including procedural compliance in reaching a bill from proposal to enactment stage.

An analysis of a system with strict regulations reveals that the banking resources demand can be difficult for large banks to comply; but for smaller ones this is not just an issue of difficulty but a matter of loss and profitability hence leading the small banks to non-viability. Using the systemic risk model,[853] the bigger banks have a high impact on affecting the Banking markets as compared to smaller ones which pose a smaller systemic risk.[854] Consequently, the banking regulations fall short of ensuring equity in terms of risk compliance by setting the same standards for both larger and smaller banks. The application of the law should be in a manner which enables start-ups to compete and have a chance of entry into the market. When capital rules are applied in a manner which are designed for transnational and large banks and the application of same principle to a small start-up amounts to discouragement of the new market entrants and has the effect of restricting them from offering to the market newer services apart

[853] Helmut Elsinger, Alfred Lehar and Martin Summer, 'Risk Assessment for Banking Systems' (2006)52 (9) Management science 1301,1314 INFORMS <https://www.jstor.org/stable/20110606?seq=1> accessed 22 January 2020.
[854] Luc Laeven, Lev Ratnovski and Hui Tong, 'Bank Size and Systemic Risk' (2014)14 IMF Staff Discussion Note < www.imf.org/external/pubs/ft/sdn/2014/sdn1404.pdf> accessed 22 January 2020

from the traditional banking services.[855] This was discussed in the second chapter and third chapter of this thesis; small banks in Pakistan, on implementation of capital adequacy rules had a choice to go extinct to merge with other banks. The total numbers of 18 banks emerged, as seen in second chapter, in order to comply with capital adequacy rules.

The bigger debate about the stability of regulation in banking is: if it might destabilise the banking sector. The idea of regulation itself has an impact on creating more systemic risks since there is a belief that the regulator is able to see the problem and swiftly acts on that problem before the market does, which has the impact of creating an illusion that there exists a greater stability and safety than what is the true position.[856] The other criticism of the regulation is related to the people who are given power by legislation to have control of the banking sector are said to be no smarter, more knowledgeable or wiser than the ones who are participating in the banking markets. Therefore, despite imperfections, laws have to be implemented in a banking system considering the volatility of the banking sector. Nevertheless, the laws ought not to be applied without taking into account the requirements of a particular banking market.

The regulators are tasked with preparation of competent auditor reports and accurate banking reports, and further prescribe fraud prevention policies, and ensure these are adhered to. But a law should not allow, or a regulator should not implement a law in a manner which has the same effect of micromanaging the banking institutions they seek to oversee. This is one of the reasons why the law in itself is not an absolute effective tool and its success depends on other factors such as good faith.[857] Since regulation may not be perfect, the primary goal of regulation such as simplification, more cost effective, internationalised, and non-duplicative is hardly achieved, trusting legislations alone to create a sound banking system is not an option.

[855] Arnoud W A Boot and Matej Marinc, 'Competition and Entry in Banking: Implications for Stability and Capital Regulation' (2006) CEPR Discussion Paper 5518 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=907461> accessed 22 January 2020; Thomas Hellmann, Kevin C Murdock and Joseph E Stiglitz, 'Liberalization Moral Hazard in Banking, and Prudential Regulation: Are Capital Requirements Enough?' (2000) American Economic Review 147,165 www.uio.no/studier/emner/sv/oekonomi/ECON4335/h14/pensumliste/pensum/hellmann117285.pdf> accessed 22 January 2020.
[856] Richard W Rahn, Banking Regulatory Limitations (April 23 2008) Washington Times <https://www.cato.org/publications/commentary/Banking-regulatory-limitations > accessed 22 January 2020.
[857] Ibid.

CHAPTER 6:
THE PROSPECT OF OPERATING A SOUND BANKING SYSTEM IN PAKISTAN: STRENGTHS & IMPEDIMENTS

6.1 INTRODUCTION

The first chapter has provided a detailed description of factors including the role of law in establishing a sound banking system in a country viz a viz obstructions in establishing and maintaining a sound banking system. In the second chapter, we have seen the essentials of a good banking system in a country and the reforms that have been adopted by the Pakistan banking system to attain growth and financial stability. It, in the second chapter, is also discussed the fact that policy making with a political connection means that everything which is passed in terms of banking laws should have a political bearing in terms of being an economic policy by the ruling political class. The laws in the banking sector always have an underlying economical aspect and as such the impact of prevailing economic conditions and microeconomic aspects and changes always go into the root of banking legislations.[858]

It is also seen that the Pakistan has adopted Basel Accord, corporate governance and banking reforms due to obligations imposed by IMF. Notwithstanding, the outstanding banking performance and good regulator structure failed to bring financial stability which is clear evidence from the fact that Pakistan's economy continues to rely on loans and foreign aid to meet its expense and to reduce budget's deficits. This clearly demonstrates that the law has to be analysed in relation to the uncertainties which can be caused to the monetary transmission system. If the law or banking regulation do not ensure the banking stability or will most likely cause an instability in the banking market, then the law has to be amended or aligned before it is passed.[859] The challenges faced by the banking system of Pakistan are also discussed in detail in chapter 2.[860] The third chapter describes the ingredients and benefits of a dynamic banking system. The chapter 4 discussed the different modes of regulatory models and chapter 5 has

[858] Robin Bade and Michael Parkin, 'Central bank laws and monetary policy' (1988) Department of Economics, University of Western Ontario 5 < https://www.researchgate.net/profile/Michael_Parkin3/publication/245629808_Central_Bank_Laws_and_Monetary_Policy/links/564a30e208ae127ff98687e5/Central-Bank-Laws-and-Monetary-Policy.pdf> accessed 10 January 2020

[859] Paolo Gelain and others, 'House Prices, Credit Growth and Excess Volatility: Implications for Monetary and Macroprudential Policy' (2013)9 (2) International Journal of Central Banking UCB 219,276 < https://www.ijcb.org/journal/ijcb13q2a11.htm> accessed 10 January 2020

[860] Political instability and corruption being major challenges were discussed rooted and supported by legal infrastructure. Chapter 2 Heading 2.4

explored the role of legislation, codes of conduct and corporate governance in achieving banking's reforms. In this last chapter, the current standing of the Pakistan Banking system is discussed and the prospect of operating and maintaining a sound banking system in Pakistan is examined. This chapter also analyses the role of legal infrastructure will respect to establishing and maintaining sound banking system.

This chapter further attempts to find an answer to the question if Pakistan banking industry adequately and capably performs sui generis responsibility of protecting money of depositors and investors.[861] We have already discussed the historical background of the State Bank of Pakistan and structure and evolution of Pakistan banking system in earlier chapters. Therefore, historical background, establishment and development of Pakistan Central Bank and Pakistan banking system would not be discussed but briefly in this chapter.

6.2 BANK AND NATURE OF ITS RELATIONSHIP WITH CUSTOMERS

A Bank is described in Pakistan as "an organization of transacting and the company of compliant, for the purpose of lending, and deposits of money from the public sectors, repayable on demands, and withdrawable by Cheques, Draft Orders and includes any Post Office Savings Bank. Banks are financial intermediaries. The role of a banking intermediary is to sell its own obligations with attractive features, at higher prices than it had paid to buy. Bank acquires some interest on selling its obligations and bears the same on buying".[862]

Section 7 of 1962 the Banking Companies Ordinance describe the business of the banking includes:

i. The borrowing, raising, or taking up of money; the lending or advancing of money either upon or without security;
ii. the drawing, making, accepting, discounting, buying, selling, collecting, and dealing in bills of exchange, hundis, promissory notes, coupons, drafts, bills of lading, railway receipts, warrants, debentures, certificates, scripps participation term certificates, term finance certificates, musharaka certificates, modaraba certificates and such other

[861] This question is also one of hypothesis of this thesis.
[862] S FA Rizvi, 'Post-liberalization Efficiency and Productivity of the Banking Sector in Pakistan' (2001) 40(4) The Pakistan Development Rev.605, 32

instruments as may be approved by the State Bank and other instruments, and securities whether transferable or negotiable or not;

iii. the granting and issuing of letters of credit, traveller's cheques, and circular notes;

iv. the buying, selling, and dealing in bullion species; the buying and selling of foreign exchange including foreign bank notes;

v. the acquiring, holding, issuing on commission, underwriting, and dealing in stock, funds, shares, debentures, debenture stock, bonds, obligations, securities participation term certificates, term finance certificates, musharaka certificates, modaraba certificates and such other instruments as may be approved by the State Bank and investment of all kinds;

vi. the purchasing and selling of bonds, scrips or other forms of securities participation terms certificates, term finance certificates, musharaka certificates, modaraba certificates and such other instruments as may be approved by the State Banks on behalf of constituents or others, the negotiating of loans and advances;

vii. the receiving of all kinds of bonds, script of valuables on deposit or for safe custody or otherwise; "the providing of safe deposit vaults": the collecting and transmitting of money and securities;

viii. the providing of finance;

ix. acting agents for any Government or local authority or any other person or persons;

x. the carrying on of agency business of any description including the clearing and forwarding of goods, giving of receipts and discharges, and otherwise acting as an attorney on behalf of customers, but excluding the business of a managing agent or treasurer of a company;

xi. acting as "modaraba company" under the provision of the Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980 (XXXI of 1980);

xii. contracting for public and private loans and negotiating and issuing the same;

xiii. the effecting, insuring, guaranteeing, underwriting, participating in managing and carrying out of any issue public or private, Government, municipal or other loans or of shares, stock debentures, debenture stock or other securities of any company, corporation or association and the lending of money for the purpose of any such issue;

xiv. carrying on and transacting every kind of guarantee and indemnity business;

xv. purchase or acquisition in the normal course of its banking business of any property, including commodities, patents, designs, trademarks, and copyrights with or without buyback arrangements by the seller, or for sale in the form of hire purchase or on

deferred payment basis with mark-up or for leasing or licensing or for rent-sharing or for any other mode of financing;

xvi. managing, selling, and realising any property which may come into the possession of the company in satisfaction of any of its claims;

xvii. acquiring and holding and generally dealing with any property or any right, title, or interest in any such property for any loans or advances;

xviii. undertaking and executing trusts;

xix. establishing and supporting or aiding in the establishment and support of associations, institutions, funds, trusts and conveniences calculated to benefit employees or ex-employees of the company or the dependents or connections of such persons; granting pensions and allowances and making payments towards insurance;

xx. subscribing to or guaranteeing moneys for charitable or benevolent objects or for any exhibition or for any public, general or useful object;

xxi. the acquisition, construction, maintenance, and alteration of any building or works necessary or convenient for the company;

xxii. selling, improving, managing, developing, exchanging, leasing, mortgaging, disposing of or turning into account or otherwise dealing with all or any part of the property and rights of the company;

xxiii. acquiring and undertaking the whole or any part of the business of any person or company;

xxiv. doing all such other things as are incidental or conducive to the promotion or advancement of the business of the company;

The essential relationship between a banker and its customer is contractual and not fiduciary.[863] Obligations are owed on both sides of the contractual arrangement; the fundamental obligation of the bank is to honour its customer's instructions and to repay on demand monies deposited in an account. Other obligations may be agreed by virtue of specific arrangements; for example, the parties may enter into a loan agreement or overdraft facility, or the bank may agree to provide certain specific services with connected obligations, for example in relation to the provision of banker's drafts, letters of credit or other instruments, or the provision of foreign currency services, or advisory services.

[863] Foley v Hill (1848) 2 HL Cas. 28; Hart v Sangster [1957] 1 Ch. 329 at 337; Joachimson v Swiss Bank Corpn [1921] 3 KB 110 at 127

In the absence of special arrangements, terms are rarely to be implied into the underlying banker/customer contract itself; for example, there is not normally an implied term in the contract between bank and customer obliging the bank to provide overdraft facilities or other finances to its customer,[864] nor is there any implied obligation upon the bank to inform its customers of the introduction of more advantageous forms of account[865] or to give a period of notice to the customer before withholding further finances.[866] Equally, there is in general no implied obligation upon the bank to advise its customer that particular borrowing is or may be imprudent.[867] A bank has a statutory duty to perform such services as it is providing with skill and care, by virtue of section 13 of the Supply of Goods and Services Act 1982. It is also under an implied obligation to keep its customer's affairs confidential.[868]

6.3 The Banking Laws in Pakistan

This section reproduces and/or describes different banking laws, in Pakistan, that not only regulates banks' relationship with their customers but also address the question and explore the ground realities if law provides adequate legal infrastructure in Pakistan to protect depositors and investors' money. The Banks in Pakistan are regulated and operated under the mechanism provided by the following laws and regulations:

1) The Negotiable Instruments Act, 1881
2) Pakistan Coinage Act, 1906
3) The State Bank of Pakistan Act, 1956
4) The Banking Companies Ordinance, 1962
5) The Banking Companies Rules 1963
6) The Banks Nationalisation Act 1974
7) The Banking Companies Ordinance, 1979
8) The Modarba Companies and Modarba (Floatation and Control) Ordinance, 1980
9) Offences in Respect of Banks (Special Courts) Ordinance 1984

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[864] Suriya & Douglas v Midland Bank [1999] 1 All E.R. 612
[865] Barclays Bank v Green Unreported May 17, 1996, CA
[866] Socomex v Banque Bruxelles Lambert SA [1996] 1 Lloyd's Rep. 156
[867] Williams & Glyn's Bank Ltd v Barnes (1980) 10 Legal Decisions Affecting Bankers 200; [1981] Com. L.R. 205; Frost v James Finlay Bank [2001] Lloyd's Rep. Bank. 302, 310–311
[868] Tournier v National and Union Bank of England [1924] 1 K.B. 461, United Pan-Europe Communications NV v Deutsche Bank AG [2000] 2 B.C.L.C. 461; Christofi v Barclays Bank Plc [2000] 1 W.L.R. 937; Paget's Law of Banking (14th edn)78,79; Wendoline Godfrey and Francis Neaten, Neate and Godfry: Bank Confidentiality (6th edn, Bloomsbury Professional 2015) ISBN-10: 1780434847

10) Protection of Economic Reforms Act 1992
11) National Accountability Ordinance, 1999
12) The State Bank of Pakistan (Banking Services Corporation) Ordinance, 2001.
13) The Financials Institutions (Recovery of Finances) Ordinance, 2001
14) The Foreign Currency Accounts (Protection) Ordinance 2001
15) Anti-Money Laundering Rules 2008
16) Anti-Money Laundering Regulations 2008
17) The Anti-Money Laundering Act 2010
18) Microfinance Institutions Ordinance, 2001
19) Electronic Transactions Ordinance, 2002
20) Payment Systems and Electronic Fund Transfer Act, 2007
21) Pakistan Coinage (Amendment) Act, 2013
22) Credit Bureau Act 2015
23) Financial Institutions (Secured Transactions) Act, 2016
24) Deposit Protection Corporation Act 2016
25) Public Finance Management Act 2019
26) Regulations for Lender of Last Resort (LOLR) Facility under Section 17G of the State Bank of Pakistan Act, 1956
27) Prudential Regulations for Corporate/commercial Banking
28) Prudential Regulations for Microfinance Banks
29) Anti-Money Laundering, Combating the Financing of Terrorism & Countering Proliferation Financing Regulations

The Negotiable Instruments Act, 1881

The Negotiable Instruments Act was enacted by the British Raj to accommodate the traditional customary practices of the transactions. The most important class of Credit Instruments that evolved in India were termed as Hundi. Their use was most widespread in the twelfth century and has continued until today. In a sense, this represents the oldest surviving form of credit instrument. This was used in trade and credit transactions; it was used as remittance instruments for transfer of funds from one place to another. A Hundi is a Banking instrument that developed in the mediaeval India. The Reserve Bank of India describes the Hundi as "an unconditional order in writing made by a person directing another to pay a certain sum of

money to a person named in the order." In Modern era Hundi served as Travellers Cheques[869]. According to Section 13 of the Negotiable Instruments Act, "A negotiable instrument means a promissory note, bill of exchange or cheque payable either to order or to bearer.

The continued application of The Negotiable Instruments Act, 1881 demonstrates not only the continuation of the traditional practices of credit transactions but also that such practices are recognised and regulated through banking laws in Pakistan[870].

The State Bank of Pakistan Act, 1956 "the 1956 Act"

The Preamble to the 1956 Act emphasised the necessity of the constitution of the State Bank to regulate the monetary and credit systems of Pakistan and to foster their growth in the best national interests with a view to securing monetary stability and fuller utilisation for the country's productive resources. Section 3 of 1956 Act describes the purpose of the establishment of the State Bank as a Bank established in perpetual succession, for the purposes of taking over as from the first day of July 1948, the management of the currency from the Reserve Bank of India and carrying on the business of Central Banking. The State Bank's affairs are managed by the Board of Directors; the Board consists of a governor, secretary and Eight (8) directors.[871] The Directors are appointed by the Federal Government on the basis of their qualifications stated to be the eminent professionals, with no conflict of interests with the business of the State Bank, from the fields of economics, finance, banking, and accountancy hall have no conflict of interest with the business of the Bank.[872] The avoidance of the conflict of interest is ensured by excluding the employees of banks, members of parliament and government's employees to be a member of the Board.[873]

The Governor is the chairman of the Board. The Board, except for the powers entrusted to the Monetary Policy Committee, oversees foreign exchange reserve management, and approves strategic investment and risk policy.[874] All decisions of the Board are taken by majority of the

[869] Evolution of Payment Systems in India' (1998) Reserve Bank of India https://www.rbi.org.in/scripts/PublicationsView.aspx?id=155 accessed14 January 2020
[870] The State Bank of Pakistan Act (1956) 17(2)(a) < http://www.sbp.org.pk/about/act/SBP-Act.pdf> accessed 14 January 2020
[871] The State Bank of Pakistan Act, 1956
[872] Sec. 9 (2) (c) The State Bank of Pakistan Act, 1956
[873] Sec. 10(10) & Sec. 13 The State Bank of Pakistan Act, 1956
[874] Sec. 9A The State Bank of Pakistan Act, 1956

members present and voting and in the event of equality of the votes, the Governor may exercise a casting vote.[875]

The Monetary and Fiscal Policies Coordination Board[876] consists of the (i). Federal Minister for Finance as Chairman (ii). Federal Minister for Commerce (iii). Deputy Chairman, Planning Commission (iv). The Governor of The State Bank (v). Secretary, Finance Division, Government of Pakistan (vi) two eminent macro or monetary economists with proven record of research and teaching.

The Co-ordination Board performs the following functions:

(a) coordinate fiscal, monetary, and exchange-rate policies;
(b) ensure consistency among macroeconomic targets of growth, inflation, and fiscal, monetary, and external accounts;
(c) meet for the purposes of clauses (a) and(b) before the finalization of the budget to determine the extent of Government borrowing from commercial banks taking into account credit requirements of the private sector, liquidity expansion determined by the Board and expected changes in net foreign assets of the banking system;
(d) meet on a quarterly basis to review the consistency of macro-economic policies and to revise limits and targets set at the time of the formulation of the budget, keeping in view the latest developments in the economy;
(e) consider limits of the Government borrowing as revised from time to time in the meetings to be held before and after passage of the annual budget;
(f) review the level of Government borrowing in relation to the predetermined or revised targets after every quarter; and
(g) review the expenditure incurred in connection with raising of loans and Government borrowing.

