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COURSE HANDOUTS

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MANAGEMENT OF FINANCIAL INSTITUTIONS BNK-604
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Lecture # 1**Financial Environment & Role of Financial Institutions**

The economic transformation under way in the former centrally planned economies (FCPEs) was motivated in part by the recognition that central planning has failed to allocate financial and real resources efficiently. This paper addresses the question of what kind of financial system should replace central planning in allocating capital and maintaining effective corporate governance during the transformation period. Financial sector reform has, at times, been portrayed as a question of adopting either a bank-based or a (securities) market-based model. In the bank-based model, commercial banks, often licensed as universal banks, take the lead in financing enterprise restructuring and investment. Proponents of the market-based model argue that the structural problems in the banking sector cannot be overcome easily; so firms will have to look to equity and bond markets for sources of new capital. Equity and bond markets in the FCPEs are not sufficiently well developed to support significant issues of new securities or to provide a mechanism for corporate control. They lack adequate liquidity, regulatory oversight, information disclosure, and clearing and payment systems. The important role of banks in maintaining the payment system and in providing credit to market participants to support trading and settlement means that until banks are restructured and recapitalized, securities market development will be constrained.

Investment funds emerging from mass privatization schemes may create concentrations of equity ownership that would allow them to play an important role in corporate control and perhaps, too, in finding sources of investment capital. They are a relatively recent innovation, however, and it remains to be seen how active they will be in financing and managing privatized enterprises.

The authorities should first establish a healthy banking sector, because it is the banks that are the most promising source of working capital and corporate control. This does not mean that securities market development should be ignored, only that it should not be a priority use of scarce government resources at the present time.

Many observers recommend that banks be given the power to act as universal banks, combining lending with securities market operations and equity investment. The potential problems associated with such a model in the FCPEs during the transformation period outweigh any potential benefits. It is recommended, therefore, that commercial banking and investment banking activities be separated, at least until banks have demonstrated competence in their commercial lending operations.

Long Run Performance of Financial Institutions for Economic Growth:

The recent economic difficulties in Southeast Asian economies are often linked to the financial sector in these countries. The business and popular press around the world are replete with stories connecting the economic crisis with difficulties in the financial sectors in these economies. The connection between the troubled banking sector and the economic slowdown is especially stressed. Asian economies that have been less impacted by the economic crisis, for example Taiwan, are often characterized as having more stable financial institutions than their neighbors.

Yet this is not the first time “financial difficulties” have been linked with poor macroeconomic performance. Many today believe the Great Depression of the 1930s was made much more severe by problems in the banking sector specifically and financial markets inefficiencies in general. More recently the dramatic economic slowdown in the 1980s in the state of Texas in the United States are often linked to the banking and savings and loan

crisis that gripped the state at the same time. This raises the question, what is the link between financial institutions and the macroeconomic performance of an economy?

Economists hold dramatically different views regarding this question. From a much earlier time, Bagehot (1873), and Schumpeter (1911) argued that an efficient financial system greatly helped a nation's economy to grow. As Ross Levine has pointed out it was Schumpeter's contention that well-functioning banks spurred technological innovation by offering funding to entrepreneurs that have the best chances of successfully implementing innovative products and production processes.

More recent economists have more skeptical about the role of the financial sector in economic growth. Joan Robinson (1952) asserted that economic growth *creates* (emphasis added) demand for financial instruments and that where enterprise leads finance follows. Robert Lucas (1988) has also dismissed the finance-economic growth relationship stating that economists "badly over-stress" the role financial factors play in economic growth.

However in recent years thanks to the work of Ross Levine (1997, 1998), Robert King (King and Levine 1993a, 1993b, 1993c) and others (Pagano 1993), economists are again reexamining the role financial markets play in economic growth. On the theoretical side complex models have been developed to illustrate the many channels through which the development of financial markets affect and are affected by economic growth. These channels include the facilitation of trading hedging, diversifying, and pooling of risk; the efficient allocation of resources; the monitoring of managers and exerting corporate control; the mobilization of savings; and the facilitation of the exchange of goods and services.