The State Bank is authorised to carry on and transact the business[877], namely:

[875] Sec. 9 (4) The State Bank of Pakistan Act, 1956
[876] Sec. 9B The State Bank of Pakistan Act, 1956
[877] The State Bank of Pakistan Act, 1956

i. the acceptance of money on deposit from, and the collection of money for the Federal Government, the Provincial Governments, Local Authorities, banks, and other persons Provided that no interest shall be paid on such deposits

ii. hold and manage the international reserves of Pakistan

iii. purchase, sale, and rediscount of bills of exchange and promissory notes

iv. purchase, sale, and rediscount of such debentures issued by a public company or corporation;

v. purchase and the sale of approved foreign exchange;

vi. purchase, sale, and rediscount of bills of exchange including treasury bills with a scheduled bank;

vii. keeping of balances with banks in countries whose currency has been declared as approved foreign exchange;

viii. The making to Local Authorities, scheduled banks or cooperative banks of advances and loans repayable on demand or on expiry of fixed periods not exceeding one hundred and eighty days against the security of:- (a) stocks, funds and securities, other than immovable property, in which a trustee is authorised to invest trust money by any law for the time being in force in Pakistan; (b) gold or silver or documents of title to the same; (c) such bills of exchange and promissory notes as are eligible for purchase or rediscount by the Bank; (d) promissory notes of any scheduled bank supported by such modaraba certificates of participation term certificates as are acceptable to the bank or by documents of title relating to goods, such documents having been transferred, assigned or pledged to any such bank as security for a loan or advance granted for bona fide commercial or trade transactions or for the purpose of financing seasonal agricultural operations of the marketing of crops;

ix. The making of loans and advances out of the Rural Credit Fund;

x. The making of loans and advances out of the Industrial Credit Fund;

xi. The making of loans and advances out of the Export Credit Fund;

xii. The making to the Federal Government or Provincial Governments of advances repayable in each case not later than three months from the date of the making of the advance;

xiii. The making to institutions or banks, specially established for the purpose of promoting agricultural or industrial development, or for the financing of construction of houses, in the country or co-operative banks of advances and loans for such amounts and on such terms and conditions as the Board may decide from time to time;

xiv. As and when directed by the Federal Government, the purchase, holding and sale of shares and debentures of any banking company as defined in Section 5 of the Banking Companies Ordinance, 1962 (LVII of 1962) or of any financing corporation or institution;

xv. providing finances to scheduled banks or financing institutions on the basis of participation in profits and losses;

xvi. issue and purchase of telegraphic transfers, demand drafts and other kinds of remittances made payable at its own branches, offices, or agencies;

xvii. drawing, accepting, making and issue of any bill of exchange, hundi, promissory note, or engagement for the payment within or without Pakistan, of Pakistan or foreign currency payable to bearer or to a banker on demand;

xviii. purchase and sale of securities of countries whose currency has been declared as approved foreign exchange with an unexpired currency of not more than ten years;

xix. purchase and sale of securities of the Federal Government or a Provincial Government or fully guaranteed by the Federal Government or a Provincial Government of any maturity or of such securities of a Local Authorities as may be specified in this behalf by the Federal Government by notification in the official Gazette on the recommendation of the Board;

xx. custody of monies, securities, and other articles of value and the collection of the proceeds, whether principal or interest, profit, dividend, or other return of any such securities;

xxi. sale and realisation of all property, whether movable or immovable which may in any way come into the possession of the Bank in satisfaction, or part satisfaction of any of its claims;

xxii. acting as agent to the Federal Government, any Provincial Government, or any Local Authority in the transaction of any of the following kinds of business, namely:- (a) the purchase and sale of gold or silver or approved foreign exchange; (b) the purchase, sale, transfer and custody of bills of exchange, securities or shares in any company; (c) the collection of the proceeds, whether principal or interest, profit, dividend or other return, of any securities]; (d) the remittance of such proceeds at the risk of the principal, by bills of exchange payable either in Pakistan or elsewhere ; (e) the management of public debt; and (f) the transaction of special drawing rights with the International Monetary Fund;

xxiii. purchase and sale of gold coins and gold or silver bullion;

xxiv. The opening of an account with or the making of any agency arrangement with, and the acting as agent or correspondent of a bank incorporated in any country outside Pakistan or the principal currency authority of any country under the law for the time being in force in that country or any international or regional bank formed by such principal currency authorities, the investing of the funds of the Bank in the shares and securities of any such international or regional bank; and the holding and transacting of special drawing rights with the International Monetary Fund;

xxv. borrowing of money, not exceeding the share capital of the State Bank from the Scheduled Bank and foreign central bank;

xxvi. making and issue of bank notes subject to the provisions of this Act;

xxvii. exercise of powers and the performance of functions and duties entrusted to the Bank by or under the 1956 Act or any other law for the time being in force;

xxviii. entering into clearing and payments arrangements with any country or group of countries and settlement of international payments transactions under such arrangements, and incurring Banking and other obligations relating thereto;

xxix. Establish credits and give guarantees;

xxx. Establish funds for the purposes of the 1956 Act or for any specified purposes as the Federal Government may notify in this behalf;

xxxi. The Bank may contribute or donate funds to a body corporate in Pakistan for the study or promotion of, or research in, banking, economics, and allied subjects;[878]

xxxii. Where the circumstances so warrant, and a scheduled bank approaches the Bank for Banking facility to improve its liquidity the Bank may provide the Banking facility;[879]

xxxiii. The Bank has power to issue such directives, instructions, and regulations for carrying out the functions of the Bank under this Act or any other law and shall be binding and enforceable;[880]

xxxiv. The Bank may take any enforcement action including imposition and collection of pecuniary penalties upon legal and natural persons for contravention of this Act, any law being administered by the Bank;[881] and

xxxv. The Bank has the sole right to issue bank notes made payable to bearer on demand in Pakistan in accordance with the provisions hereinafter made.[882]

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[878] Section 17F The State Bank of Pakistan Act, 1956
[879] Section 17G The State Bank of Pakistan Act, 1956
[880] Regulatory Powers Sec 17H (1) The State Bank of Pakistan Act, 1956
[881] Regulatory Powers Sec 17H (2) The State Bank of Pakistan Act, 1956
[882] Sec 24 The State Bank of Pakistan Act, 1956

xxxvi. Generally, the doing of all such matters and things as may be necessary, incidental to or consequential upon the exercise of its powers or the discharge of its duties or functions under the 1956 Act.

The Banking Companies Ordinance, 1962

The Banking Companies Ordinance 1962 “the 1962 Ordinance” was promulgated to consolidate the banking laws. The Banks, scope of its operations, the regulations of the banks, the Regulator, and the Regulatory authority of the State Bank is discussed in this Ordinance. Some of the relevant sections are reproduced below:

Section 7 of 1962 Ordinance describe the business of the banking includes:

xxv. The borrowing, raising, or taking up of money; the lending or advancing of money either upon or without security;

xxvi. the drawing, making, accepting, discounting, buying, selling, collecting, and dealing in bills of exchange, hundis, promissory notes, coupons, drafts, bills of lading, railway receipts, warrants, debentures, certificates, scrips participation term certificates, term finance certificates, musharika certificates, modaraba certificates and such other instruments as may be approved by the State Bank and other instruments, and securities whether transferable or negotiable or not;

xxvii. the granting and issuing of letters of credit, traveller’s cheques, and circular notes;

xxviii. the buying, selling, and dealing in bullion species; the buying and selling of foreign exchange including foreign bank notes;

xxix. the acquiring, holding, issuing on commission, underwriting, and dealing in stock, funds, shares, debentures, debenture stock, bonds, obligations, securities participation term certificates, term finance certificates, musharika certificates, modaraba certificates and such other instruments as may be approved by the State Bank and investment of all kinds;

xxx. the purchasing and selling of bonds, scrips or other forms of securities participation terms certificates, term finance certificates, musharika certificates, modaraba certificates and such other instruments as may be approved by the State Banks on behalf of constituents or others, the negotiating of loans and advances;

xxxi. the receiving of all kinds of bonds, scrips of valuables on deposit or for safe custody or otherwise; “the providing of safe deposit vaults”: the collecting and transmitting of money and securities;

xxxii. the providing of finance;

xxxiii. acting agents for any Government or local authority or any other person or persons;

xxxiv. the carrying on of agency business of any description including the clearing and forwarding of goods, giving of receipts and discharges, and otherwise acting as an attorney on behalf of customers, but excluding the business of a managing agent or treasurer of a company;

xxxv. acting as “modaraba company” under the provision of the Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980 (XXXI of 1980);

xxxvi. contracting for public and private loans and negotiating and issuing the same;

xxxvii. the effecting, insuring, guaranteeing, underwriting, participating in managing and carrying out of any issue public or private, Government, municipal or other loans or of shares, stock debentures, debenture stock or other securities of any company, corporation or association and the lending of money for the purpose of any such issue;

xxxviii. carrying on and transacting every kind of guarantee and indemnity business;

xxxix. purchase or acquisition in the normal course of its banking business of any property, including commodities, patents, designs, trademarks, and copyrights with or without buyback arrangements by the seller, or for sale in the form of hire purchase or on deferred payment basis with mark-up or for leasing or licensing or for rent-sharing or for any other mode of financing;

xl. managing, selling, and realising any property which may come into the possession of the company in satisfaction of any of its claims;

xli. acquiring and holding and generally dealing with any property or any right, title, or interest in any such property for any loans or advances;

xlii. undertaking and executing trusts;

xliii. establishing and supporting or aiding in the establishment and support of associations, institutions, funds, trusts and conveniences calculated to benefit employees or ex-employees of the company or the dependents or connections of such persons; granting pensions and allowances and making payments towards insurance;

xliv. subscribing to or guaranteeing moneys for charitable or benevolent objects or for any exhibition or for any public, general or useful object;

xlv. the acquisition, construction, maintenance, and alteration of any building or works necessary or convenient for the company;

xlvi. selling, improving, managing, developing, exchanging, leasing, mortgaging, disposing of or turning into account or otherwise dealing with all or any part of the property and rights of the company;

xlvii. acquiring and undertaking the whole or any part of the business of any person or company;

xlviii. doing all such other things as are incidental or conducive to the promotion or advancement of the business of the company;

xlix. any other form of business which the State Bank by circular, specifies as a form of business in which it is lawful for a banking company to engage.

Section 13 of 1962 Ordinance imposes the requirement as to minimum paid-up capital and reserves as it may be determined by the State Bank before it commences business

Section 25 makes it obligatory on the banks to follow the policy as it may be determined by the State Bank as to the credit ceilings to be maintained, credit targets to be achieved for different purposes, sectors and regions, the purposes for which advances may or may not be made, the margins to be maintained in respect of advances, the rates of interest, charges or mark-up to be applied on advances and the maximum or minimum profit sharing ratios, prohibiting the giving of loans, advances and credit to any borrower or group of borrowers on the basis of interest.

Section 25A requires every banking company to furnish to the State Bank credit information in such manner as the State Bank may specify, and the State Bank may, either of its own motion or at the request of any banking company, make such information available to any banking company.

Section 25AA deals with the special reports, submitted to the Federal Government by the State Bank, every year on cases of write off of loans, mark-up and other dues, or Banking relief through rescheduling and restructuring of loans and subsidised loans provided by the banking companies, in which established banking practices or authorised procedures have been departed from with a view to causing wrongful loss to the bank or conferring wrongful gain on

any constituent or such departure has caused wrongful loss to the bank or conferred wrongful gain on any constituent.

Section 26 gives power to The State Bank to prohibit acceptance of deposits by foreign banks.

Section 29 imposes obligations on the banks to furnish to the State Bank a monthly return, in the prescribed form and manner, showing particulars of the required company's assets as maintained in Pakistan in cash, gold or unencumbered approved securities valued at a price not exceeding "the lower of the cost or" the current market price an amount which shall not at the close of business on any day be less than "such percentage" of the total of its time and demand liabilities in Pakistan.

Section 40 entrusts the State Bank with the power of inspection to inspect any banking company and its books and accounts.

Section 40A makes the State Bank Responsible to systematically monitor the performance of every banking company so as to ensure that it is complying with the applicable statutory criteria and banking rules and regulations; and to taking such remedial steps as may be required in accordance with law, to report the shortcomings and violations on the part of the banking company's management in failing to discharge its responsibility in accordance with the applicable statutory criteria and banking rules or regulations, or is failing to protect the interests of depositors, or is advancing loans or finances without due regard for the best interests of the banking company or for reasons other than the merits.

Section 41 makes it obligatory upon the banks to follow the directions of the State Bank given, in the public interest, to prevent the affairs of any bank being conducted in a manner detrimental to the interests of the depositors or in a manner prejudicial to the interests of the bank; or to secure the proper management of any banking company generally.

Section 41A authorises the State Bank to remove directors or other managerial persons from office where the State Bank is satisfied that such officer not being lower in rank than a branch manager who is likely to be detrimental to the interests of the banking company or its depositors or otherwise undesirable; or in the public interest; or to prevent the affairs of a banking company being conducted in a manner detrimental to the interest of its depositors or in a

manner prejudicial to the interests of the banking company; or to secure the proper management of any banking company.

Section 41B gives power of the State Bank to supersede the Board of Directors of a banking company where conditions as specified in section 41A exists.

Section 41D deals with the Prosecution of directors, chief executives, or other officers:

Notwithstanding anything contained in section 41A, the State Bank may direct prosecution of a director or chief executive by whatever name called or other officer who, in its opinion, has knowingly acted in a manner causing loss of depositors' money or of the income of the banking company.

Section 42 assigns further powers and functions to the State Bank by authorising it (a) caution or prohibit banking companies generally or any banking company in particular against entering into any particular transaction or class of transactions and generally give advice to any banking company; (b) require banking companies generally, or any banking company in particular, to refrain from taking such actions as it may specify in relation to any matter relating to the business of such banking company or companies, or to take such action in relation thereto as the State Bank thinks fit; (c) on a request from the banking companies concerned and subject to the provisions of section 59 assist as intermediary or otherwise, in proposals for the amalgamation of such banking companies; (d) during the course, or after the completion, of any inspection of a banking company under section 40, by order in writing and on such terms and conditions as may be specified therein— (i) require the banking company to call a meeting of its directors for the purpose of considering any matter relating to or arising out of the affairs of the banking company, or require an officer of the banking company to discuss any such matter with an officer of the State Bank; (ii) depute one or more of its officers to watch the proceedings at any meeting of the Board of Directors of the banking company or of any committee or of any other body constituted by it; (iii) require the Board of Directors of the banking company or any committee or any other body constituted by it to give in writing to any officer specified by the State Bank in this behalf at his usual address all notices of, and other communications relating to, any meeting of the Board, committee or other body constituted by it; (iv) appoint one or more of its officers to observe the manner in which the affairs of the banking company or of its offices or branches are being conducted and make a

report thereon; (v) require the banking company to make, within such time as may be specified in the order, such changes in the management as the State Bank may consider necessary in consequence of the state of affairs disclosed during or by the inspection; (e) without prejudice to the generality of this section or any provision of this Ordinance- (1) if the State Bank is satisfied that one or more of the circumstances exist under which a banking company, – i. has become or is likely to become insolvent; ii. has suspended or is likely to suspend payments as these fall due; iii. has defaulted or is likely to default in making payments to depositors; iv. is carrying on its business in a manner detrimental to the interests of its depositors, creditors, or other stakeholders; v. has contravened any provisions, or any restrictions or condition imposed on its license; vi. has engaged any director, chief executive or an officer of a banking company who is or is likely to be detrimental to the interests of the banking company or its depositors or otherwise undesirable; vii. has created hindrance, delay, or obstruction for the State Bank in performance of its supervisory functions; viii. has wilfully destroyed, concealed, or moved outside of Pakistan all or part of its assets, the administration, operation and books or records; ix. has failed to meet capital adequacy or minimum capital requirements prescribed by the State Bank; x. has defrauded its depositors and creditors; xi. is wilfully engaged in or is being used for criminal activities; xii. is part of a Banking group which is under liquidation, or in respect of which a custodian, receiver, administrator, or liquidator has been appointed; xiii. is a branch or subsidiary of a banking company whose license to carry on banking business in the country of its origin has been cancelled; xiv. has breached requirements under, any document of commitment to the State Bank; or xv. is otherwise in a situation or circumstance which in the opinion of the State Bank may materially impair the ability of the banking company to make payments, meet its obligations or otherwise continue its operations, The State Bank may, keeping in view the gravity of the situation and compliance behaviour of the banking company, from time to time, invoke any one or more of the following actions, namely: -

(i) require the banking company to submit a plan of action to redress any discrepancies; (ii) require the banking company or Board of Director of the banking company to furnish documents of commitment for compliance with the measures prescribed by The State Bank and to secure the interests of its depositors; (iii) where the banking company or the Board of Directors fail to provide documents of commitment or fulfil its obligation under the same pursuant to clause (ii), The State Bank may-- (a) take any action under sections 41A, 41B or section 47; and (b) carry out any capital reduction and cancel any portion of shares of the banking company which is

depleted or unrepresented by available assets or dilute the participation of the existing shareholders by issuing shares to such persons and at such consideration as may be determined by The State Bank.

Provided The State Bank exercises the power reasonably, fairly and justly and provide an opportunity of being heard to the banking company or aggrieved person before making the order and if The State Bank is of the opinion that any delay would be detrimental to the public interest or the interest of the banking company or its depositors, The State Bank may, at the time of giving the opportunity aforesaid or at any time thereafter and pending the consideration of the representation aforesaid, if any, make an appropriate interim order. The banking company or the aggrieved person shall have the right to appeal to the Central Board of Directors of The State Bank; and (1B) Nothing contained in this section shall be read to dilute or affect powers of The State Bank otherwise conferred in the Ordinance. (2) The State Bank shall make an annual report to the Federal Government on the trend and progress of banking in the country, with Islamic Banking.[883]

Section 43A gives power to call for certain information, documents or records respecting any business carried on by the company where a company, firm or any other person is transacting in any manner or form whatsoever the business of banking in contravention of sub-section (1) of section 271 or is receiving or has received deposits of money in contravention of section 27A.

The State Bank may appoint interim Receiver to preserve money and take control of all record, all moneys, cash securities, title deeds, properties, whether movable or immovable under section 43AA, in the interest of the persons from whom the deposits of moneys were received, it is necessary that the moneys received and other assets of the company, firm or person, whether held in the name of that company, firm or person or of any other persons, are protected and preserved.

Such company, firm or person or any director, manager, officer, partner or employee or agent, beneficiary, or transferee of such company, firm or person or their dependants or any other person deriving or claiming title through any of them may also be restrained from alienating,

[883] M L Tannan, 'Banking Law and Practice in Pakistan' (1978) Banking Law- Pakistan, Mansoor Book House 346.082 TAN

transferring, selling, assigning, disposing of, or parting with possession of any property, movable or immovable, or deriving any benefit, rent or income therefrom.

The State Bank under section 47 may apply to the Federal Government for suspension of business by a banking company and to prepare a scheme of reconstruction or amalgamation. The Federal Government, after considering the application made by The State Bank, may make an order of moratorium staying the commencement or continuance of all action and proceedings against the company for a fixed period but not more than 6 months. The banking company shall not during the period of moratorium make any payment to any depositors or discharge any liabilities or obligations to any other creditors. The State Bank may, in the public interest or in the interests of the depositors; or to secure the proper management of the banking company; or in the interests of the banking system of the country prepare a scheme for the reconstruction of the banking company, or for the amalgamation of the banking company with any other banking institution

Section 82A deals with Appointment of Banking Ombudsman who shall be appointed by the President in consultation with the Governor of The State Bank of Pakistan. The jurisdiction of the Banking Mohtasib[884] in relation to banking transactions shall be to make enquiries into complaints of banking malpractices; perverse, arbitrary, or discriminatory actions; violations of banking laws, rules, regulations, or guidelines; inordinate delays or inefficiency and corruption, nepotism, or other forms of maladministration.

Section 82 G requires the Banking Mohtasib to submit a report to The State Bank setting out a review of the activities of his office during the preceding year.

The Banking Companies Rules 1963

These Rules deal with the procedural aspects of the incorporation and approval of a banking company such as provision of the list of officers, deposits of the capital with The State Bank, license of companies, list of offices and manners of publications of accounts etc.

[884] Banking Ombudsman

The Banks Nationalization Act 1974

The State Bank of Pakistan implemented the Nationalization Act in 1974.

Objectives of Nationalization

1. "Disbursement of funds to the desired channels to achieve the priorities set out by the government for social welfare projects.
2. Equitable distribution of credit to different classes, sectors, and regions" (Bonte 1999).[885]

The Banking Companies Ordinance, 1979

This Ordinance established a specialist Banking Court as opposed to Banking Tribunals with the object of expediting the recovery of the loans and realising securities. This act gives Banking Court powers of civil jurisdiction to be triable by the judge equivalent to a District Judge.

The Modarba Companies and Modarba (Floatation and Control) Ordinance, 1980

The Modarba company is technically a company that would be a listed company with the purpose of seeking investment. This Ordinance was passed to meet the needs of misguided demand for the Islamisation of laws by the then Military ruler and the legislation principally served the purpose of restricting the interest payments against such investments.

The interpretation clause defines the Modarba as a business in which a person participates with his money and another with his efforts or skill or both his efforts and skill and shall include Unit Trusts and Mutual Funds by whatever name it may be called.

Offences in Respect of Banks (Special Courts) Ordinance 1984

[885] Rudi Bonte, 'Supervisory Lessons to be Drawn from the Asian Crisis' (1999)2 Basel Committee On Banking Supervision WP <www.bis.org/publ/bcbs_wp2.pdfhttp> accessed January 2020

This Ordinance empowers the Banking Court to deal with matters of criminal cognizance with respect to the offences coming within the ambit of the functions of a bank. The qualification for the appointment of the judge is set to be a judge of the High Court.

National Accountability Ordinance, 1999

The preamble of Ordinance explains it's objectives:
An Ordinance to provide for the setting up of a National Accountability Bureau so as:
to eradicate corruption and corrupt practices and hold accountable all those persons accused of corrupt practices and matters ancillary thereto;
to provide for effective measures for the detection, investigation, prosecution, and speedy disposal of cases involving corruption, corrupt practices, misuse or abuse of power or authority, misappropriation of property, taking of kickbacks, commissions and for matters connected and ancillary or incidental thereto;
for the recovery of outstanding amounts from those persons who have committed default in the repayment of amounts to Banks, Financial Institutions, Governmental agencies, and other agencies;
for the recovery of state money and other assets from those persons who have misappropriated or removed such money or assets through corruption, corrupt practices and misuse of power or authority;
to educate the society about the causes and effects of corruption and corrupt practices;
to implement policies and procedures for the prevention of corruption in the society; and internationally cooperate in combating corruption and seek, obtain, or give mutual legal assistance in matters concerning corruption and for matters connected, ancillary or incidental thereto.

The State Bank of Pakistan (Banking Services Corporation) Ordinance, 2001[886]

The State Bank of Pakistan (Banking Services Corporation) Ordinance, 2001 was enacted to provide for the establishment, management, and control of SBP Banking Services Corporation as a subsidiary of The State Bank of Pakistan, and for the transfer thereto of a part of the

[886] www.sbp.org.pk/about/ordinance/ordinance.pdf

undertaking and certain employees of The State Bank of Pakistan, and for matters connected therewith or ancillary thereto;

The State Bank under section 18 of Ordinance can delegate its powers and can perform delegated functions, under section 5, of The State Bank including (a) the carrying on of the Transferred Undertaking, statutory and administrative functions and activities of The State Bank transferred or delegated by The State Bank to the Bank under this Ordinance; (b) the handling of receipt, supply and exchange of bank notes and coins which are legal tender; (c) the issue, supply, sale, encashment and handling of prize bonds, holding draws thereof and other savings instruments of the Federal Government or of a Provincial Government; (d) the performance of any other activity or business which The State Bank may, by order in writing, specify; (e) the carrying on of any business and discharging of any functions and powers as are incidental to, or in connection with, the affairs of the Bank, including, without limiting the generality of the foregoing and, the power to enter into any contracts or other instruments or any financial or other transactions, issue guarantees and indemnities, borrow and lend moneys, accept deposits of money, make investments, purchase and hold any property and assets, and to provide any services to The State Bank and to others and receive any fee, commission or other compensation for such services; and to carry out its function effectively, the Bank if deemed necessary may, with the prior approval of the Board and The State Bank, establish one or more subsidiaries for the purpose of conducting its business.

However, The State Bank is restricted to transfer or delegate any of the functions specified in section 9A of The State Bank of Pakistan Act, 1956 (XXXIII of 1956, including— (a) (b) (c) (d) formulation and monitoring of monetary and credit policies; regulation and supervision of the financial sector; foreign exchange regime and exchange rate policy; and payment and settlement system.

Microfinance Institutions Ordinance, 2001[887]

Microfinance Institutions Ordinance provide mechanism to regulate microfinance institutions to protect the depositors and customers and to safeguard these institutions against political and other outside interference; Microfinance institutions are purposed for providing organizational,

[887] www.sbp.org.pk/l_frame/MF_Inst_Ord_2001.pdf

financial and infrastructural support to poor persons, particularly poor women, for mitigating poverty and promoting social welfare and economic justice through community building and social mobilization and to provide for matters connected therewith or ancillary thereto.

The most relevant sections are summarised below:

Section 5 restricts the use with its name the words "Microfinance Bank" or "MFB" or its derivatives or any words or letters which convey that it is a microfinance bank without registration.

Section describes the functions and powers of a microfinance institution:

render assistance to micro-enterprises and provide microfinance services in a sustainable manner to poor persons, preferably poor women, with a view to alleviating poverty.

provide financing facilities, with or without collateral security, in cash or in kind, for such terms and subject to such conditions as may be prescribed, to poor persons for all types of economic activities including housing, but excluding business in foreign exchange transactions,

except to receive remittances from abroad payable only in Pakistan Rupees to beneficiaries in Pakistan to accept deposits;

to accept pledges, mortgages, hypothecations, or assignments to it of any kind of movable or immovable property for the purpose of securing loans and advances made by it;

undertake the management, control and supervision of any Organization, enterprise, scheme, trust fund or endowment fund for the benefit and advancement of poor persons;

buy, sell, and supply on credit to poor persons industrial and agricultural inputs, livestock, machinery, and industrial raw materials, and to act as agent for any Organization for the sale of such goods or livestock;

invest in shares of body corporate, the objective of which is to provide microfinance services and technical, vocational, education, business development and allied services to the poor and micro enterprises;

provide storage and safe custody facilities;

to carry out survey and research, and to issue publication and maintain statistics relating to the improvement of economic condition of poor persons;

provide professional advice to poor persons regarding investments in small business and such cottage industries as may be prescribed;

encourage investments in such cottage industries and income generating projects for poor persons as may be prescribed;
provide services and facilities to customers to hedge various risks relating to microfinance activities;
render managerial, marketing, technical and administrative advice to customers and assisting them in obtaining services in such fields;
borrow and raise money and open bank accounts;
purchase, take on lease, or otherwise acquire, sell, exchange, surrender, lease, mortgage, dispose of and deal in any movable and immovable property and rights of all kinds for and on behalf of its customers for the purpose of promoting development opportunities, building of assets, resource allocation, promotion of markets, and adoption of better technology for economic growth and development;
establish subsidiaries, whether wholly or partly owned, and to appoint agents in various locations for various activities which it may consider necessary for the proper discharge of its functions;
pay, receive, collect, and remit money and securities within the country;
acquire, maintain, and transfer all movable and immovable property including residential premises, for carrying on its business;
open account or make any agency arrangement with, and to act as agent or correspondent of, any bank or financial institution;
invest its surplus funds in Government and such other marketable securities as The State Bank may from time to time notify;
impose and receive fees, charges, profits or return for its services;
mobilize and provide financial and technical assistance and training to micro enterprises;
undertake mobile banking to expedite transactions and reduce costs;
establish trust and endowment funds;
receive grants from the government and any other sources permitted by The State Bank; and
generally, do and perform all such acts, deeds and things as may be necessary, incidental, or conducive to the fulfilment of their functions and the attainment of their objectives;

Section 7 prohibits and restricts a microfinance institution from undertaking or transacting any kind of business other than that authorized by, or under, this Ordinance.
Further restrictions:

Where a microfinance institution is required by any authority to undertake or assist a micro enterprise or other such activities which it considers economically or otherwise unsound, the microfinance institution shall not undertake or assist such activity until and unless the said authority has provided adequate guarantee to the microfinance institution or indemnify any losses that it may incur in the undertaking of such activity.

No microfinance institution shall create a floating charge on the undertaking or any of its assets or part thereof, unless the creation of such floating charge is certified in writing by The State Bank as not being detrimental to the interest of the depositors of such institution.

Any such charge created without obtaining the certificate of The State Bank shall be invalid.

Section 19 obligates setting up of Depositors' protection funds for the purpose of providing security or guarantee to persons depositing money in such institutions. The depositors' protection fund shall be used to make payment to the individual depositors with aggregate deposits of up to ten thousand rupees in case of liquidation of the microfinance institution.

The Banking Institutions (Recovery of Finances) Ordinance, 2001[888]

This Ordinance also deals with the establishment of the Banking Court of civil jurisdiction. The Banking Court has jurisdiction to deal with the matter involving value up to 50 million Rupees. The High Court would act as a Banking Court for any amount above 50 million Rupees. The important factor for this ordinance was to take of cognizance over a loan that had already been written off, adjusted, or agreed to be adjusted due to involvement of political elements.

The Foreign Currency Accounts (Protection) Ordinance 2001

This ordinance was promulgated to recreate the market trust and encourage customers to open and maintain a foreign currency account. This extra assurance was given due to an unthoughtful act of freezing the foreign currency accounts by the previous government. The Ordinance gives assurance whereby no person holding a foreign currency account shall be deprived of his right to hold or operate such an account or in any manner be restricted temporarily or permanently to lawfully sell, withdraw, remit, transfer, use as security or take out foreign currency there from within or outside Pakistan.[889]

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[888] www.sbp.org.pk/about/ordinance/Ordinance_1.pdf

[889] Section 3

Anti-Money Laundering Rules 2008

These Rules deal with the cooperation with the foreign companies, and maintenance of the forfeited properties.

Anti-Money Laundering Regulations 2008

These Regulations specify the designated body i.e., FMU[890] with whom the specious transactions are to be reported.

The Anti-Money Laundering Act 2010

Section 3 describes the Offence of money laundering as acquiring, converting, possessing, using, or transferring property of criminal origin and concealing or disguising the true nature, origin, location, disposition, movement, or ownership of property.

Section 5 deals with the setting up of the National Executive Committee to combat money laundering. The Committee to be consisted of the following members, namely: — 5 (a) Minister for Finance or Advisor to the Prime Minister on Finance (b) Minister on Foreign Affairs Member (c) Minister for Law and Justice Member (d) Minister for Interior Member (e) Governor SBP Member (f) Chairman SECP Member ((h) Director General Member (i) any other member to be nominated by the Federal Government.

The Section 5(3) deals with the functions of the Committee: (a) develop, review and oversee the implementation of national strategy to fight money laundering and financing of terrorism; (b) determine offences existing in Pakistan that may be considered to be predicate offences for the purposes of this Act; (c) provide guidance and sanction in framing of rules and regulations under this Act; (d) make recommendations to the Federal Government for effective implementation of this Act and framing of national policy to combat money laundering and financing of terrorism; (e) issue necessary directions to the agencies involved in the

[890] Not defined in Regulations but defined as Banking Monitoring Unit in Anti Money Laundering Act 2010

implementation and administration of this Act; (f) discuss any other issue of national importance relating to money laundering and financing of terrorism;

Section 26 authorises the Federal Government to enter into an agreement on reciprocal basis with the Government of any country outside Pakistan for (a) the investigation and prosecution of any offence under this Act or under the corresponding law in force in that country; (b) exchange of information for the prevention of any offence under this Act or under the corresponding law in force in that country; (c) seeking or providing of assistance or evidence in respect of any offence under this Act or under the corresponding law in force in that country ; (d) transfer of property relating to any offence under this Act or under the corresponding law in force in that country.

Section 29. deals with the Reciprocal arrangements for processes and assistance for transfer of the persons accused of money laundering.

Electronic Transactions Ordinance, 2002[891]

This Ordinance is promulgated to recognize and facilitate documents, records, information, communications, and transactions in electronic form, and to provide for the accreditation of certification service providers

Payment Systems and Electronic Fund Transfer Act, 2007[892]

This Act deals with supervision and regulation of Payment Systems and Electronic Fund Transfers in Pakistan and to provide standards for protection of the consumer and to determine respective rights and liabilities of the financial institutions and other Service Providers, their consumers, and participants. Section 4 provides The State Bank authority to designate a Payment System as a Designated Payment System. This authority can be revoked by The State Bank under section5.

[891] www.sbp.org.pk/about/act/ETC202.pdf
[892] www.sbp.org.pk/psd/2007/EFT_Act_2007.pdf

Credit Bureau Act 2015[893]

This Act authorise the incorporation and functioning of credit bureaus for
collecting credit information relating to debtors of:
(i) a banking companies. (ii) microfinance banks; (iii) a financial institution, which means
(a) any company, whether incorporated within or outside Pakistan, which transacts business of banking or any associated or ancillary business in Pakistan through its branches within or outside Pakistan and includes a government savings bank but excludes The State Bank of Pakistan;
(b) a modaraba, leasing company, investment bank, financing company, unit trust or mutual fund of any kind and credit or investment institution, corporation, or company; and
(c) any company authorized by law to carry on any similar business;
(iv) nonbanking financial company; and
(v) any company, corporation or institution or class of companies or institutions as the Federal Government may from time to time, by notification in the official Gazette, specify for the purpose;

Deposit Protection Corporation Act 2016[894]

Deposit Protection Corporation (DPC) is a wholly owned subsidiary of The State Bank of Pakistan and established in wake of the DPC Act 2016. The corporation commenced its business with effect from June 01-2018. Deposit Protection Corporation plays a key role in promoting financial stability by sustaining confidence in the banking system. The objective of DPC is to compensate the small and financially unsophisticated depositors to the extent of protected deposits in the unlikely event of a bank failure. Deposit Protection Corporation is governed by an independent and professional board of directors under the Chairmanship of Deputy Governor of The State Bank of Pakistan, while its affairs are administered by the Managing Director. The Federal Government nominates the Board of Directors in consultation with The State Bank of Pakistan. All banks scheduled under subsection (2) of section 37 of The State Bank of Pakistan Act, 1956 (XXXIII of 1956), unless exempted or excluded by the Board, shall compulsorily be member institutions of the Corporation and liable to pay the prescribed premium. DPC collects premiums from member institutions as empowered by the

[893] www.sbp.org.pk/about/act/CreditBureauAct-2015.pdf
[894] www.sbp.org.pk/l_frame/Act-2016-DPC-NationalAssemblySec.pdf

DPC Act 2016 and manages the received funds separately for both Islamic and conventional premiums. DPC steps forwards in the unlikely event of bank failure as notified by The State Bank of Pakistan and compensates its depositors up to the amount as prescribed within 30 days after the notification after adopting the approved procedure of reimbursement.[895]

Public Finance Management Act 2019[896]

An Act to give effect to the financial proposals of the Federal Government to strengthen management of public finances with the view to improving definition and implementation of fiscal policy for better macroeconomic management, to clarify institutional responsibilities related to financial management, and to strengthen budgetary management.

Regulations for Lender of Last Resort (LOLR) Facility under Section 17G of The State Bank of Pakistan Act, 1956[897]

In order to mitigate routine maturity mismatches and liquidity shortages, The State Bank of Pakistan (SBP) uses standing liquidity facility (i.e., SBP reverse repo facility) and Open Market Operation (OMO) that are carried out against marketable government securities (MTBs & PIBs). However, in order to counter exceptional circumstances where a solvent bank faces purely a short-term liquidity shortage but cannot procure sufficient funding from the market or from The State Bank's standing facility, SBP may provide LOLR financing under the section 17G of the SBP Act to a solvent schedule bank against adequate collateral to improve its liquidity. Section 17G. (Lender of last resort) says: "Where the circumstances so warrant and a scheduled bank approaches the Bank for financial facility to improve its liquidity and where the bank in the opinion of the Bank, is solvent and can provide adequate collateral to support the financial facility, the Bank may provide the financial facility, in accordance with the regulations made by the Bank in relation thereto."

I. The LOLR facility under section 17G will be provided by The State Bank of Pakistan in exceptional circumstances to improve the liquidity of a solvent bank scheduled under section 37 of the SBP Act. This facility will be to cope with purely temporary liquidity shortages. Before availing this facility, the borrowing bank is

[895] https://www.dpc.org.pk/About.asp
[896] www.sbp.org.pk/l_frame/PublicFinanceManagementAct_2019.pdf
[897] www.sbp.org.pk/l_frame/Regulations-LOLR-facility-for-Banks.pdf

expected to have exhausted all the available sources of funding from the market. II. III. In addition to the existing solvency position of the bank as per its latest financials, The State Bank will also consider other factors that can have bearing on the solvency of the bank during the period of LOLR facility. These factors include but are not limited to the business model of the bank, its fund generation capacity, and availability of credible recovery plans to address the liquidity strain. The LOLR facility can be in the form of loan, advance or Shariah-compliant finance.

II. The LOLR facility will be secured against adequate collateral, while Shariah-compliant LOLR facility will be extended in line with Shariah principles. In order to mitigate any financial risk, the adequate haircuts will be applied on the value of collateral and The State Bank will obtain a first charge on any collateral pledged or assigned to support LOLR facility. Subject to the requirements of the SBP Act, 1956 in respect of collateral against which SBP can provide financing facility, the following eligible collaterals, or combination thereof, may be obtained for securing the LOLR facility:

• Approved Securities: As defined in the Banking Companies Ordinance 1962; and other securities, bonds, Sukuks, or claims, by whatever name called, as guaranteed by the Federal Government;

• Collateralized Term Finance Certificates /Bonds/Sukuk of investment grade. However, TFCs, Bonds and Sukuk, etc., of a bank/DFI which are eligible additional Tier-1 or Tier-2 capital of the issuing bank/DFI under Basel capital requirements will not be eligible collateral for LOLR facility;

• Any other collateral as permissible under the SBP Act;

• Personal Guarantees of the sponsors may also be obtained to further secure the facility. The LOLR facility will carry a markup/profit rate equal to or above SBP's ceiling rate under Interest Rate Corridor. However, the Sharia-compliant LOLR facility will be consistent with the principles of Shariah. The facility will be strictly for short-term, intending to overcome interim liquidity shortages. The SBP may prescribe certain requirements/restrictions on the concerned scheduled bank e.g., bar on dividends and bonuses payments, restriction on related party exposures, prohibition of repayments to certain related parties, bar on creation of illiquid assets, etc.

The concerned scheduled bank and, where deemed appropriate, its sponsors will provide undertaking that:

• The terms and conditions of the LOLR Facility agreement will be complied in letter and spirit;

• LOLR Facility would be used for improving the liquidity position of the bank; and

• The bank will comply with other requirements/restrictions as may be imposed by The State Bank (e.g. bar on dividends and bonuses payments, restriction on related party exposures, prohibition of repayments to certain related parties, bar on creation of illiquid assets, etc.). The LOLR facility may be considered as one of the possible recoveries/contingency measures for meeting interim liquidity shortages in extremely exceptional circumstances. Moreover, as a part of the recovery/contingency planning function, banks may institute mechanisms to pre-position eligible collaterals for LOLR facility so that they can approach the SBP with necessary documents.

III. The minimum set of documents required for availing LOLR facility are as follows:

a. Written request, duly signed by the bank's Chief Executive Officer, for LOLR facility specifying required amount; reasons specifying the need for LOLR facility; Steps that have already been taken to cope with the liquidity pressures; list of assets as collateral and their value; and necessary information about the financial position of the bank.

b. In case of Sharia-compliant facility, the Chief Executive Officer of the bank will provide undertaking to ensure Shariah compliance of all the aspects (inter alia collateral) of the Shariah Compliant-LOLR facility throughout the facility period, in line with Shariah Governance Framework issued by The State Bank, as amended from time to time. Besides, the bank's Shariah Board will actively monitor the facility for Shariah compliance throughout the LOLR facility period.

c. Resolution(s) of the Board of Directors of the bank specifically acknowledging the need of LOLR facility for the bank, authorizing specific official(s) to enter into agreement with SBP for LOLR facility and take actions to fulfil the conditions thereof, and endorsing the terms of the LOLR Facility;

d. A written concrete plan highlighting the steps the bank will take to resolve liquidity problem and repay the LOLR facility;

e. Necessary documents for LOLR facility and creation of charge on collaterals, e.g. promissory note, undertaking for LOLR facility, letter or agreements of assignments, endorsement, lien, and fiduciary guarantees, etc.

f. SBP may, if deemed appropriate, require written commitments of the sponsor shareholders of the concerned bank to provide necessary support to the bank and make good the losses from their own sources in case the bank fails to restore its liquidity position.

Prudential Regulations for Corporate/commercial Banking[898]

The State Bank of Pakistan recognizing the importance of infrastructure financing in the country, issued Infrastructure Project Financing (IPF) Guidelines in 2005. These guidelines were then updated in 2010. In order to promote infrastructure financing in Pakistan, the SBP is now issuing Prudential Regulations (PRs) for Infrastructure Project Financing. These regulations have been developed on the basis of broad based internal as well as external stakeholders' consultations. These PRs for IPF draw strength from the financial sector's experiences and SBP's forward looking approach in this area. These Prudential Regulations place emphasis on important features of infrastructure project finance which will facilitate the banks and DFIs to assess the cash flow generating capacity of the projects like the requirement of technical feasibility, comprehensive risk assessment, project insurance, technical monitoring of the project during loan tenure and requirement of supply and off-take agreements. It is hoped that these features of the Regulations will help banks and DFIs to develop expertise for financing infrastructure projects, essentially by evaluating the intrinsic cash flow generating ability of these projects.

IPF.1 – Credit Appraisal

A thorough credit appraisal of an IPF shall be carried out in order to identify and mitigate the project risks, and to ascertain that the project will function as per plans. Assessment of the technical, financial, and economic viability of the project shall also be carried out to determine adequacy of the project cash flows. Furthermore, banks/DFIs shall thoroughly review and assess the validity of assumptions on which cash flow projections have been made to repay project debt and meet its obligations under the Financing Agreement(s)

[898] www.sbp.org.pk/publications/prudential/PRs-IPF.pdf

IPF.1.1 -- Analysis of Financial Model(s)

Banks/DFIs shall comprehensively evaluate the financial model(s), prepared inhouse or provided by financial advisor/Project Company, at the time of due diligence to create project forecasts and conduct scenarios & sensitivity analysis. Banks/DFIs shall use this model(s) after financial close to update for changes in various assumptions so as to look for early warning signals with respect to any overruns that may be expected in the project cost.

IPF.1.2 -- Requisite Expertise for Appraisal

Banks/DFIs which are involved in IPF, shall develop the requisite expertise (human resources, IT system etc.) to conduct a thorough appraisal of the proposed project in consultation with the technical, legal, insurance, financial and environment advisors (as the case may be).