On the empirical side a growing body of studies at the firm-level, industry-level, country-level and cross-country comparisons have demonstrated the strong link between the financial sector and economic growth. King and Levine's (1993a, 1993b, and 1993c) research has shown that level of financial depth (defined as the ratio of liquid assets to GDP) does in fact help to predict economic growth. Other work by Levine (1997, 1998) has shown that financial intermediary development does positively influence economic growth, these results are shown to be robust, that is the relationships still hold when other factors that are known to influence economic growth are held constant. In many ways the current research has opened as many new questions as it has attempted to answer. On the theoretical side, questions still exist on how and why do financial markets and institutions evolve? Why are financial markets at different levels of development in different markets?

This research has also raised a number of very interesting public policy questions. Such as: under what legal environment do financial institutions develop more rapidly? Financial regulation -- how are countries' financial systems regulated and supervised, how can these be quantified, and to what extent do the differences matter. What is role of regulation in encouraging financial market development? What impacts both positive and negative will the recent bailout of financial institutions and financial markets have on the long run development of financial markets?

I would like to turn our attention to one of these issues that I find most intriguing: why do financial markets develop at different rates in different economies? That is, why do financial institutions tend to cluster in high-income areas or economies and low-income areas seem to suffer from a lack of financial institutions? A related question is; do financial markets drive economic growth or does economic growth drive the creation of financial market and institutions?

FINANCIAL MARKETS & INSTITUTIONS:

In economics a **financial market** is a mechanism that allows people to easily buy and sell (trade) financial securities (such as stocks and bonds), commodities (such as precious metals or agricultural goods), and other fungible items of value at low transaction costs and at prices that reflect the efficient market hypothesis.

Financial markets have evolved significantly over several hundred years and are undergoing constant innovation to improve liquidity.

Both general markets, where many commodities are traded and specialized markets (where only one commodity is traded) exist. Markets work by placing many interested sellers in one "place", thus making them easier to find for prospective buyers. An economy which relies primarily on interactions between buyers and sellers to allocate resources is known as a market economy in contrast either to a command economy or to a non-market economy that is based, such as a gift economy.

In Finance, Financial markets facilitate:

- The raising of capital (in the capital markets);
- The transfer of risk (in the derivatives markets); and
- International trade (in the currency markets).

They are used to match those who *want* capital to those who *have* it.

Typically a borrower issues a receipt to the lender promising to pay back the capital. These receipts are *securities* which may be freely bought or sold. In return for lending money to the borrower, the lender will expect some compensation in the form of interest or dividends.

Definition

The term **financial markets** can be a cause of much confusion.

Financial markets could mean:

1. Organizations that facilitate the trade in financial products. I.e. ***Stock exchanges facilitate the trade in stocks, bonds and warrants.***
2. The coming together of buyers and sellers to trade financial products. I.e. ***stocks and shares are traded between buyers and sellers in a number of ways including: the use of stock exchanges; directly between buyers and sellers etc.***

In academia, students of finance will use both meanings but students of economics will only use the second meaning.

Financial markets can be domestic or they can be international.

Types of financial markets:

The financial markets can be divided into different subtypes:

- Capital markets which consist of:
 - Stock markets, which provide financing through the issuance of shares or common stock, and enable the subsequent trading thereof.

- Bond markets, which provide financing through the issuance of Bonds, and enable the subsequent trading thereof.
- Commodity markets, which facilitate the trading of commodities.
- Money markets, which provide short term debt financing and investment.
- Derivatives markets, which provide instruments for the management of financial risk.
 - Futures markets, which provide standardized forward contracts for trading products at some future date; see also forward market.
- Insurance markets, which facilitate the redistribution of various risks.
- Foreign exchange markets, which facilitate the trading of foreign exchange.