IPF.1.3 -- Minimum Information Requirements

Banks/DFIs, shall obtain and evaluate detailed due diligence of the proposed project which may include reports from financial, technical, legal, insurance and environment advisors. The financial feasibility, if required, may be endorsed by an auditing firm on the approved panel of SBP. The banks/DFIs shall get the technical feasibility report independently reviewed by their technical advisor, which can be an engineering firm of repute registered with concerned authority in Pakistan or internationally. Moreover, banks/DFIs shall also obtain minimum information to their satisfaction regarding the proposed Infrastructure Project in accordance with Annex-A (IPF: Checklist for Minimum Information Requirements). Banks/DFIs should get the project documents, as specified in section 6 of Annexure A, vetted by a legal counsel or syndicate legal counsel.

IPF.1.4 -- Assessment of Infrastructure Projects

Infrastructure Projects usually go through development, construction, start-up, and operation stages. Banks/DFIs shall, therefore, assess these stages separately for risk mitigation purposes.

While some of the Regulations in this regard are given as under; however, banks/DFIs may put in place additional safeguard measures as per their own IPF.

1.4.1 Development Phase

The funding needs during this phase should be met primarily through capital from the sponsor(s). However, at the stage of financial closure, the Financing Agreement(s) should have a clause where Project Company/borrower is covered that lenders will perform as per Financing Agreement(s) as long as all covenants are being met by the Project Company/borrower.

IPF.1.4.2 Construction and Start-up Phase

Banks/DFIs shall adequately safeguard their interests from major risks arising from, but not limited to, construction delays, cost overruns, technical design flaws, changes in government regulations etc and stress upon the provision of risk assessment and allocation matrix/report. Banks/DFIs shall also hedge identified and potential risks by opting for fixed price (where applicable), date certain construction contracts (including turnkey contracts), and built-in provisions for liquidated damages if the contractor fails to perform, along with obtaining insurance cover for certain areas of the project or any other measure necessary to mitigate the following risks:

A. RESPONSIBILITY OF ASSUMING COMPLETION RISK:

Banks/DFIs shall properly assess and negotiate risks arising during the completion phase of the project with the sponsors. All such risks shall be the responsibility of the project company, its sponsors, contractors, suppliers, and insurers (as the case may be).

B. PHYSICAL AND FINANCIAL COMPLETION OF INFRASTRUCTURE PROJECTS:

To protect against the risk of physical and financial non-completion of the Infrastructure Project, banks/DFIs are advised to closely observe following issues for risk mitigation:

(i) Project Funds Agreement (PFA): To ensure that unexpected costs do not jeopardise the project's completion, creditors and sponsors may have a commitment for standby financing as part of the initial financial package. This may be provided by sponsors through a contractual agreement, i.e., Project Funds Agreement (PFA), which is a standby subordinated loan or equity, wherein sponsors may either provide or arrange the requisite funds.

(ii) Financial Completion Agreement (FCA): It is pertinent to emphasize that a new project may reach physical completion but may not become self-sustaining for a number of reasons, such as supply problems, weak market demand or other adverse changes in micro or macroeconomic conditions. If financial completion is not achieved, profitability will suffer, and the project is likely to encounter debt servicing difficulties. Project documentations, therefore, may include a Financial Completion Agreement (FCA), which specifies, in contract form, the initial financial projections of the project against which creditors and investors are willing to invest funds. Under FCA, the sponsors typically commit to provide subordinated loans or additional equity to the project until the agreed financial performance is achieved. By requiring sponsors to ensure project financial completion, lenders greatly reduce the default risk of the project. The lenders may, at their own discretion, require the sponsors to arrange suitable insurance cover, if available, for covering such risk.

(iii) Exposure without Financial Closure: No bank/DFI should take any exposure until satisfying themselves that financial close has been achieved. iv. Insurance: To ensure fulfilment of obligations by the sponsors, their obligations under PFA/FCA may be backed-up by a letter of credit, bond or guarantee from a creditworthy third party. However, for mitigating force majeure that cannot be contractually allocated, banks/DFIs are advised to call for purchase of insurance cover, wherever possible, by the sponsors, so as to mitigate both direct and indirect types of force majeure.

Anti-Money Laundering, Combating the Financing of Terrorism & Countering Proliferation Financing Regulations[899]

The State Bank of Pakistan (SBP) has issued the Anti-Money Laundering, Combating the Financing of Terrorism & Countering Proliferation Financing (AML/ CFT / CPF) Regulations

[899] www.sbp.org.pk/bprd/2022/CL33-Annex-B.pdf

for SBP's Regulated Entities (REs) under powers conferred to it under Section 6A (2) of the Anti-Money Laundering Act, 2010. Accordingly, any violation of the aforesaid AML/ CFT/ CPF Regulations shall attract penal as well as administrative actions under the applicable laws/rules/regulations, including the AML/ CFT Sanctions Rules, 2020. SBP REs shall appropriately comply with the requirements stipulated in these Regulations considering their size, nature of business and complexities of operations; through proper documentation of the scope and applicability of requirements envisaged in these Regulations.
Regulations contain 15 regulations covering the Risk Based Approach to AML/ CFT, Customer Due Diligence (CDD), Targeted Financial Sanctions under UNSC Act, 1948 and ATA, 1997, Counter Measures For High-Risk Jurisdictions and Regulation and Supervision.

6.4 The State Bank of Pakistan & Its Role in developing Sound Banking system

The State Bank of Pakistan "The State Bank" is the principal regulator of the banking and financial system in Pakistan. It has been tasked to ensure the adoption of a sound and robust approach to meet the standards required to maintain the public trust in the banks. The regulation policy framework of the State Bank is based on the objective approach, and it fully appreciates the fact that a sound and stable banking system has a direct bearing on economic growth and development of the country. Being the Central Bank of the country, the State Bank of Pakistan has been entrusted with the responsibility to formulate and conduct monetary and credit policy in a manner consistent with the Government's targets for growth and inflation and the recommendations of the Monetary and Fiscal Policies Coordination Board with respect to macroeconomic policy objectives. The basic objective underlying its functions is two-fold (a) the maintenance of monetary stability, thereby leading towards the stability in the domestic prices; and (b) the promotion of economic growth.

We have seen in the second chapter that one of the main roles which a central bank plays in the banking practice is that of ensuring banking stability and maintaining a monetary policy. In the wake of the banking crises which managed to ignite very serious debates on the appropriateness and the powers of the central banks to effectively supervise commercial banks, the key concern for many legislators was to enact various legislative tools to allow better supervision by the central banks. To the public, the major role of this institution is to regulate

the commercial banking sector, any failure of these banks is usually associated with bad supervision as one of the reasons.[900]

Under The State Bank of Pakistan Order 1948, the Bank was charged with the duty to regulate the issue of Bank notes and keeping of reserves with a view to securing monetary stability in Pakistan and generally to operate the currency and credit system of the country to its advantage. The scope of Bank's operations had been widened considerably by including the economic growth objective in its statute under The State Bank of Pakistan Act 1956. The Bank's participation in the development process has been in the form of rehabilitation of banking system in Pakistan, development of new Banking institutions and debt instruments to promote banking intermediation, establishment of Development Banking Institutions (DFIs), directing the use of credit according to selected development priorities, providing subsidised credit, and development of the capital market.

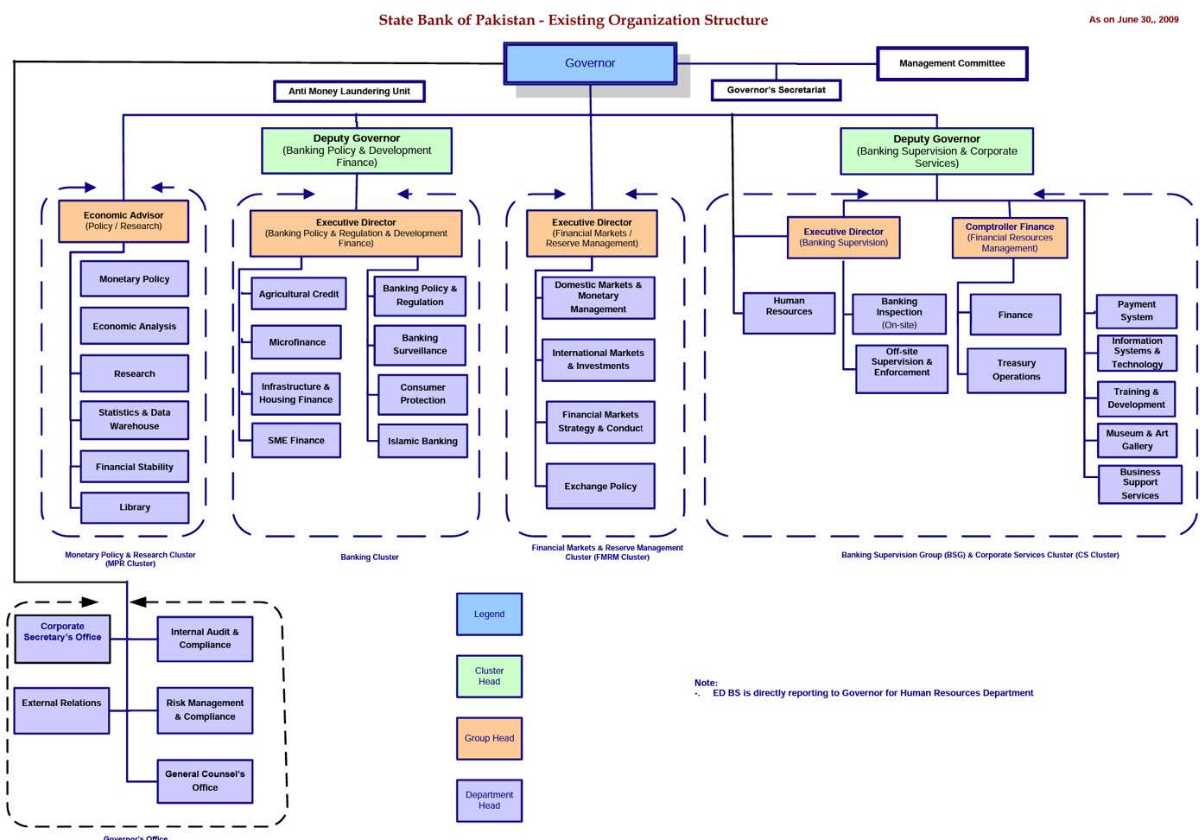
As discussed earlier, the scope of the Bank's operations was considerably widened in The State Bank of Pakistan Act 1956, which required the Bank to "regulate the monetary and credit system of Pakistan and to foster its growth in the best national interest with a view to securing monetary stability and fuller utilisation of the country's productive resources". Under Banking sector reforms, The State Bank of Pakistan was granted autonomy in February 1994. On 21st January 1997, this autonomy was further strengthened by issuing three Amendment Ordinances (which were approved by the Parliament in May 1997) amending the laws namely, The State Bank of Pakistan Act 1956, Banking Companies Ordinance 1962, and Banks Nationalisation Act 1974.

The changes in The State Bank Act gave full and exclusive authority to the State Bank to regulate the banking sector, to conduct an independent monetary policy and to set limits on government borrowings from the State Bank of Pakistan. The amendments to Banks Nationalisation Act abolished the Pakistan Banking Council and institutionalised the process of appointment by assigning the role of appointments of the Chief Executives and Boards of the nationalised commercial banks and development finance institutions to The State Bank.

[900] Schinasi Garry, Responsibility of Central Banks for Stability in Banking Markets International (2003) Monetary Fund IMF Working Paper 03/121 ISBN:9781451854404/1018-5941; Tommaso Padoa-Schioppa, 'The Transformation of the European Banking System' Central Banks and Banking Stability: Exploring the Land in Between (2003) 25 second ECB Central Banking Conference October 2002 269,310 ISBN 92-9181-348-6 ; Andrew Large, Banking Stability: Maintaining Confidence in a Complex World (2003)15 Bank of England Banking Stability Review FSR 170,174 ISSN 1365-7267

The amendments also increased the autonomy and accountability of the Chief Executives and the Boards of Directors of banks. Like Central Banks in developing countries, The State Bank of Pakistan performs both the traditional and developmental functions to achieve macroeconomic goals.

In order to have effective regulations mechanism as shown in the table,[901] The State Bank has set up a department named Banking Policy & Regulations Department which is required to achieve the regulatory objective by incorporating the needs for adaptation of the international best practices for banking industry. The Banking Policy & Regulations Department ensures a close liaison with the Banking Surveillance, Off-site Supervision & Enforcement, Banking Inspection, SME & Microfinance Departments. The department is assigned a role to create a regulatory environment that innovates and diversifies the banking sector in a way that does not affect the soundness and stability of the banking system. The department, in order to achieve its regulatory objectives, has developed a new set of Prudential Regulations (PRs) for various sectors such as Corporate, SMEs, and Consumer Financing in consultation with Pakistan Banks Association and other stakeholders.



[901] www.sbp.org.pk/reports/annual/arFY09/Vol2/Annexure-C-.pdf

The State Bank played a dynamic role in the implementation of Basel and acted as a monitor by providing required time, efforts, and policy. Banks in Pakistan will focus on the implementation process, implementation can be achieved if the process runs smoothly with proper planning and resources.[902] The State Bank set up a department with the name of Banking Policy & Regulations Department and other departments within the State Bank to achieve the regulatory objective by incorporating the needs for adaptation of the international best practices for banking industry.[903] The functions of these department is briefly discussed as:

6.4.1 Banking Regulation Division

This Division is responsible for continuous reviewing and proposing changes/amendments to the banking laws and Prudential Regulations for the development of an effective legal and regulatory framework to promote prudent, sound banking practices to ensure healthy financial sector in Pakistan. The division is also responsible for capacity building of the personnel of the department through arrangement of training courses, seminars, and conferences both at foreign and local levels. In addition, it also facilitates the implementation of Performance Management System in the Department.[904]

6.4.2 Licensing and Corporate Governance Division

This Division looks after the policy issues regarding licensing of new banks, branch licensing, authorization of booths, installation of Automated Teller Machine, evaluating schemes of amalgamation/merger of banks, financial Institutions, privatization of Public Sector Banks/financial Institutions, preparation, and management of various Schemes for addressing the problems of Non-Performing Loans and respond to any other issue regarding banking practices. This Division is also responsible for assessing the “Fit & Proper Test” for the President/Chief Executive and Board of Directors of the banks and Banking Institutions.[905]

6.4.3 Support and Liaising Division

[902] <http://www.pakistanbanks.org/events_highlights/interviews/basel_ii_impact_on_banking_industry.html> accessed January 2020
[903] Raza, Syed Salim. (2009). Current Crisis and the Future of Banking Regulation. Institute of Bankers Pakistan, Karachi, October 21
[904] https://ibp.org.pk/wp-content/uploads/2017/10/Introduction-to-Banking-Systems-Stage-1.pdf> accessed January 2020
[905] Ibid

The main responsibilities entrusted to this division are to have a close liaison with foreign central banks, International Banking Institution, and trade bodies on issues of bilateral and multilateral interests, deal with the cases of unclaimed deposits, liaising with National Accountability Bureau (NAB), to recommend names of loan defaulters on requests of banks/Banking Institutions for placement on Exit Control List (ECL) and respond to the queries of the government and legislative bodies. This Division is also handling the issue of introduction of Deposit Insurance Scheme (DIS) in the country. Other responsibilities of the Division include monitoring of funds flow of ADB funded Programmes of Technical Assistance for Banking Sector; and preparation, consolidation, and monitoring of the BPRD Annual Business Plan. The unit of internal audit is also working under this Division.[906]

6.4.4 Complaints Redressal & Services Division

This Division works to have the amicable settlement of various public grievances against the commercial banks and also performing the ex-officio functions of Deputy Custodian of the enemy property. Moreover, the function of the Division is to provide support services to BPRD in achieving its goals by providing logistic support in time and coordinating the administrative matters of the staff/officer in an efficient manner.[907]

6.4.5 Banking Surveillance Department

The Banking Surveillance Department was responsible for supervising banking institutions in the country. The department ensured effective adherence to the regulatory and supervisory policies which monitors risk profiles and evaluates operating performance of individual banking Institutions and the industry while issuing guidelines for managing various types of risks. It also ensured that banks are adequately capitalized and have policies and systems in place to assess various risks.

The department was also responsible for the implementation of the Basel II Accord in Pakistan. The function and activities of the Credit Information Bureau also falls within the domain of the Banking Surveillance Department. The Credit Information Bureau collect credit data, under

[906] World bank (2009). Overview, Banking Market Structure, Regulations, and Policies. Bringing Finance Pakistan. world bank.org. pp: 1-18
[907] World bank (2009) (n 906)

section 25A of the Banking Companies Ordinance 1962, maintain its database and disseminate credit information to Banking institutions online to facilitate their credit appraisal process. The main objectives/key result areas of the Department are; -

6.4.5.1 Main Objectives/Key Result Areas:

i. To ensure effective regulatory and supervisory oversight of Banking Institutions.
ii. To assess and review, periodically, performance and future outlook of the banking system.
iii. To monitor risk profiles of banks, to prescribe guidelines etc. requiring Banking Institutions to put in place adequate Risk Management Systems
iv. Developing detailed understanding of New Basel Capital Accord.
v. To ensure compliance with Basel Core Principles of Banking Supervision.
vi. To provide online collection & dissemination of credit related information to Banking institutions in order to facilitate their credit appraisal process.[908]

6.4.5.2 Departmental Structure:

The Department has been continuously improving its operations so that it remains effective in the face of changing practices of the banking system. To undertake the above stated variety of functions, the Department has been structured into different divisions. A brief description of each is given below: -

6.5 Risk Management & Analysis Division (RMD)

This Division is responsible for monitoring different risks faced/assumed by individual banking Institutions and prescribes policies/issues guidelines etc. for managing/mitigating these risks. It also monitors, inter alia, the capital adequacy of banks to ensure that the banks remain adequately capitalized. It also monitors operational risks and reviews of operational policies of commercial banks and lays down disclosure requirements and monitors compliance thereof.[909]

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[908] Baig, S.A. 1999. Banking System in Pakistan (Part – I). Finance and Markets. www.pakistaneconomist.com
[909] http://www.pide.org.pk/pdf/PDR/2002/Volume4/567-580.pdf accessed January 2020

6.6 Basel Accord & Core Principles Division (BA&CPD)

The primary objective of this Division was to implement the Basel Accord in the banking sector. This involved participating in capacity building of the banking industry to understand, adapt and implement the Basel Accord and then to also monitor compliance in this regard. The other objective was to ensure compliance with Basel Core Principles of Banking Supervision.

6.7 Banking Sector Assessment Studies Division (BSASD)

This Division was primarily responsible for reviewing and assessing, on a periodical basis, the banking system performance, and its future outlook. This Division also conducted various stress testing exercises to assess the resilience of the banking sector to various financial shocks.

6.8 Credit Information Bureau (CIB)

The Credit Information Bureau (CIB) was established in 1992. Functions and activities of CIB were being governed under Section 25(A) of Banking Companies Ordinance1962. Ever since its inception, the CIB in Pakistan has been playing a pivotal role in gathering, organizing, and disseminating critical information relating to creditworthiness of borrowers to assist financial institutions in their lending decisions and averting the occurrence of default. Financial institutions started submitting their borrowers' data of Rs. 0.5 million & above on quarterly basis. Subsequently the frequency of data submission was shifted from quarterly to monthly basis. In April 2003, the State Bank enhanced the coverage and effectiveness of CIB by introducing eCIB online facilities. CIB was the first bureau of the region introducing online facilities to its member financial institutions. This development enabled financial institutions to upload their data directly into the eCIB system and also generate online CIB reports.[910]

Upon the inception of Basel II, the State Bank issued circulars to all banks and Banking institutions that they would have to mandatorily adopt the guidelines and rules enshrined in the Basel II without further delay. The State Bank recommended that the responsibility of

[910] http://www.sbp.org.pk/ecib/about.htm

implementing Basel II may be assigned to the Head of Risk Management or Chief Credit Officer or Chief Banking Officer. The Banks were required to establish an adequate setup and report to the State Bank the name and other particulars of the coordinator for Basel II implementation as soon as possible but not later than 31st May 2005.[911]

6.5 The Role of International Bodies in Creating Sound Banking System Through Central Banks

The role of the Central Banks is supported by non-governmental organisations which have been instrumental to creating international standards in banking practices and corporate governance to manage the internal affairs of the banking institutions. The Basel Committee and the Organisation for Economic Co-operation and Development (OECD) have been instrumental in ensuring that there is an international standard present to govern the national banks which mushroomed as a result of deregulation and opening of the finance sector. The OECD has been in the frontline for setting the norms of corporate governance for the application to the banking institutions. The organisation started way back in 1999 in its quest for developing corporate governance guidelines. The organisation issued its first guidelines in the same year which contained standards to assist governments in their role of improving and evaluating the legal, regulatory, and institutional framework for corporate governance in their respective countries.[912]

These OECD Guidelines provided the standards and suggestions for investors, stock exchange, corporations and other parties which relate to the banking sector and the finance sector.[913] These corporate governance structures and standards have been instrumental in setting the new era of internal compliance systems and these standards proved crucial for banking institutions. These guidelines have served as a model for corporate governance for banking institutions on their own volition and even created a base for central banks and other national supervisors to create suitable corporate governance models which fit their specific banking sector.

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[911] John Hawkins and Philip Turner, 'International Banking Reform: Regulatory and Other Issues' (2000) Bank for International Settlements Washington Conference Paper <https://siteresources.worldbank.org/INTMACRO/Resources/HawkinsTurner.pdf> accessed January 2020

[912] Organisation for Economic Co-operation & Development, 'OECD Principles of Corporate Governance' (1999) <www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=C/MIN(99)6&docLanguage=En> accessed 10 January 2020

[913] ibid

OECD has also been instrumental in reminding the supervisors and the banking institutions on desirable principles which have to be present for proper stability of the banking system. The Organisation has been instrumental in doing research on banking supervision throughout various jurisdictions and proving that corporate governance standards play a crucial role in stabilising Banking institutions including banks.[914] The Organisation has insisted that for proper stability, supervisors have the duty to ensure that there is corporate governance in every banking institution, including individual institutions, their subsidiaries, and their branches. This strong interest of effective corporate governance is premised on supervisory experience in various jurisdictions which underscores that there is an indispensable necessity of putting in place an appropriate level of accountability coupled with competence in the management of the institutions within every bank. There has also been the emphasis of a governance banking system which allows collaboration between the various banking institutions and the banking supervisors and regulators; this works with the bank management working smoothly working with the supervisors in relation to market research, statutory compliance, and provision of information to the supervisor for an effective supervision.

The other body, the Basel Committee on Banking Supervision which has been discussed in chapter 4[915] of this thesis. Various reports and principles have been issued on corporate governance and banking activities[916] by Basel. These reports have been instrumental in setting forth the core techniques and strategies for sound corporate governance for banking sectors. These can be summed up as follows:

a. "Establishing strategic objectives and a set of corporate values that are communicated throughout the banking organisation;"[917]
b. "Setting and enforcing clear lines of responsibility and accountability throughout the organisation;"[918]
c. "Ensuring that board members are qualified for their positions, have a clear understanding of their role in corporate governance and are not subject to undue influence from management or outside concerns;"[919]

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[914] Organisation for Economic Co-operation & Development, 'Corporate Governance: A Survey of OECD Countries' (2004) OECD 12 < www.oecd.org/corporate/ca/corporategovernanceprinciples/21755678.pdf> accessed 10 January 2020. e
[915] Heading 4.5
[916] Basel Committee on Banking Supervision, 'Principles for the Management of Credit Risk'(2000) Consultative paper 30 November 1999 Basel < https://www.bis.org/publ/bcbs75.pdf> accessed 10 January 2020
[917] Basel Committee on Banking Supervision, 'Enhancing Corporate Governance for Banking Organisations' 5 (September 1999 <https://www.bis.org/publ/bcbs56.pdf> accessed 10 January 2020
[918] Basel Committee on Banking Supervision (n 916)
[919] Basel Committee on Banking Supervision (n 916) p 6

d. "Ensuring that there is appropriate oversight by senior management;"[920]
e. "Effectively utilising the work conducted by internal and external auditors, in recognition of the important control function they provide;"[921]
f. "Ensuring that compensation approaches are consistent with the bank's ethical values, objectives, strategy and control environment;"[922] and
g. "Conducting corporate governance in a transparent manner."[923]

These standards developed by the Basel Committee have been instrumental in recognising the role which the senior management play in corporate governance and in internal compliance by agreeing that the senior management in banks makes an important component of corporate governance and that the board of directors has the task of creating the much-needed balances and checks to the senior management in the banks.

Transparency is also another important governance tenet which the Committee has not only mastered but advocated relentlessly. The management of the banks and the board must be transparent in every way. The Committee has ensured that all members of the Basel Accord encourage their supervisors to ensure that constituent banking institutions have clear, transparent, and identifiable responsibility and communication lines which allow better business area and decision making.[924]

Basel II has also been instrumental in shaping the performance and working of numerous banks all over the world. Its adoption of the Capital Accord in 1988 as a legally but non-binding international accord among the leading central banks and national banking regulators and supervisors has been instrumental in setting the ground for the concept of minimum amount of capital requirements and adequacy for transnational banks and conglomerates.[925] The implications of the Accord are that banking supervisors have a framework that they can use to

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[920] Basel Committee on Banking Supervision (n 916) p.7
[921] Basel Committee on Banking Supervision (n 916) p.7
[922] Basel Committee on Banking Supervision (n 916) p.7
[923] Basel Committee on Banking Supervision (n 916) p.7
[924] David Cairns & Christopher Nobes, 'The Convergence Handbook: A Comparison Between International Accounting Standards and UK Banking Reporting Requirements 101' (ICAEW 2000). The International Journal of Accounting(2001)36(3) Pauline Weetman ELSEVIER 385,386 v+108< https://www.sciencedirect.com/science/article/abs/pii/S0020706301001133> accessed 10 January 2020.
[925] Ward Jonathan, 'The Supervisory Approach: A Critique' (2002) University of Cambridge WP 02 CFAP <https://www.repository.cam.ac.uk/handle/1810/225214> accessed 10 January 2020; Ward Jonathan, 'The New Basel Accord and Developing Countries: Problems and Alternatives'(2002)Working Paper 04 <https://g24.org/wp-content/uploads/2016/01/The-New-Basel-Accord-and-Developing-Countries-Problems-and-Alternatives.pdf> accessed 10 January 2010; George A Walker, International Banking Regulation Law, Policy & Practice (2001)19 discussing the Basel Capital Accord, Kluwer Law Intl SBN-13: 978-9041197948

have the discretion of approving a number of risk management activities and corporate governance practices for decision making and internal processes, as well as a system to ensure that the substantive requirements in terms of capital requirement, liquidity, and disclosure system for investors are in place. An example of how this Accord plays a crucial role in creating sound banking practices is contained under the first Pillar (Pillar One), whereby the senior management of the bank and the board have the duty of overseeing and making sure that there is approval of the estimation processes and capital ratings.[926]

Competence is required so that there can be sound banking, and this is engraved in Basel II. The fact that the banking management is expected to have a good and thorough grasp of the operation and design of banking and the underlying operation risks, markets, capital rating systems, and credit evaluation makes it hard for banks to employ unqualified personnel. The directors in the banking sector are also expected to have a fair knowledge of banking risks, capital adequacy, risk management and other related banking concepts.[927]

The risks can be averted as early as possible by the assistance of the application of Basel II. The members of the senior management are required by the Accord to supervise and oversee banking testing processes which have the effect of evaluating the compliance of the bank with capital adequacy provisions of the law, and by ensuring that the overall control environment in the bank is properly addressed. The duties are placed on the senior management to be able to justify any discrepancies and hence making the banking management more accountable. The Committee's[928] emphasis on the reporting process of banking institutions is well outlined by the Accord making it easy for central banks and other national supervisors to carry out their work and additionally ensuring that the internal ratings-based approach of a bank for its determination of adequacy of its capital is well detailed and justifiable.[929]

[926] Basel Committee on Banking Supervision, 'The New Basel Capital Accord'(2001) Consultative Document <www.bis.org/publ/bcbsca03.pdf> accessed 10 January 2020. Pillar One countries, looking at the relevant part, as follows: All material aspects of the rating and estimation processes must be approved by the bank's board of directors or a designated committee thereof and senior management. These parties must possess a general understanding of the bank's risk rating system and detailed comprehension of its associated management reports
[927] Basel Committee on Banking Supervision (n 926)
[928] Ward Jonathan, 'The Supervisory Approach: A Critique' (2002) University of Cambridge WP 02 CFAP <https://www.repository.cam.ac.uk/handle/1810/225214> accessed 10 January 2020; George A Walker, International Banking Regulation Law, Policy & Practice (2001)19 discussing the Basel Capital Accord, Kluwer Law Intl SBN-13: 978-9041197948
[929] Jonathan (n 928)

The Basel Committee recognises that the success of corporate governance primarily sticks with the senior management of a bank and the board of directors. This is a clear indication that a great effort from the supervisor should be directed to making sure that there is a proper structure of governance which allows transparency and functioning of these two bodies in a manner which best allows risk management, proper decision making. This understanding has been the core focus on corporate governance and supervisors have been ensuring that these bodies are well entrenched, and that the internal compliance mechanism is well propped.[930]

Since there are so many interplays between the law and practice, striking an optimal convergence could be very hard.[931] This revelation implies that compliance can be possible even without a bank adopting the industry set practices specifically as a bank could opt to adopt international standards in order to make sure that all branches in several jurisdictions have a uniform and systematic compliance model. The other ways in which the Committee has been trying to push is the enforcement of contracts, such as those of service providers; clarification of the roles which the boards, the management and the senior official of banks undertake; creating capacity for anti-corruption bodies and ensuring that the banking system is operated in a bribery and corruption free system; aligning the regulations and law and other supervisory measures with the interests of the shareholders, the creditors, the manager and the public at large; and ensuring that proper consultation is undertaken in banking issues.[932]

These standards have already been incorporated in many industrial Countries and have been internationally accepted as banks have always used these standards to judge their regulatory compliance and their corporate governance progress.[933] Since the OECD and the Basel Committee come up with global standards and guidelines, they have an application which is wide and can easily be modified to fit the shoes of either developing[934] or developed Countries.

[930] Working Group on Corporate Governance Basel Committee on Banking Supervision, 'Enhancing Corporate Governance for Banking Organisations' (February 2006) 161(10) Bank For International Settlements ISBN web: 92-9197-699-7
[931] Dima Jamali, Asem Saifuddin and Myriam Rabbath, 'Corporate Governance and Corporate Social Responsibility Synergies and Interrelationships' (2008)16(5) Corporate Governance: An International Review 443,459 DO - 10.1111/j.1467-8683.2008.00702.x
[932] Aslı Demirgüç-Kunt, , Enrica Detragiache and Thierry Tressel, Banking on the Principles: Compliance with Basel Core Principles and Bank Soundness' (2008): 17(4) Journal of Banking Intermediation 511,542 SBN/ISSN:9781451865028/1018-5941
[933] Epstein, Gerald A and Arjun Jayadev, The Rise of Rentier Incomes in OECD Countries: Balkanization, Central Bank Policy and Labor Solidarity (2005) Balkanization and the World Economy Elgar 46,74ISBN 978-1-84542-965-2
[934] Erik Berglöf and Ernst-Ludwig Von Thadden, The Changing Corporate Governance Paradigm: Implications for Transition and Developing Countries (Davidson Institute WP263, Ecole des HEC/DEEP 1999) ; Thankom G Arun and John DTurner, 'Corporate Governance of Banks in Developing Economies: Concepts and Issues' (2004)12 (3) Corporate Governance: An International Review 371,377<https://doi.org/10.1111/j.1467-8683.2004.00378.x> accessed 13 January 2020

It has been shown to be more flexible to apply to non-OECD Countries[935] and even in countries with Islamic banking[936] upon making relevant adjustments.[937]

6.6 The Prospect of operating sound Banking System in Pakistan: issues and evolution

Pakistan is a lower-middle-income country with a high degree of external vulnerability due to a periodic balance of payments crisis and a development model that prioritized attracting foreign investment. After the late 1980s, Pakistan's development model began changing wholescale from a 'developmentalist' state-led model based on import substitution industrialization, to a 'neoliberal' model based on 'Washington consensus' principles. While Pakistan is no longer a primarily agricultural economy, industrial growth has stagnated since the 80s, and the economy has become increasingly services based. Until the late 1980s,[938] Pakistan had a typically 'repressed' financial system, with a high degree of policy directed lending through public DFIs, a nationalized commercial banking system, and credit planning. Financial liberalization and deregulation began in 1988 under an IMF structural adjustment program.[939]

We have seen in second chapter, Pakistan's banking system consists of Scheduled Commercial Banks which includes nationalized, foreign, and private banks; and also, Non-Banking Banking Institutions (NBFIs) that are Development Finance Institutions (DFIs), Investment Banks, leasing companies, modarabas, and housing finance companies. However, Scheduled Banks and NBFIs (excluding modaraba and leasing companies) are both synchronised by the State Bank of Pakistan's Prudential Regulations, albeit through different wings, and are subjected to

[935] Fianna Jesover and Grant Kirkpatrick, 'The Revised OECD Principles of Corporate Governance and Their Relevance to Non-OECD Countries'(2005)13 (2) Corporate Governance: An International Review 127,136 <DOI: 10.1111/j.1467-8683.2005. 00412.x> accessed 13 January 2020

[936] Wafik Grais and Matteo Pellegrini, 'Corporate Governance in Institutions Offering Islamic Banking Services: Issues and Options' (2006) World Bank Policy Research WP 4052< http://documents.worldbank.org/curated/en/326011468329975762/pdf/wps4052.pdf> accessed 13 January 2020

[937] Abdussalam Mahmoud Abu-Tapanjeh, 'Corporate Governance from the Islamic Perspective: A Comparative Analysis with OECD Principles (2009)20(5) Critical Perspectives on accounting Elsevier 556,567 < https://ie.um.ac.ir/images/329/Articles/Others/Latin/26.pdf> accessed 13 January 2020

[938] Zaidi, S.A., 2015. Issues in Pakistan's Economy: A Political Economy Perspective. Oxford University Press, Oxford.

[939] Janjua, A., 2003. History of The State Bank of Pakistan (1977–88). The State Bank Printing Press, Karachi.

different regulatory requirements, set by The State Bank of Pakistan, such as capital and liquidity reserve requirements.[940]

Pakistani banking has observed radical changes, as discussed in the second chapter, over the period of 75 years since its independence in 1947. Initially, the banking sector suffered from a grave lack of capital and doubts owing to the worse situation of established political and socioeconomic conditions. The banking sector was suffering from the lack of trained human resources and professionals which resulted in poor quality of products and services. To find better results and to enhance the banking sector the State Bank of Pakistan was established as the central bank on July 1, 1948, to control the banking sector of the country. Some subsequent amendments were made to extend the control and functions of The State Bank of Pakistan through The State Bank of Pakistan Act 1956.[941]

6.6.1 Major Issues faced by the Banking System of Pakistan

In the 1950s and 60s, Pakistan was held up as the poster child for late development and state-led industrialization. Since the 1990s, Pakistan was among a set of developing countries that wholeheartedly implemented IFI sponsored liberalization reform, resulting in a dramatic transformation from a state-led 'developmentalist' model up until the 1970s, to a 'neoliberal' model based on Washington Consensus principles after the 2000s.[942]

In the early years of Pakistan's development, two banks were given a special mandate to address the long-term financing needs of specific clients of the private and public sectors. These were the Industrial Development Bank of Pakistan (IDBP), which was established to provide term finance to small industries, and the Pakistan Industrial Credit and Investment Corporation (PICIC) which extended term finance to medium and large industries. During the 1960s, while PICIC remained in the private sector and IDBP enjoyed relative managerial autonomy, they were well managed and became major sources of foreign exchange term financing for private industrial investment.[943]

[940] Ahmed, T., and N. Bebe. (2007). Role of Commercial Banks in the Economic Development of Pakistan. Proceedings of the Bangkok Conference 2007: Issues in Global Research in Business and Economics. December 27-29, 2007, Bangkok, Thailand

[941] Ahmed, T., and N. Bebe. (2007). Role of Commercial Banks in the Economic Development of Pakistan. Proceedings of the Bangkok Conference 2007: Issues in Global Research in Business and Economics. December 27-29, 2007, Bangkok, Thailand

[942] Jones E The Political Economy of Bank Regulation in Developing Countries: Risk and Reputation (2000) Oxford University Press 9780198841999 p.105

[943] Pakistan Banking Perspective 2021 - https://assets.kpmg › dam › kpmg › pdf › 2021/06

In the 1970s, nationalization led to serious problems and in the 1980s both institutions were faced with serious portfolio deficiencies coupled with institutional problems, including loss of experienced staff. The National Development Finance Corporation (NDFC) and Bankers' Equity Ltd. (BEL) were established in 1973 and 1980, respectively. NDFC was instituted as a bank for public sector enterprises while BEL was originally set up to promote Islamic instrument notably providing equity finance to private industry, underwriting equity issues, and arranging consortia finance participation from the NCBs In 1982, three joint venture companies, Pak-Kuwait Investment Company Ltd., Pak-Libya Holding Company, and Pak-Saudi Industrial and Agricultural Investment Company were established to provide loans and venture capital to industry. As PICIC, IDBP, and BEL weakened, and NDFC stagnated, their market shares were taken over by the joint-venture writing.[944]

In 1960-70s, during the nationalization period, the government took control of all banks by imposing several restrictions on banking activities with a major focus on the credit ceiling. These restrictions resulted in non-productive lending activities because of political interference rather than project viability. The problems of the financial sector originated in the nationalization of banking institutions, weakening of appropriate regulations, undue outside interference, and the erosion of an accountability mechanism. Government, which owned most of the banking sector, had allowed political interference to twist credit allocation and loan recovery decisions of the NCBs and DFIs. Together they had accounted for 90 percent of the bad loans of the entire system. Similarly, loan recovery by the NCB and DFI officers and staff has been thwarted by fear of politically motivated retribution. Banking regulation and supervision over the NCBs and DFIs was then shared by three agencies—the Ministry of Finance, the Pakistan Banking Council, and the State Bank; the State Bank's authority had been weakened by conflicts of interest and questionable incentives: the State Bank did not have the autonomy to exercise its supervisory powers over most of the banking sector, i.e., the NCBs and DFIs. Because of a conflict between the Banking Companies Ordinance and the Bank Nationalization Act (which set up the NCBs) the State Bank could not exercise its powers to discipline the NCBs through various enforcement measures, especially the removal of management or withdrawal of banking licenses.

[944] Pakistan Banking Perspective 2021 - https://assets.kpmg › dam › kpmg › pdf › 2021/06

Prior to the 1990s, regulatory functions were also shared between the Ministry of Finance, Pakistan Banking Council, the State Bank, and the Corporate Law Authority. The failure of governance that afflicts the NCBs and the State Bank was a reflection of the general weakness in governance across the various development sectors. There has been a disrespect for the law and the judiciary has been subjugated to political power. Harassment of the private sector was frequent through misuse application of the law. Even the accountability mechanism set in place was biased and lacked credibility. While the State Bank had been granted greater autonomy in the conduct of monetary policy through a legal enactment, in effect this autonomy had not been exercised. The main reason was that the overall balance of power was heavily tilted in favour of the Prime Minister. Parliament and the Cabinet were circumvented in policy making so that the Governor of the State Bank could hardly challenge the direction of the Prime Minister in any matter. This was visibly demonstrated during the foreign exchange crisis in the post-May 1998 period, when the State Bank circulars were issued but were contradicted by the Prime Minister.[945]

Political interference in banks' management decisions was publicly demonstrated when some private sector loan defaulters advertised in the press that they were willing to reschedule their outstanding loans on the same conditions as those provided to the Prime Minister's family businesses by some banks. This shows that different criteria were applied for evaluating loan decisions of the influential.[946] This was due to selective enforcement of recovery procedure against bona fide loan defaulters whereas deliberate default by a corrupt political elite were able to reschedule its loans due to misuse of political power whereas genuine businesses were being aggressively pursued without offering any terms. Therefore, legislative, and administrative support which was introduced to promote the speedy foreclosure of collaterals could not progress much for these reasons and other reasons including: First, press statements by government functionaries regarding decisions taken by the newly appointed professional managements with respect to downsizing cast doubt about the autonomy of banks in making decisions and delay and jeopardize the restructuring process. Second, by introducing a distorted incentive scheme to loan defaulters and then by extending the deadline to avail of the same, The State Bank had sent the wrong signal to the market about its commitment to recover loans.[947] The loan recovery process is also marked by perceptions among defaulters of unequal

[945] Pakistan Banking Perspective 2021 - https://assets.kpmg › dam › kpmg › pdf › 2021/06
[946] Khan, M., The Political Economy of Industrial Policy in Pakistan 1947–1971, SOAS, University of London, London, 1999
[947] Zaidi, A., Issues in Pakistan's Economy: A Political Economy Perspective, Oxford University Press, Karachi, 2015

treatment by the Government. Third, notwithstanding the above, the reforms overestimate the speed at which loans can be recovered. For instance, even if then total defaults of PRs120 billion were properly collateralized, and courts were able to give early verdicts in favour of liquidation, it is highly unlikely that such a large portfolio could be sold in such a depressed market, especially since these would be all cash transactions without bank credit support.[948]

The authority to appoint or remove NCB and DFI management was also vested with the Government, through the Ministry of Finance and the Pakistan Banking Council. It was also the Government, not the central bank, that had the authority to grant banking licenses and permission to open branches. The State Bank's supervisory capacity was itself weak. Moreover, there were major organizational and systemic problems that worked against The State Bank's efforts to modernize, including the legal risks for banks. Overstaffing and over branching were caused by political interference and by militant labour unions that resisted downsizing, making it difficult to attract bona fide investors.