The capital markets consist of primary markets and secondary markets. Newly formed (issued) securities are bought or sold in primary markets. Secondary markets allow investors to sell securities that they hold or buy existing securities.

Raising Capital

To understand financial markets, let us look at what they are used for, i.e. what is their purpose?

Without financial markets, borrowers would have difficulty finding lenders themselves. Intermediaries such as banks help in this process. Banks take deposits from those who have money to save. They can then lend money from this pool of deposited money to those who seek to borrow. Banks popularly lend money in the form of loans and mortgages.

More complex transactions than a simple bank deposit require markets where lenders and their agents can meet borrowers and their agents, and where existing borrowing or lending commitments can be sold on to other parties. A good example of a financial market is a stock exchange. A company can raise money by selling shares to investors and its existing shares can be bought or sold.

The following table illustrates where financial markets fit in the relationship between lenders and borrowers:

Financial Environment			
Lenders	Financial Intermediaries	Financial Markets	Borrowers
Individuals Companies	Banks Insurance Pension Mutual Funds Companies Funds	Inter bank Stock Exchange Money Market Bond Market Foreign Exchange	Individuals Companies Central Government Municipalities Public Corporations

Lenders

Many **individuals** are not aware that they are lenders, but almost everybody does lend money in many ways. A person lends money when he or she:

- Puts money in a savings account at a bank;
- Contributes to a pension plan;
- Pays premiums to an insurance company;

- Invests in government bonds; or
- Invests in company shares.

Companies tend to be borrowers of capital. When companies have surplus cash that is not needed for a short period of time, they may seek to make money from their cash surplus by lending it via short term markets called money markets.

There are a few companies that have very strong cash flows. These companies tend to be lenders rather than borrowers. Such companies may decide to return cash to lenders (e.g. via a share buyback.) Alternatively, they may seek to make more money on their cash by lending it (e.g. investing in bonds and stocks.)

Borrowers

- **Individuals** borrow money via bankers' loans for short term needs or longer term mortgages to help finance a house purchase.
- **Companies** borrow money to aid short term or long term cash flows. They also borrow to fund modernization or future business expansion.
- **Governments** often find their spending requirements exceed their tax revenues. To make up this difference, they need to borrow. Governments also borrow on behalf of nationalized industries, municipalities, local authorities and other public sector bodies. In the UK, the total borrowing requirement is often referred to as the public sector borrowing requirement (PSBR). Governments borrow by issuing bonds. In the UK, the government also borrows from individuals by offering bank accounts and Premium Bonds. Government debt seems to be permanent. Indeed the debt seemingly expands rather than being paid off. One strategy used by governments to reduce the *value* of the debt is to influence *inflation*.
- **Municipalities and local authorities** may borrow in their own name as well as receiving funding from national governments. In the UK, this would cover an authority like Hampshire County Council.
- **Public Corporations** typically include nationalized industries. These may include the postal services, railway companies and utility companies.
- Many borrowers have difficulty raising money locally. They need to borrow internationally with the aid of Foreign exchange markets.

Derivative Products

During the 1980s and 1990s, a major growth sector in financial markets is the trade in so called **derivative products**, or **derivatives** for short.

In the financial markets, stock prices, bond prices, currency rates, interest rates and dividends go up and down, creating *risk*. Derivative products are financial products which are used to *control* risk or paradoxically *exploit* risk.

Currency markets

Seemingly, the most obvious buyers and sellers of foreign exchange are importers/exporters. While this may have been true in the distant past, whereby importers/exporters created the initial demand for currency markets, importers and exporters now represent only 1/32 of foreign exchange dealing, according to BIS.

Analysis of financial markets

Much effort has gone into the study of financial markets and how prices vary with time. Charles Dow, one of the founders of Dow Jones & Company and The Wall Street Journal, enunciated a set of ideas on the subject which are now called Dow Theory. This is the basis of the so-called technical analysis method of attempting to predict future changes. One of the tenets of "technical analysis" is that market trends give an indication of the future, at least in the short term. The claims of the technical analysts are disputed by many academics, who claim that the evidence points rather to the random walk hypothesis, which states that the next change is not, correlated to the last change.