Pakistan banking has become a prime example of credit institutions operating in a regulatory environment that allows them to misallocate credit and mismanage their balance sheets. An expansion of bank credit induced by capital inflows created further opportunities for banks to expose the financial system to a larger risk of financial loss. As a preventive measure, the authorities in Pakistan decided to collect foreign exchange reserves in The State Bank instead of the commercial banks, thus asking commercial banks to surrender foreign exchange to The State Bank. But The State Bank and the Government did not manage foreign exchange resources from potentially volatile sources in a manner that was prudent and responsible. By the end of May 1998, the short-term foreign exchange liabilities of the banking system were $11.2 billion against official gross reserves of $1.1 billion. Loan defaults of banks and DFIs reached a level of PRs121 billion at the end of December 1996 that was nearly 21 percent of total advances, and close to 5 percent of gross domestic product (GDP). Of the total amount of PRs102 billion owed to banks at the end of December 1996, PRs83 billion have been loaned to the NCBs and to four small State-owned specialized banks. The bulk of "stuck-up" loans has been used mostly for project financing to large-scale textile industries. The largest 250 defaulters accounted for about 70 percent of the total loan defaults.

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[948] Haque, N. Ul, 'Financial market reform in Pakistan', The Pakistan Development Review, vol. 36, no. 4 II, 1997

6.6.2 Banking Reforms

To overcome these problems, other banking sector reforms were initiated and implemented in the early 1990s. The government decided to privatize state-owned banks and liberate entry of new banks through these reforms. The State Bank further removed business restrictions in the banking sectors by changing the interest rate structures, eliminating concessional lending schemes and lifting the cap for project financing in 1997–98. These reforms not only asserted a positive influence on society by mobilizing the resources to productive sectors at competitive prices but also strengthened the performance of banks. The higher value of loan loss provisions in the state-owned banks also identified their inefficiency in loan disbursement and loan collection. The private domestic banks, as a result, experienced impressive growth during 1992–1997: their deposit-based market share increased from 5.6 to about 13 percent or by 132 percent, while their loan-based market share increased from 4 to 12 percent or by 200 percent.

The freezing of foreign exchange accounts, while the country's gross foreign exchange reserves were a little less than $600 million, at the time when foreign exchange liabilities of the banking system were $11.2 billion against official gross reserves of $1.1 billion, was the largest failure of the banking system in Pakistan's history, affecting accounts worth $11 billion (PRs533 billion), causing a loss to depositors of at least PKRs100 billion at the kerb exchange rate of PKRs55 per dollar. The loss could be more as the kerb rate inevitably rises. Significantly this was not a commercial bank failure, but a reflection of the lack of prudential management by the State Bank and the Government, which are the supervisors and regulators of prudential behaviour in the banking system. The affected depositors were ordinary citizens of Pakistan, whose $11 billion deposits financed a large portion of the country's current account deficit since 1991. This resulted in a loss of annual inflow of $2.5 billion into the Government's reserves at a time of uncertain official aid commitments and poor export prospects. It is also interesting to note that nearly $4 billion had mysteriously been withdrawn at the official rate of PRs46/$ just before freezing of accounts, and according to secondary data, it had left the country through the black market for foreign exchange. All these actions resulted in large-scale financial disintermediation and an inevitable financial crash as the freeze on foreign exchange accounts had cost Pakistan about $2.5 billion in annual inflows in the balance of payments. About $7 billion remained frozen in foreign currency

On the recommendation of the IMF, the State Bank was made the sole regulator of the banking system in 1991, given formal independence from the Ministry of Finance in 1994. Furthermore, a number of measures were taken to strengthen the regulatory capacity of the State Bank under the World Bank, FSAL, between 1997 and 1999.[949] On the recommendation of the IMF, in 1997, the Pakistan Banking Council was abolished in 1997, making The State Bank sole regulator of the banking system.[950]

Between 1947 and the late 1970s, the first six governors had domestic banking or civil service backgrounds, and the next five governors had only loose affiliation with the IFIs, for instance holding consultancy assignments, or attending training courses. The appointment of career IMF bureaucrat Muhammad Yaqub in 1993 reflected the clear shift towards outward orientation by the governments of the 1990s. The appointment of Ishrat Hussain in 1999 and then Shamshad Akhtar in 2006, who had previously made their careers in the World Bank and Asian Development Bank, respectively reflected the consolidation of the new financial sectors strategy. This was followed by the appointment of international investment bankers as governors from 2009 onwards In particular, by 1999, the institutional reforms that gave it sufficient independence regulatory power had been completed and coincided with the appointment of Ishrat Hussain who was an aggressive advocate for Basel I and II.[951]

Under Shamshad Akhtar, the drive for Basel II implementation was strengthened. Akhtar was a strong advocate for Basel II and described it as nothing short of a 'revolution' in risk management. According to an employee, of State Bank, who had worked closely with Akhtar, 'It was a political move—we felt that some people wanted to get banking licenses and we didn't want them to get it, and we thought it would be good if some of the smaller banks that were facing solvency and liquidity problems merged. They protested but we implemented it anyway".[952]

The thrust of the 1997/98 reform program was to improve the environment for, and ability of, bank owners, bank management, bank regulators, the markets, and the courts to provide better governance and regulation in order to promote efficient financial intermediation. The reform program focuses on:

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949 Janjua A 2004. History of The State Bank of Pakistan (1988–2003) The State Bank Printing Press, Karachi.
950 Janjua A 2004. History of The State Bank of Pakistan (1988–2003) The State Bank Printing Press, Karachi.
951 Munir, K., Naqvi, N., Pakistan's post-reforms banking sector Economic and Political 2015 Weekly 48, 7–8
952 http://www.dawn.com/news/210105

• speeding up the privatization of State-owned institutions, and assuring necessary restructuring and improved management;
• improving the legal and judicial process for enforcement of financial contracts;
• centralizing the regulatory authority in The State Bank;
• strengthening The State Bank's capabilities to perform
its enhanced responsibilities; and
• improving prudential regulations and the supervision of financial institutions.

A liberalized, privatized, and internationalized banking sector was seen as vital to this development strategy. As part of IFI conditionality and financial liberalization, the independence and regulatory power of the Pakistani central bank, The State Bank was greatly strengthened. At the same time, internationally oriented politicians began to appoint former IFI bureaucrats to key posts at The State Bank, generating strong peer incentives for officials to international standards. By 2000 The State Bank took over from the IFIs in becoming the main actor driving through Basel I and then II adoption. Initially this was done against the wishes of the domestic banks, which viewed the adoption of international standards as a heavy burden but were not politically powerful enough to oppose The State Bank, either because they were still in the process of privatization or were loss-making because of the financial crisis of the 1990s.

That Government had also injected fresh equity to strengthen the capital base of the nationalized commercial banks. For the poor, who don't have anything to mortgage, the government established microfinance banks where no collateral is required.[953] They could get up to Rs. 20-25 thousand in micro loans. Many people have availed this opportunity, some bought a cow, some bought a milch buffalo or opened a small shop and female borrowers bought sewing machines. They have started income-generating activities and recovery is no problem from the micro-finance banks. Approximately, 125,000 poor people have been given loans in the first two years.[954] These loans were given to a person who could demonstrate that he had sufficient disposable income to repay the monthly instalments after taking care of his family needs. Before 1999 only 30 thousand cars were produced but in the last fiscal 100,000 cars were being produced. 70% of the parts and components for these cars are manufactured in

[953] Microfinance Institutions Ordinance, 2001 provide mechanism to regulate microfinance institutions to protect the depositors and customers and to safeguard these institutions against political and other outside interference
[954] https://www.bis.org/review/r050203e.pdf

Pakistan which was creating employment. Those who are producing the auto parts have made an investment of millions of rupees and generated new job opportunities.[955]

6.6.3 Effect of Reforms on Soundness of Banking System & adoption of International Standards

This resulted in remarkable improvements of the banking system. In the 'World Money-based Forum's Money related Development Report 2009, Pakistan has been positioned 49 out of 55 States. Under Factors, Policies and Institutions column, Pakistan positions 52nd in institutional, 50th in business surrounding conditions and 48th in related to managing money firms and steady nature/lasting nature/strength. In relation to managing money, Intermediation, Pakistan positions 46th in keeping money, 51st in non-saving money and 25th in relation to managing money markets. Under related to managing money, Pakistan positioned 50th[956].

During the 2000s banking regulation was delegated to the newly autonomous SBP, which carried the pace of financial reforms forward. As part and parcel of banking sector internationalization, Pakistan is one of the highest adopters and implementers of Basel I, II, and III and the Basel Core Principles (BCPs), but with different actors driving adoption over time. Starting from a domestically oriented model, over the course of the 1980s to 2000s, Pakistan's politicians were the initial drivers for convergence. Subsequently, regulators pushed for Basel adoption, and finally, once the banks' interests became aligned with those of politicians and regulators, all three major actors pushed for a concerted convergence on Basel standards.

By the 2000s, the post-liberalization Pakistani financial system was highly concentrated, consisting mainly of five large domestic commercial banks, MCB, UBL, HBL, ABL, and NBP, which together account for about 80 per cent of all profits in the banking sector, and 60 percent of bank deposits.[957] These five banks were internationally oriented: although domestic for regulatory purposes, they became partially foreign owned, with majority shareholdings of UBL and HBL being sold to foreign investors.

[955] ibid
[956] http://www3.weforum.org/docs/GCR2018/05FullReport/TheGlobalCompetitivenessReport2018.pdf
[957] https://doi.org/10.1017/S0026749X16000585

6.6.4 Adoption of Basel Accord in Pakistan Banking System

While Basel I and BCP adoption in Pakistan was a result of IMF and World Bank conditionality, over the course of the late 1980s and 2000s, Pakistani politicians, whether civilian or military, increasingly shifted away from prioritizing state-led industrial development, to embrace a more international orientation and championing financial services exports in particular. A liberalized, privatized, and internationalized banking sector was seen as vital to this development strategy, even though the specifics of Basel adoption fell under politicians' radar and were not as politically salient an issue as other reforms like bank privatization.[958] The adoption of international banking standards was seen as important for inter Nationalizing the banking sector, but regulators also made instrumental use of Basel standards to force bank consolidation.[959]

Pakistan was a relatively late adopter of Basel I, waiting nine years after it was agreed internationally to introduce it into domestic regulation. In 1997, all commercial banks, NBFIs, and foreign banks were instructed to adopt the system of risk-weighted capital in line with the Basel accord through BPRD Circular #36 of 4 November 1997.[960] After a significant delay following the BCBS's 1996 amendment to Basel I to include a capital charge for market risk, The State Bank amended the capital adequacy framework, in order to 'align the regulatory capital requirement with the internationally accepted standards and institute a true risk-based capital adequacy framework' in August 2004 (The State Bank of Pakistan, 2004).

In 2003 The State Bank issued a 'Handbook for Corporate Governance', which was modelled directly on the Core Principles, as these were considered 'international best practise' at the time. The new governance document provided guidelines for bank boards of directors, management, and auditors.[961]

Basel II adoption by Pakistan was extremely fast, showing The State Bank's enthusiasm for the new regulations. The State Bank issued a 'roadmap' for Basel II implementation in March

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Burki, A. and Niazi, S., 'The effects of privatisation, competition and regulation on banking efficiency in Pakistan, 1991–2000', CRC Conference on: Regulatory Impact Assessment: Strengthening Regulation Policy and Practice, University of Manchester, United Kingdom, 2003

959 Privatization, and Efficiency: Evidence from Pakistan. Journal of Banking & Finance, 29 (8-9), 2381–2406

960 www.sbp.org.pk/bsd/1997/MCR%20Circular%201997.pdf

961 https://www.sbp.org.pk/about/corp_gov/index.htm

2005 via BSD Circular No. 3 2005,[962] less than a year after the BCBS replaced Basel I with Basel II, followed by detailed instructions in June 2006 via BSD Circular #8 of 27 June 2006.[963]

Pakistan was ambitious in its adoption, going quickly for the most complex components, including Internal Rating Based (IRB) approaches. In addition, the components were introduced by The State Bank in a largely unmodified form, with the instruction document following the original Basel II documents almost word for word, even giving detailed instructions for the calculation of risk weights for financial instruments that barely existed in Pakistan, such as collateralized OTC derivatives. Basel II regulations in Pakistan were not modified for specialized banks, DFIs, or smaller banks.[964]

Basel III began to be adopted with a three-year delay from when the BCBS issued the new accord in 2010, and the initial set of instructions contained only requirements to implement the core capital, leverage ratio, and capital conservation buffer, as the SBP wanted some time to consult with all the relevant stakeholders about the relevance of elements such as the countercyclical capital buffer, LCR, NSFR, and domestic systemically important financial institutions (D-SIFI).

The State Bank took a more gradual approach compared to its speedy adoption of Basel II. However, this gradual approach was combined with the State Bank modifying certain elements of Basel III such as the CAR and capital conservation buffer to make them even stricter than the original requirements. Available assessments from IMF FSAPs and Article IV Consultations, World Bank reports, The State Bank self-assessments, and the US Department of State's Investment Climate Statements, between 1998 and 2017, suggest that although compliance lagged during the initial phases of Basel I and II implementation during the late 1990s and early 2000s because of capacity constraints, especially among small banks, since the mid-2000s compliance with implemented Basel II and III standards has been largely substantive. Pakistan is also judged by the IMF to have achieved a degree of compliance with most of the Core Principles.[965]

[962] https://www.sbp.org.pk/bsd/2005/C3.htm
[963] https://www.sbp.org.pk/bsd/2006/C8.htm
[964] Jones E The Political Economy of Bank Regulation in Developing Countries: Risk and Reputation (2000) Oxford University Press 9780198841999
[965] IMF, 2004 Pakistan: Financial System Stability Assessment (IMF Country Report No. 04/215)

Although the State Bank was less zealous about Basel III than it had been about Basel II, in order to compensate for Pakistan's FATF blacklisting, it not only went ahead with Basel III adoption, but modified certain elements to make them even more stringent than the original standard. Therefore, in Pakistan after 2007, incentives for convergence were salient for all three sets of major actors, which explains the high degree of adoption and implementation.

Basel adoption in Pakistan can broadly be divided into three distinct phases, the first being IFI led, the second central bank led, and third private bank led. While Basel I was first introduced to Pakistan as part of a wider regulatory overhaul under various World Bank programmes, the newly strengthened The State Bank soon took the reins and became an ardent advocate of Basel II. This was despite the fact that banks were initially reluctant because of the high regulatory cost of adoption. The financial crisis proved to be a turning point in The State Bank's attitude to international regulatory standards, with the perceived failure of Basel II in preventing the global financial crisis resulting in a much more cautious attitude to adoption. However, by this time, a new advocate for Basel II and then III had emerged i.e., the large internationalized domestic commercial banks that had initially been reluctant adopters of Basel standards.

During this first phase, the World Bank and IMF were the main players in driving through Basel I adoption as part of structural adjustment conditionalities. For example, full-time finance ministers were rarely appointed during this time, with civilian governments instead relying on advisors from the IMF and World Bank to ensure the implementation of conditionalities (Zaidi, 2015). One of the main 'project objectives' of the World Bank BSAL I, on which release of funds for the next BSAL was conditional, included revising capital adequacy rules to bring them in line with the Basel I minimum CAR of 8 per cent by 31 December 1997 (World Bank, 1998). The IMF programmes included a similar performance criterion to make prudential regulations on capital adequacy consistent with international norms.[966] In the years following, all of the nationalized commercial banks became compliant, with only four of the small banks remaining non-compliant by 2002, while noncompliant DFIs were gradually phased out. During the 2000s, although the IMF and World Bank remained important in influencing Pakistan's financial sector policies, the government, especially the newly independent central bank, took the reins of economic policymaking. Under Shaukat Aziz, a former international investment banker, who was appointed finance minister in 1999, and then prime minister in

[966] Wilf, M. Market forces or international institutions? The under-emphasized role of IFIs in domestic bank regulatory adoption.

2004, the international orientation of the financial sector was consolidated. Aziz's vision revolved around globalising the banking sector; both through attracting inward foreign investment and through outward internationalization of Pakistani banks. During this period banking regulation was delegated to the newly autonomous The State Bank, which had started taking a much more proactive role in designing financial sector policy as its regulatory powers had been expanded, and autonomy increased under IFI structural adjustment. Basel II adoption was given impetus by the appointment of two The State Bank's governors between 1999 and 2009, Ishrat Hussain and Shamshad Akhtar, who were ardent advocates of adopting Basel II, influenced by their IFI background.

When the Basel II regime replaced Basel I in 2004, the State Bank was already well connected to transnational regulatory networks and keeping abreast of current international developments and 'best practice'. According to an interview with a State Bank official responsible for Basel implementation, 'we have constantly been observing international developments. There has been an accepted notion in the State Bank that all international standards should be complied with until it is seen that there is some kind of negative'.[967] Following international regulators, Ishrat Hussain thought that Basel I had some 'inherent rigidities' that undermined its effectiveness, which were remedied by Basel II.[968]

Meanwhile, the domestic banks, although not opposed to Basel II in principle, were reluctant to adopt the new standards too quickly because of the heavy costs this would entail. A survey conducted by the State Bank in 2003 found that the majority of banks i.e., 49 per cent thought that Basel II should not be implemented until 2008, and that the Standardized Approach as opposed to the IRB would be sufficient.[969] The lack of necessary infrastructure including the required IT and software and prospective costs in attaining training from foreign consultants were inter alia reasons for such reluctance. The State Bank pushed ahead with Basel II adoption despite the banks' complaints: 'Ishrat's response to bank complaints was that if you cannot do this [implement Basel II] then you have no business running a bank and I will find a buyer for you'.[970] According to interviewees, whereas before the 2000s banks never faced penalties for non-compliance with the State Bank regulation, under Hussain these penalties were rigorously

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[967] Jones E The Political Economy of Bank Regulation in Developing Countries: Risk and Reputation (2000) Oxford University Press 9780198841999
[968] www.sbp.org.pk/about/speech/governors/dr.shamshad/2006/Demystifying-Basel-II-02-Nov-06.pdf
[969] https://www.sbp.org.pk/bsd/2005/C3.htm
[970] Jones E The Political Economy of Bank Regulation in Developing Countries: Risk and Reputation (2000) Oxford University Press 9780198841999

enforced. During this period, the domestic banks were still in the process of privatization or were loss-making because of the financial crisis of the 1990s, and so were not politically powerful enough to oppose the State Bank.[971]

The foreign banks also wanted domestic banks to implement Basel II both because they were engaged in correspondent banking relationships with the domestic banks, and they found Basel II compliance reassuring in this regard, but also because they did not want to be at a competitive disadvantage to domestic banks. Another important channel through which foreign banks aided Basel II implementation was through the transfer of personnel from early adopting foreign banks such as Citibank, American Express, and Bank of America to domestic banks. After The State Bank made Basel II compliance mandatory, many domestic banks poached foreign bank-trained personnel because of the lack of local expertise on Basel II, in order to rush ahead with compliance.

In addition, Pakistani banks wanted to continue to internationalize by attracting foreign investment and making alliances with foreign banks. The large banks believed compliance with the most advanced approaches would signal their relative sophistication to foreign investors and regulators and set them apart from both their domestic as well as regional rivals in order to improve their international standing: 'The State Bank pressure is equal across banks, but we are trying to go further in order to get recognition from our international partners. We take Basel as an opportunity to up our game'. Some banks also found compliance helpful when making international alliances with foreign banks. For example, one domestic bank made an alliance with a US bank, whereby the Pakistani bank issued the US banks' credit cards in Pakistan. According to the CEO of this bank, Basel II and III compliance helped them to get the deal, as the US bank had their own due diligence requirements for choosing foreign partners, and 'Basel compliance helps'. The banking industry implemented the framework of the new Basel II accord in December 2006. Basel II is important for the Pakistan banking system; Basel II was initiated by The State Bank Pakistan, according to the international banking system and it would facilitate relationships between Banking markets. The

[971] Jones E The Political Economy of Bank Regulation in Developing Countries: Risk and Reputation (2000) Oxford University Press 9780198841999

implementation of Basel II has been initiated by The State Bank of Pakistan that has provided sufficient time to all banks for the implementation of Basel II.[972]

On implementation of Basel II, some banks faced high cost of implementation and while certain banks found the Basel II implementation flexible due to competition in the banking sector some considered it costly although Development Finance Institutions and banks together provided supervision to Basel II measures. However, Basel II helped the maintaining of capital requirements for the small banks[973] by adopting an operational risk process that was based on the capital charge percentage of the banks of gross income.[974]

On 5th September 2008, The State Bank, in order to further strengthen the solvency of individual bank and Banking institutions, decided to raise the Minimum Capital Requirements as well as Capital Adequacy Ratio calculated as per Basel II, in the following way:

i. The minimum Paid up Capital requirements for all locally incorporated banks was raised to Rs. 23 billion (net of losses) to be achieved in a phased manner as shown below:

Minimum Paid up Capital (Net of losses)	Deadline by which to be increased
Rs 5 billion	31-12-2008
Rs 6 billion	31-12-2009
Rs 10 billion	31-12-2010
Rs 15 billion	31-12-2011
Rs 19 billion	31-12-2012
Rs 23 billion	31-12-2013

ii. Branches of foreign banks operating in Pakistan were also required to increase their assigned capital to Rs. 23 billion (net of losses) within the prescribed timelines. However,

972 Andrew Conford (June 2005)34 ‘The Global Implementation of Basel-II: Prospects and Outstanding Problems’ International Developments in Banking Regulations Discussion Paper, Banking Market Center < https://unctad.org/en/Docs/itcdtab35_en.pdf> accessed January 2020
973 Bank for International Settlements, ‘A New Capital Adequacy Framework, (2000) A Consultative Paper Basel June1999 https://www.bis.org/publ/bcbs50.pdf> accessed January 2020
974 Maximilian J.B Hall, ‘Basel-II: Panacea or Missed Opportunity?’ (2006)7 (1-2) Journal of Banking Regulation 106-132

those foreign banks, whose Head Offices held Paid up capital (free of losses) of at least equivalent to US$ 300 million and had Capital Adequacy Ratio of at least 8% or minimum prescribed by their home regulator, whichever is higher, were allowed with the prior approval of The State Bank to maintain the following MCR:

a) Foreign Banks, operating with up to 5 branches were required to raise their assigned capital to Rs. 3 billion latest by 31st December 2010.

b) Foreign Banks operating or plan to operate with 6 to 20 branches were required to raise their assigned capital to Rs. 6 billion by 31st December 2010.

The banks were given discretion to achieve the required the Minimum Capital Requirements as well as Capital Adequacy Ratio either by fresh capital injection or retention of profits.[975] The stock dividend declared after meeting all the legal and regulatory requirements and duly disclosed in the annual Audited Accounts was allowed to be counted towards the required paid up capital of the bank pending completion of the formalities for issuance of bonus shares.[976]

The new Basel II banking system implementation in Pakistan banks transactions required:

1. "Standardized Approach for credit risk and Basic Indicator / Standardized Approach for operational risk from 1st January 2008.
2. Internal Ratings Based Approach from 1st January 2010. (Banks interested in adopting Internal Ratings Based Approach for capital requirement against credit risk before 1st January 2010 may approach The State Bank for the purpose. Their request will be considered on a case-to-case basis).
3. To ensure smooth transition to Basel II there would be a parallel run of one and half year for Standardized Approach and two years for IRB Approach starting from 1st July 2006 and 1st January 2008 respectively".[977]

[975] Jaime Caruana, 'Implementation of Basel II" Banking Markets, Institutions, and Instruments' (2005)14(5) Bank for International Settlements (BIS)253,265
<https://doi.org/10.1111/j.0963-8008.2005.00107.x> a January 2020
[976] Francesco Cannata and Mario Quagliariello, 'The Role of Basel II in the Subprime Banking Crisis: Guilty or Not Guilty?' (2009) Centre for Applied Research in Finance Research Paper No. 3/09<
https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1330417> accessed January 2020
[977] Seema S Hai, SQ Minnhaj and Roohi Ahmed, 'Implementation of Basel II: Issues, Challenges, and Implications for Developing Countries' (2007) University of Karachi 1,12 <
http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.568.9361&rep=rep1&type=pdf> accessed January 2020

On 15th April 2009, the State Bank made adjustments to its above requirement and gave its view of the general global slowdown in growth and capital accumulation by Banking institutions and representations from shareholders, revised figured for the minimum Paid up Capital to be achieved within the following time frame:

S. No	Minimum Paid up Capital (free of losses)	Timeframe
1	6 billion Rupees	31.12.2009
2	7 billion Rupees	31.12.2010
3	8 billion Rupees	31.12.2011
4	9 billion Rupees	31.12.2012
5	10 billion Rupees	31.12.2013

On 15 August 2013, the State Bank informed all the banks and financial institutions as to its decision to implement the Basel III reforms, to be effective as from 31 December 2013, to further strengthen the capital related rules. The transitional arrangements in line with the international timelines were adopted to implementing the Basel III in phases with a target deadline of full implementation by 31 December 2019. The major changes under the Basel III reform package pertained to numerator of the Capital Adequacy Ratio i.e., eligible capital. The State Bank, on 5 November 2014, required the banks and financial Institutions to prepare their capital adequacy related disclosure on a given template to be used effective from the accounting year ending 31 December 2014. It was explained that the standard templates were designed to satisfy the Rules of "composition of capital disclosure requirements" to enhance the consistency and comparability of capital related disclosures made by banks.[978]

In 2012, the State Bank governor Yaseen Anwar expressed scepticism about the effectiveness of Basel III to the Islamic Financial Services Board in Istanbul and noted that the new complex international regulations were not well suited to the Pakistani financial system because they did not have a high degree of exposure to the complex financial products that were responsible for the 2008 crisis in the first place.[979] But due to the international market pressures inherent

[978] Basel III regulatory consistency assessment programme (April 2012) Basel Committee on Banking Supervision
[979] Anwar, Y. 2012 International regulatory initiatives to enhance global financial stability, 9th Islamic Financial Services Board Summit. Istanbul, Turkey

in an ‘outward oriented’ approach to the financial sector, the State Bank had to continue keeping up to date with Basel III adoption, and even over-comply with certain components.

The State Bank took a more gradual approach compared to its speedy adoption of Basel II. Basel III began to be adopted with a three-year delay from when the BCBS issued the new accord in 2010, and the initial set of instructions contained only requirements to implement the core capital, leverage ratio, and capital conservation buffer, as the State Bank wanted some time to consult with all the relevant stakeholders about the relevance of elements such as the countercyclical capital buffer, LCR, NSFR, and domestic systemically important financial institutions (D-SIFI). However, this gradual approach was combined with The State Bank modifying certain elements of Basel III such as the CAR and capital conservation buffer to make them even stricter than the original requirements

In a reversal from the previous phase of adoption, the main actors driving adoption of Basel II and later III now became the five large privatized domestic commercial banks. This was due to the market pressures inherent in a globalized and competitive financial environment. The large five banks wanted to maintain their historic network of foreign branches. In addition, Pakistani banks wanted to continue to internationalize by attracting foreign investment and making alliances with foreign banks (interviews with various domestic banks). The large banks believed compliance with the most advanced approaches would signal their relative sophistication to foreign investors and regulators and set them apart from both their domestic as well as regional rivals in order to improve their international standing.

In particular, the State Bank was worried about the negative stigma associated with Pakistani banks in the post 9/11 environment, as banks came under scrutiny for terrorism financing, but especially since Pakistan was blacklisted by the FATF between 2008 and 2010 and again from 2012 to 2014. The State Bank combined a gradual approach to Basel III adoption with over-compliance since keeping up to date with the latest international standards was seen as an important counterweight to the blacklisting. Frankly speaking, it is to demonstrate to the outside world that Pakistani banks are safe and sound because we have a lot of other challenges like the FATF’. It was also expected that it would not be much of a problem for most banks to meet the Basel III requirements, since The State Bank regulations had already been very stringent, and the capital adequacy ratio for the banking system was already at 14 per cent, commercial banks, pressure to implement Basel II and III also comes from the ADB, which

now provides much of its financing in Pakistan through private banks rather than through the government. Basel compliance affects the allocations private banks receive from the ADB, since before entering into an agreement the ADB evaluates domestic banks' risk management. If they feel risk management is weak, they will not enter into an agreement with that bank and being Basel compliant is an important way of allaying these fears. Pakistan moved from being a domestically oriented country during the pre-1980 era, to a 'policy-driven' pathway to Basel adoption due to the shift towards an internationally oriented development strategy by political elites between the late 1980s and early 2000s, in conjunction with IMF and World Bank structural adjustment programmes.

It is now a statutory responsibility of the State Bank to ensure the stability and soundness of the banking system. The banking supervision departments viz. Banking Policy and Regulations Department (BP&RD), Banking Surveillance Department (BSD), Off-Site Supervision and Enforcement Department (OSSED) and Banking Inspection Department (BID) have been assigned this important function to work jointly and severally to ensure the soundness of individual banks and of overall banking industry.[980]

Basel component	Adoption	Implementation
Basel I	BPRD Circular 36 of Nov 1997—Credit risk BSD Circular 12 of August 2004—Market risk	Credit risk—1998 Market risk—2004
Basel II	BSD Circular 3 of March 2005 (Roadmap document) and BSD Circular 8 of June 2006 (detailed instructions) (9/10 components)	Standardized approach—2008 Internal-ratings-based approach—2010
Basel III	BPRD Circular 6 of 2013 BPRD Circular 8 of 2016 (4/8 components)	CET-1, CCB, leverage ratio —2013–19 LCR and NSFR—2017–18

Source: Various SBP (State Bank of Pakistan) documents

6.7 If the Pakistan banking industry adequately and capably performs sui generis responsibility of protecting money of depositors and investors?

[980] http://www.sbp.org.pk/MFD/pbbc/Salim-Raza.pdf> accessed January 2020

In the above headings of this chapter in particular 6.6, it is explored and argued that Pakistan, having adopted Basel, is in a position, subject to resolution of issues discussed in Chapter 2[981] to operate a sound banking system. In chapter 4[982] it was explored that the Pakistan banking system has an effective mechanism of prudential regulation ensuring avoidance of risk in lending.

In the first chapter the Banking Entropy Theorem was discussed:[983] The inadequacy of the laws in fully regulating the industry cannot fully guarantee sound banking: banking regulations and their effectiveness tend to get weakened over time by (a) industry workarounds, (b) regulatory changes, and (c) legislative changes. The main exceptions come during and after banking crises, when public revulsion against banking excesses enables, perhaps even forces, a tightening of regulation.[984]

The justification for this entropy theorem is premised on the following ideas as outlined by Parker:[985] Firstly, its reason is that the monetary rewards for any successful producer in the banking sector are enormous, especially in the US and the UK. Secondly it is premised on the fact that due to the high potential payoffs in the industry, the banking industry tends to attract a country's top brainpower and most of the innovative talents in the country. Thus, people pursuing finance and banking careers tend to be smarter than the average person, making them more creative, less risk-averse and more avaricious and maybe even risk-loving. Third premise, banking regulation reduces; the potential or actual; profitability of a banking institution in one way or another, thus the need of finding ways through innovation to go around regulatory boundaries rewards very handsomely. This means that banking commerce is in the rarest of circumstances affected by bribery and, even though some regulations are tough, banking regulators have always favoured the perspective of a system that is highly regulated, even when everything is going on well or in good times. Another premise that is relied on by Parker is the

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[981] Particularly under heading 2.4
[982] Heading 4.4
[983] Alan S Blinder, 'Banking Entropy and the Optimality of Over-Regulation' (November 2014) 17th Annual International Banking Conference Working Paper 242, 40 <https://www.princeton.edu/ceps/workingpapers/242blinder.pdf> accessed 09 January 2020 Douglas D Evanoff, Andrew G Haldane and George G Kaufman, The New International Banking System: Analysing the Cumulative Impact of Regulatory Reform(48 World Scientific Publishing Company 2015) ISBN-13: 978-9814678322
[984] Blinder (n 983)
[985] Parker CB, 'The Banking Industry Needs More Effective Regulatory Rreforms, Says Stanford Expert' (November 3, 2014) Stanford Report < https://news.stanford.edu/news/2014/november/banking-regulation-admati-110314.html>accessed 08 January 2020.

fact that in politics there is the syndrome of "money talks" and as such financiers and bankers have a lot of money which they spend on lobbying both the executive and the legislative arms of government. The obvious result of this is that regulators will be more inclined in implementing regulations influenced by politics which may prejudice banking practices. Therefore, this brings out the second view which shows regulations can be applied in an unsustainable way, that of a "grabbing hand" implying that too powerful regulations and supervision will be positively related to corruption and conversely not to the improvement of banking stability and performance.[986]

It must be noted that regulations go hand in hand with regulators and supervisors and as such the effectiveness of any piece of regulation is essential in the quest for sound banking practices.[987] The theoretical basis for regulatory supervision is based on the idea that the private sector itself cannot effectively guarantee sound banking practices as the banking institutions are profit driven just like any businesses, and that if left unmonitored it will cause an element of sub-optimal stability and performance. Thus, it is revealed that a powerful supervisor backed by sound regulations would help ameliorate any market failure in such a system.[988] This view sees banking regulations and the governments' intervention as a "helping hand" in ensuring that their banks are not prone to be socially costly and contagious.[989] The downside as outlined herein is that too powerful supervision and excessive regulations lead to exertion of negative influence on the banking system negating sound practices. It has been noted that those governments with powerful supervisory bodies can easily use the influence and power of the bodies to favour some specific constituents, extract bribes and bring in campaigns to Countries.[990]

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[986]James Barth ,Gerard Caprio Jr and Ross Levine, 'Bank Regulation and Supervision: What Works Best?' (April 2004)13(2) NBER Working Paper 9323 205,248 <www.sciencedirect.com/science/article/pii/S1042957303000603> accessed 09 January 2020.

[987] Daesik Kim and Anthony M Santomero. Risk in Banking and Capital Regulation' The Journal of Finance' (December 1988) 43(5) XLIII, The Journal of Finance American Finance Association 1219,1233 < https://onlinelibrary.wiley.com/doi/abs/10.1111/j.1540-6261.1988.tb03966.x> accessed 09 January 2020.; Honohan Patrick and others, 'The Irish Banking Crisis: Regulatory and Banking Stability Policy' (2010) Central Bank of Ireland MPRA Paper 24896, 1,184<https://core.ac.uk/download/pdf/6493912.pdf> accessed 09 January 2020.

[988] Charles Albert Eric Goodhart, 'The Changing Role of Central Banks' (2011) 18(2) Banking History Rev Banking Markets Group 35 <www.bis.org/events/conf100624/goodhartpaper.pdf> accessed 09 January 2020.

[989] James Barth ,Gerard Caprio Jr and Ross Levine, 'Bank Regulation and Supervision: What Works Best?' (April 2004)13(2) NBER Working Paper 9323 205,248 <www.sciencedirect.com/science/article/pii/S1042957303000603> accessed 09 January 2020.

[990] Marco Arnone and others, 'Central Bank Autonomy: Lessons From Global Trends' (June 2009) 56(2) International Monetary Fund Staff Papers IMF working paper WP/07/88 263,296 <www.researchgate.net/publication/46526574_Central_Bank_Autonomy_Lessons_From_Global_Trends> accessed 09 January 2020

It is also seen that the State Bank Act 1957 and Banking Companies Ordinance 1962 contained necessary and required protections for the setting and maintaining sound banking system. But these laws had no practical relevance because the appointments from the bank officers to the regulator's governors previous to the 1990s were appointed on political basis. Therefore, bank regulatory laws and banking laws in Pakistan had no value more than dry ink on the paper. The State Bank did not have the autonomy to exercise its supervisory powers over most of the banking sector, i.e., the NCBs and DFIs. Because of a conflict between the Banking Companies Ordinance and the Bank Nationalization Act, The State Bank could not exercise its powers to discipline the NCBs through various enforcement measures, especially the removal of management or withdrawal of banking licences. Only the Government, through the Ministry of Finance and the Pakistan Banking Council, had the authority to appoint or remove NCB and DFI management.

Banks in Pakistan had, in the past, been catering to the needs of the government's organizations, subsidizing the fiscal deficit, serving a few large corporations, and engaging in trade financing. There was no lending to small and medium enterprises, to the housing sector or to the agricultural sector, which created most of the growth and employment in Pakistan. Most important, the financial system suffered from political interference in lending decisions and also in the appointment of managers.[991]

The Pakistan banking system would not have had four times more employees than actual requirements and unnecessary branches with minimal performance in case these laws had been followed with letter and spirit by the successive governments who owned all the banks before 1992 when reforms started to be introduced in the Pakistan banking system resulting in privatisation of banks. Until the end of 1996, all the five large institutions to be sold were heavily overstaffed, while three NCBs, namely, National Bank of Pakistan, Habib Bank and United Bank had by far too many branches to achieve reasonable profitability. In the government's owned banks, the staff worked like typical government employees, coming to office at 9:00 a.m., checking files; having nothing important to do and leaving at 5.00 p.m. without doing much work. These banks suffered from a high bureaucratic approach, overstaffing, unprofitable branches, and poor customer service.[992] Administrative costs were high, reducing profits of depositors. Overstaffing and over branching were caused by political

[991] https://www.bis.org/review/r050203e.pdf
[992] https://www.bis.org/review/r050203e.pdf

interference and by militant labour unions that resisted downsizing, making it difficult to attract bona fide investors.[993]

Before privatization, the staff and branches of these institutions were rationalized through voluntary separation with the help of an attractive severance payment program. Through this program, 20,000 employees, or 25 percent of total staff, were laid off from the NCBs and DFIs. The cost of the severance payment program was about $350 million on an after-tax basis.[994] The Government injected Rs. 30.7 billion to offset the losses incurred by these nationalized commercial banks and recapitalize them. Professional bankers were appointed as Chief Executives and persons from the private sector enjoying a reputation of competence and integrity on the Board of Directors.[995] The banking sector as a whole experienced declining profitability, increasing inefficiencies, a weakening capital base, and a build-up of non performing asset stock of nonperforming loans (NPLs) grew from PRs25 billion in 1989 to PRs128 billion in June 1998, or 4 percent of gross domestic product (GDP), while total deposits grew only a little faster than inflation. Loan defaults of banks and DFIs reached a level of PRs121 billion at the end of December 1996 nearly 21 percent of total advances, and close to 5 percent of gross domestic product (GDP). Of the total amount of PRs102 billion owed to banks at the end of December 1996, PRs83 billion have been loaned to the NCBs and to four small State-owned specialized banks. The bulk of "stuck-up" loans has been used mostly for project financing to large-scale textile industries. The largest 250 defaulters accounted for about 70 percent of the total loan defaults.[996] Several factors contributed to the disintermediation of deposits, including:

i. an increasing dollarization of the economy;
ii. growing direct borrowing by the Government through attractive tax-advantaged national savings schemes to help finance the deficit
iii. a low return on bank deposits due to high reserve requirements and the inefficiency of banks,

- especially the NCBs; and
- a lack of savers' confidence in the NCBs.[997]

In 2017, Pakistan's financial assets to GDP ratio was 74.7% out of which 55.3% was contributed by banks. The remainder is contributed by Central directorate of national saving

[993] https://assets.kpmg › dam › kpmg › pdf › 2021/06
[994] https://assets.kpmg › dam › kpmg › pdf › 2021/06
[995] https://www.bis.org/review/r050203e.pdf
[996] https://assets.kpmg › dam › kpmg › pdf › 2021/06
[997] https://assets.kpmg › dam › kpmg › pdf › 2021/06

(CDNS) 10.6%, Insurance companies 4%, Non-banking financial institutions 3.5%, Development financial institutions 0.7% and Microfinance banks 0.7%, Financial developments are also playing a vital role in the economic growth of Pakistan. Financial assets to GDP ratio in Pakistan remained 74.7% in 2017 out of which 55.3% is contributed by banks, so the performance of the banking sector in Pakistan cannot be overlooked. However, such contribution of banks does not come out of sudden; we have seen that the banking industry in Pakistan witnessed several developments and ongoing reforms since 1992 after three decades of managing banking system breaching the banking regulations every possible ways by restricting the regulator to comply with its regulatory obligations, breaching rules of corporate governance by making appointments on political basis and/or by nepotism and using the banking system as banking facility to funds the government and its department.

The government also promulgated The Foreign Currency Accounts (Protection) Ordinance 2001 to recreate the market trust and encourage customers to open and maintain a foreign currency account. This extra assurance was given due to an unthoughtful act of freezing the foreign currency accounts by the previous government. The Ordinance gives assurance whereby no person holding a foreign currency account shall be deprived of his right to hold or operate such an account or in any manner be restricted temporarily or permanently to lawfully sell, withdraw, remit, transfer, use as security or take out foreign currency there from within or outside Pakistan.[998]

The deposit insurance scheme, another initiative to protect depositors, is widely acknowledged as one of the key components of the financial stability regime. It provides a variety of benefits to the financial system including (i) contribute towards a stable financial system and protects financially unsophisticated depositors from the loss of their deposits, (ii) create a formal protection mechanism thus removing the uncertainty about how depositors will be treated in case of bank failures, and (iii) reducing the potential fiscal burden on the government. The State Bank Vision 2020 accordingly envisaged establishment of Deposit Protection Corporation (DPC) as a key milestone towards achieving the financial stability goal. The Deposit Protection Corporation Act was promulgated in August 2016 which has allowed for the establishment of Deposit Protection Corporation (DPC) as a wholly owned subsidiary of the State Bank. In terms of Section 12 of DPA, the State Bank has already appointed managing

[998] Section 3

director of DPC for the period of five years. The general superintendence, direction, and management of DPC shall vest in the board to be appointed by the federal government. The State Bank has approached the federal government for nomination of the directors on the DPC board. The membership of DPC is mandatory for all scheduled banks. The periodic premium payments to be made by the banks shall be the major source of funding for the DPC. The threshold of deposit coverage and rate of premium shall be determined by the DPC Board. The DPC will invest the premium received from the banks in secured investments (mainly government bonds) and will build up the resource/funds base for payment to the depositors in case of failure of a bank.[999]

DPC is a wholly owned subsidiary of the State Bank of Pakistan and established in wake of the DPC Act 2016.[1000] The corporation commenced its business with effect from June 01-2018. DPC plays a key role in promoting financial stability by sustaining confidence in the banking system. DPC collects premiums from member institutions as empowered by the DPC Act 2016 and manages the received funds separately for both Islamic and conventional premiums. DPC steps forwards in the unlikely event of bank failure as notified by the State Bank and compensate its depositors up to the amount[1001] as prescribed within 30 days after the notification after adopting the approved procedure of reimbursement.[1002]

The Pakistan banking industry, therefore prima facei, seemed to have necessary laws, regulations and regulatory mechanisms to provide required protection to investors and depositors.

6.8 If Pakistan has Sound Banking System, then why it fails in producing natural outcome of strengthening Financial Stability?

This question continued to remain very puzzling jigsaw throughout this research, while researching, collected material and conducting analysis and compiling the data into this thesis. The following findings are supported by numerous documents that are referred in this thesis:

[999] www.sbp.org.pk/reports/annual/arFY17/Vol-1/Chapter-3.pdf
[1000] www.sbp.org.pk/l_frame/Act-2016-DPC-NationalAssemblySec.pdf
[1001] Currently it is Rs. 500,000
[1002] https://www.dpc.org.pk/About.asp

1. The Pakistan has a sound banking system which has proven its strength during economic crisis of recent history as discussed in second chapter. The banking system conversely shown progressed during 2007-2009 global banking crisis and adequately coped with the pressure during worldwide lockdowns due to Pandemic 2019-2020.
2. Pakistan banking system has implemented Basel Accord, prudential supervision, and corporate governance mainly due to obligations imposed by IMF and other bodies.
3. Pakistan has advanced banking laws to regulate banking, which is evident from the 'World Money-based Forum's Money related Development Report 2009: Pakistan had been positioned 49 out of 55 States. Under Factors, Policies and Institutions column, Pakistan positioned 52nd in institutional, 50th in business surrounding conditions and 48th in related to managing money firms and steady nature/lasting nature/strength. In relation to managing money, Intermediation, Pakistan positioned 46th in keeping money, 51st in non-saving money, 25th in relation to managing money markets and 50th in relation to managing money.[1003]

The interviews of banking professionals at management position, in-house banking lawyers, lawyers, and some officials of central bank were conducted in order to explore the answer to the question if there is sound banking system; if yes, why there is no financial stability despite presence of claimed sound banking system in Pakistan. All these personals have declined to give consent to quote them, and their answers are reproduced on anonymity basis:

1. The central bank continues to maintain that there is no issues with banking system or its soundness and system is protected by sufficient adequacy of regulatory mechanism and regulations which would continue to maintain the soundness of banking.
2. The senior officials of banks echo the voice of the central bank's officials with complaints that the regulations are stricter then required for the Pakistan's banking system and banks feel like suffocated sometimes.
3. The lawyers on both sides however agreed that the laws and regulations are not strictly implemented and there is huge back log of cases in banking courts even though the procedure is designed to conclude any proceedings without delay.

[1003] http://www3.weforum.org/docs/GCR2018/05FullReport/TheGlobalCompetitivenessReport2018.pdf

The third point warranted further investigations particularly in the light of the challenges, discussed in the chapter two,[1004] including NPLs, political instability, legal infrastructure, and corruption. It is discussed in second chapter that Pakistan's judicial history is full of ups and downs. In 1949 Federal Court of Pakistan was established and Mian Abdul Rashid was appointed to be succeeded by the controversial period of Justice Muhammad Munir who introduced the "theory of necessity" to validate the dissolution of constituent Assembly in 1954.[1005]

It is further discussed the Suo Moto actions by judges of apex Courts has added unnecessary and controversial case load in the court's diary. Whereas no effort was made by the same judges to resolve huge caseload pending for years and some for decades in the courts including banking courts.[1006] This is despite fully knowing that the judiciary works under heavy workload due to the bulging population and surge in litigation.

The financing needs stem from a current account deficit is around $10 billion and principal repayments on external debt of around $24 billion.[1007] Pakistan needed to add an extra cushion of $4 billion over the next 12 months.[1008] In order to meet this enormous demand Pakistan government keeps on knocking at the doors of IMF and other countries asking for help and loans whereas considerable amount of money is blocked by the legal infrastructure i.e., courts, legislation, code of conduct and regulations. The first two chapters contain extensive discussions on nature of bank customer relationship, role of banks in economy by lending depositors' money to entrepreneurs and consequentially contributing towards GDP growth and containing inflation by keeping it to minimum.

Money loses its value to the inflation over the times which clearly means one thing that the banks lose considerable money while attempting to recover it through nonending court process despite the banking laws dictate the claim to be concluded without allowing the opportunity to defend[1009]and no adjournment is allowed. The purposes of setting up banking courts and promulgation of a special law, the Banking Companies (Recovery of Loans) Ordinance of 1978 was transferring cases out the jurisdiction of ordinary civil courts and providing special

[1004] Heading 2.4
[1005] Federation of Pakistan Vs Molvi Tamizuddin Khan PLD 1955 FC 240
[1006] https://www.nation.com.pk/08-Feb-2016/10-000-cases-pending-with-banking-courts
[1007] www.sbp.org.pk/press/2022/Pr-31-Jul-2022.pdf
[1008] From July 2022
[1009] Leave of court is required to defend a recovery claim.

procedure for speedy recovery of bank loans through special forum. Under this special procedure a borrower was required to file an application "PLA" for leave to defend to obtain leave of the Court first to defend the suit. A PLA contains a summary of the substantial questions of law as well as fact in respect of which, in the opinion of the defendant, evidence needs to be recorded. Financial Institutions (recovery of finances) Ordinance 2001 demands Banking Courts (for recovery of loan/finances) to decide matters within 90 days period, but the courts are unable to do it.

Section 13 (3)[1010] states the courts will not adjourn any case for more than seven days. "But the courts give adjournments for months purely due to the burden of pending cases," said Sahabzada Muzaffar Ali, ex-legal consultant NAB and former legal head of Bank of Punjab. "Section 11 of the same law empowers the banking courts to pass an interim judgment on a recovery suit to the distance of claim which is admitted by defendants and the case can go for execution after expiry of 30 days.

The banking courts in Punjab had yet to decide over 10,000 cases[1011] pending for last many years for the reasons including unavailability of staffers especially stenographers, absence of technological support and unsupportive attitude of lawyers of majority parties were causing delay in dispensation of justice in adequate workers, low salaries, proper infrastructure and discouraging delaying tactics of lawyers, unnecessary adjournments, lawyers' strikes, low strength of judges against the rising burden of working were the other factors of such case pendency of in the banking courts of Punjab.

The above findings naturally lead to further enquiries into legal infrastructure and it was interestingly found that the regulations were lawyer was not independent of the political bodies. The members of regulators are elected for fixed terms and there is no limitation in seeking re-election. This simply mean that regulator is dependent upon the members it is meant to regulate to be elected and re-elected for the post. In addition to regulatory body the lawyers have Local Bar Association that elects it representatives on annual basis. There is no limit on election expenditure and independent sources from within lawyers' groups confirmed that costs of

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[1010] Financial Institutions (recovery of finances) Ordinance 2001

[1011] https://www.nation.com.pk/08-Feb-2016/10-000-cases-pending-with-banking-courts

conducting election (expense on giving lavish dinners and canvassing) is between PKR10 Million and PKR 50 Million. There was no contradiction in response that the elected members earn between PKR 100 million and PKR 500 million during the year they hold their elected position.

It was shocking to learn that judges, at any level, are not able to decline an application, petition, claim, or appeal is it is filed by any of elected members of bar association. There had been a number of reported cases of a judge being threatened in case he tries to conduct his office in accordance of rule of law and by refusing unjust rule of man. Local bar association does not hesitate to call for a strike for the alleged reason of misconduct by a judge. Such alleged misconduct would normally be refusal of an application by a judge on merits. It is therefore clear that implementation of banking regulations and banking laws is possible as far as a matter has not reached a court. Once a claim for recovery or any other claim is in the court then the outcome is more dependent on the position of respective lawyers involved in the case then merits.

If this heading 6.8 is discussed in conjunction with heading 2.4.6 then it becomes less puzzling to find an answer why sound banking system of Pakistan does not produce financial stability. There is no assurance if a matter shall reach its conclusion within foreseeable time; further f outcome of a matter is more likely to be based on position of respective lawyers and parties' socio-political status than rule of law. Corruption, bribery, and political influence are additional factors in jeopardising a matter.

It is therefore recommended that regulations and current regulatory system and regulations of lawyers are to be given serious thoughts and reformation are to be introduced in Pakistan before the collapse of whole legal infrastructure and other organs of State.

6.9 CONCLUSIONS

The banking sector in Pakistan should be considered to be a highly regulated sector; a vast part of the 180 million population of Pakistan remains unacquainted to the formal monetary framework especially in semi provincial areas. The relevant sections of 29 different banking laws, laws regulating the affairs of central bank and existing banking regulations created by

code of conduct[1012] by regulators were reproduced and analysed in this chapter. This clearly demonstrates that the law has to be analysed in relation to the uncertainties which can be caused to the monetary transmission system. If the law or banking regulation do not ensure the banking stability or will most likely cause an instability in the banking market, then the law has to be amended or aligned before it is passed

On the recommendation of the IMF, The State Bank was made the sole regulator of the banking system in 1991, given formal independence from the Ministry of Finance in 1994. Furthermore, a number of measures were taken to strengthen the regulatory capacity of the State Bank under the World Bank, FSAL, between 1997 and 1999.[1013] On the recommendation of the IMF, in 1997, the Pakistan Banking Council was abolished in 1997, making The State Bank sole regulator of the banking system.[1014]

Between 1947 and the late 1970s, the first six governors had domestic banking or civil service backgrounds, and the next five governors had only loose affiliation with the IFIs, for instance holding consultancy assignments, or attending training courses. The appointment of career IMF bureaucrat Muhammad Yaqub in 1993 reflected the clear shift towards outward orientation by the governments of the 1990s. The appointment of Ishrat Hussain in 1999 and then Shamshad Akhtar in 2006, who had previously made their careers in the World Bank and Asian Development Bank, respectively reflected the consolidation of the new financial sectors strategy. This was followed by the appointment of international investment bankers as governors from 2009 onwards In particular, by 1999, the institutional reforms that gave it sufficient independence regulatory power had been completed and coincided with the appointment of Ishrat Hussain who was an aggressive advocate for Basel I and II.[1015]

An enormous untapped market is accessible for budgetary administrations. Due to these difficulties, Pakistan's management of the accounts industry has been experiencing hazards since 2009. Despite the troublesome working environment, the banks' numbers demonstrate that the saving money part in Pakistan has been performing admirably. It may be observed that current global efforts in this regard seem to converge towards a narrow topic that the relaxed regulations on baking ought to be tightened through the making of stringent domestic

[1012] By way of issuing circulars to banks by State Bank of Pakistan
[1013] Janjua A 2004. History of The State Bank of Pakistan (1988–2003) The State Bank Printing Press, Karachi.
[1014] Janjua A 2004. History of The State Bank of Pakistan (1988–2003) The State Bank Printing Press, Karachi.
[1015] Munir, K., Naqvi, N., Pakistan’s post-reforms banking sector Economic and Political 2015 Weekly 48, 7–8

law. Based on this understanding, the remaining part of this section would compare the Banking regulatory structures in three representative jurisdictions including the United States, the United Kingdom, and China.

The answer to the question if the Pakistan banking industry adequately and capably performing sui generis responsibility of protecting money of depositors and investors is affirmative at the time of writing this thesis. The credit to this positive response, however, goes to IMF and World Bank that obligated Pakistan governments to undertake banking reforms in 1990s and continued to add conditionality on Pakistan to not only adopt Basel Accord but also implement it.

This chapter explores the answer to question why sound banking system in Pakistan fails to produce financial stability in the country. It is concluded that the answer is in legal infrastructure of Pakistan. Although Pakistan has implemented corporate governance, Basel Accord and laws containing adequate protection mechanism for sound banking system. There are alarming concerns with the legal infrastructure which fails the efforts by made by both regulator and banks in maintaining sound banking system.

Conclusion of Thesis

The contribution of this thesis in existing research is that the poor legal infrastructure not only leads to political instability and corruption in a country, but it also restricts economic and financial stability albeit presence of sound banking system that is regulated by independent regulator in accordance with establish practices of corporate governance and prudential regulations. This thesis proposes that the regulations for a country's legal system are warranted to be as good as banking system in order to keep maintenance of sound banking and collect its benefits in the shape of financial stability.

Rule of law ensures application of the law and its implementation without discrimination. If the law is to be selectively applied and rules are to be enforced differently on a society then laws and regulations would not only become scandalous but also ineffective.

It is explored in this thesis that Pakistan continues to depend on borrowing in order to meet its expense and reduce budget deficits. Nevertheless, the legal infrastructure in Pakistan terribly failing its targeted achievements by legitimising corruption, political instability and allowing political and internal influence on courts in order to obtain desired results. If there courts in Pakistan were independent and rule of law was followed, then Pakistan could have better fiscal stability that would not require borrowings.

It is argued that banking industry is a very crucial industry in any economy. The banking institutions have a fundamental role to play in all modern economies of the world; these institutions may be very fragile without the application of sound banking practices in a banking system. Economic stability can always be shaken by unpredictable national, regional, or global banking crises that strike from time to time; law and legal institutions perform important roles to tackle the occurrence of such crises and rescue the economy of a country.

The relationship between economic policy and banking laws are monitored by central banks in consultation with Treasury (Department of Finance) which can submit monetary policies based on economic data to be used to determine the banking policies and regulations which are

adopted in a given sector.[1016] The legislative process is evidence of connection between banking laws and the existing economic realities. Any regulation is usually passed through the government ministry after consultation and following legislative process Bade reveals that the importance of economic policy to banking is seen in the relationship in which the banking sector can influence the economy and vice versa; this is a phenomenon which has been recognised by various governments which have always struggled to ensure that the two areas are well balanced.[1017]

Any major banking regulation is usually accompanied by broad stakeholder participation with various economic regulators such as competition authorities, capital markets regulators and ministries, with a view to creating a sound practice in the banking sector which is in line with and compatible with a country's monetary policy and financial policy. This shows that the banking system is highly related and connected to the larger financial market and hence the whole economy. This close connection and relationship acts in two ways in that inasmuch as the macro and micro economic policies can impact on the enacted laws, the laws also have the impact on affecting the elements of the economy such as available credit and liquidity.[1018] In consequence the banking laws should be enacted to comply with the underlying macro and micro economic policies. The role of economic policy is seen by the fact that the body in charge of Australia Federal Economic Policy, the Federal Treasury, has to work with the Reserve Bank in implementing economic policies and ensuring that the same is incorporated into the banking system. The fact that the central banks have the primary roles of maintaining financial stability, stabilizing inflation, and economic activity maintenance, means that the central bank's main functions include both micro stability within the banking sector and further the macroeconomic indicators. This means that the central banks will have to formulate any policies and regulations in a manner which allows for the smooth functioning of the banking sector and ensure that the two are not in direct conflict with the Banking stability.

The central bank plays a major role in creating and installing good practices in the banking sector in the provision of macroeconomic contexts for the reduction of poverty levels and economic development. The institutions also have a role in promoting currency stability and

[1016] Hasan Iftekhar, Paul Wachtel and Mingming Zhou, 'Institutional development, Banking deepening and economic growth: Evidence from China' (2009) Journal of Banking & Finance.
[1017] This Concept has been present in Belgium under Article 29 of the Organic law of the National Bank, 1939
[1018] De Nicolò Gianni, Giovanni Dell'Ariccia, Luc Laeven, and Fabian Valencia, 'Monetary policy and bank risk taking' (2010); Angelini Paolo, Stefano Neri and Fabio Panetta, 'Monetary and macroprudential policies' (2011).

low inflation. The element of sound commercial banking is also crucial as a role of central bank and as a regulator the central banks are mandated that there is risk free lending and efficient non-cash payment systems. The practice of the central bank has been to use proper tools to maintain price stability, market operations and interest rates at an optimal level, not too high to hurt the economy and not too low to eat into the profitability of the commercial banks. This practice is made possible by issuance of binding guidelines and regulations under the central bank legislation.

The State Bank of Pakistan "The State Bank" is the regulator of the banking system in Pakistan. The State Bank was constituted under The State Bank Act 1956. Section 3 of 1956 Act describes the purpose of the establishment of The State Bank as a bank established for the management of the currency from the Reserve Bank of India and carrying on the business of Central Banking. Its constitution, as originally laid down in The State Bank of Pakistan Order 1948, remained unchanged until 1 January 1974 when the bank was nationalised, and the scope of its functions was considerably expanded. The State Bank of Pakistan Act 1956 considerably widened the scope of its operations which required the Bank to "regulate the monetary and credit system of Pakistan and to foster its growth in the best national interest with a view to securing monetary stability and full utilisation of the country's productive resources. The basic objective underlying its functions are two-fold (a) the maintenance of monetary stability, thereby leading towards the stability in the domestic prices, and (b) the promotion of economic growth. One of the major responsibilities of The State Bank is the maintenance of external value of the currency. In this regard, the Bank is required, among other measures taken by it, to regulate foreign exchange reserves of the country in line with the stipulations of the Foreign Exchange Act 1947. As an agent to the Government, the Bank has been authorised to purchase and sell gold, silver or approved foreign exchange and transactions of Special Drawing Rights with the International Monetary Fund under sub-sections 13(a) and 13(f) of S. 17 of The State Bank of Pakistan Act, 1956. The State Bank's affairs are managed by the Board of Directors consists of a governor, secretary and Eight (8) directors[1019]. The Directors are appointed by the Federal Government on the basis of their qualifications in the fields of economics, finance, banking, and accountancy.[1020]

[1019] Sec. 9 The State Bank of Pakistan Act, 1956
[1020] Sec. 9 (2) (c) The State Bank of Pakistan Act, 1956

The responsibility of a Central Bank in a developing country goes well beyond the regulatory duties of managing the monetary policy in order to achieve the macroeconomic goals. Ever since its establishment, The State Bank of Pakistan, besides discharging its traditional functions of regulating money and credit, has also played an active developmental role to promote the realisation of macroeconomic goals. These macro prudential policies have an impact in every Banking sector like savings and commercial banks, insurance companies, finance companies and pension funds. In addition to that there is an implied and express (by legislations) mandate for the central banks, or any other regulatory or supervisory body to work with the Ministry in its functions hence ensuring that any input from the Ministry goes to the root of banking regulations, guidelines, and decrees.[1021]

The UK system is one of the most developed systems and many jurisdictions in the world may find this system worth following. Dynamic banking system in the country is created using corporate governance which is recognised as an essential factor to sound banking. The traditional model on corporate governance in the banking sector has primarily been fashioned to involve the banking supervisor making use of statutory stipulation to advance governance standards for banking institutions. These governance standards primarily touch on the interest of the depositors, the shareholders, creditors, and other stakeholders. This importance of these banking consideration in banking is ingrained in the Bank of England that has two specialized committees: The Banking Policy Committee and the Monetary Policy Committee which have an explicit mandate to coordinate between themselves.[1022]

Practice has proven that effective corporate governance is the basis for obtaining and maintaining public trust and confidence in the banking system, which is a key to the stable banking system and the running of the whole economy. The very important and relevant Board of Monetary and Fiscal Policies Coordination[1023] of the State Bank of Pakistan is headed by the Ministers who are usually unqualified or under qualified to give instrumental insight on the crucial elements necessary for the effective regulations, economic policies, and progression of the banking sector as a whole. The State Bank has set up a Banking Policy & Regulations Department to achieve the regulatory objective by incorporating the needs for adaptation of the

[1021] Ministry of Finance Norway, About the Norwegian Ministry of Finance (2017) <https://www.regjeringen.no/globalassets/upload/fin/brosjyre/2011/about_the_ministry_of_finance.pdf> accessed on 15 Aug. 17
[1022] Bank of England, Remit for Monetary Policy Committe (19 March 2014) <www.bankofengland.co.uk/monetarypolicy/Documents/pdf/chancellorletter140319.pdf> accessed on 15 Aug. 17
[1023] Sec. 9B The State Bank of Pakistan Act, 1956

best practices for the banking industry. Nevertheless, it is known that unsound Banking corporate governance will lead to bank failures, in turn will cause the potential impact on the Banking system and may have a broad impact on the macro-economy, causing huge public cost and serious consequences. Additionally, Pakistan has major issues of corruption that negate all the positive aspects and efforts employed to have effective supervision of banks. Officers are employed on the basis of political recommendations instead of merit-based appointments.

The banking system and banking regulations in Pakistan is a good example to demonstrate role of soft law and contribution of international bodies in reforming and strengthening the banking system of a country.

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