The scale of changes in price over some unit of time is called the volatility. It was discovered by Benoît Mandelbrot that changes in prices do not follow a Gaussian distribution, but are rather modeled better by Levy stable distributions. The scale of change, or volatility, depends on the length of the time unit to a power a bit more than 1/2. Large changes up or down are more likely than what one would calculate using a Gaussian distribution with an estimated standard deviation.

Financial markets in popular culture

Only negative stories about financial markets tend to make the news. The general perception, for those not involved in the world of financial markets is of a place full of crooks and con artists. Big stories like the Enron scandal serve to enhance this view.

Stories that make the headlines involve the incompetent, the lucky and the downright skillful. The Barings scandal is a classic story of incompetence mixed with greed leading to dire consequences. Another story of note is that of Black Wednesday, when sterling came under attack from hedge fund speculators. This led to major problems for the United Kingdom and had a serious impact on its course in Europe. A commonly recurring event is the stock market bubble, whereby market prices rise to dizzying heights in a so called exaggerated bull market. This is not a new phenomenon; indeed the story of Tulip mania in the Netherlands in the 17th century illustrates an early recorded example.

Financial markets are merely tools. Like all tools they have both *beneficial* and *harmful* uses. Overall, financial markets are used by honest people. Otherwise, people would turn away from them *en masse*. As in other walks of life, the financial markets have their fair share of rogue elements.

FINANCIAL INSTITUTIONS

In financial economics, a financial institution acts as an agent that provides financial services for its clients. Financial institutions generally fall under financial regulation from a government authority.

Types of Financial Institutions

Common types of financial institutions include banks, Insurance Co, Leasing Co, Investment Co, and Mutual Funds.

Banks

A bank is a commercial or state institution that provides financial services, including issuing money in various forms, receiving deposits of money, lending money, and processing transactions and the creating of credit.

Central Bank

A central bank, reserve bank or monetary authority, is an entity responsible for the monetary policy of its country or of a group of member states, such as the European Central Bank (ECB) in the European Union, the Federal Reserve System in the United States of America, State Bank in Pakistan.

Its primary responsibility is to maintain the stability of the national currency and money supply, but more active duties include controlling subsidized-loan interest rates, and acting as a "bailout" lender of last resort to the banking sector during times of financial crisis (private banks often being integral to the national financial system).

Commercial Bank

A commercial bank accepts deposits from customers and in turn makes loans, even in excess of the deposits; a process known as fractional-reserve banking. Some banks (called Banks of issue) issue banknotes as legal tender.

Investment Bank

Investment banks help companies and governments and their agencies to raise money by issuing and selling securities in the primary market. They assist public and private corporations in raising funds in the capital markets (both equity and debt), as well as in providing strategic advisory services for mergers, acquisitions and other types of financial transactions.

Saving Bank

A savings bank is a financial institution whose primary purpose is accepting savings deposits. It may also perform some other functions.

Micro Finance Bank

For the purpose of poverty reduction program, such kind of banks is working in the different countries with the contribution of UNO or World Bank.

In Pakistan 7 Micro Finance Banks are providing services under the SBP prudential regulation.

Islamic Bank

Islamic banking refers to a system of banking or banking activity that is consistent with Islamic law (*Sharia*) principles and guided by Islamic economics. In particular, Islamic law prohibits usury, the collection and payment of interest, also commonly called *riba* in Islamic discourse.

Specialized Banks

1. ZTBL

The Zarai Taraqati Bank Limited It is also known as Agricultural Development Bank of Pakistan (ADBP).

It is the premier financial institution geared towards the development of the agricultural sector through the provision of financial services and technical know-how.

2. IDBP

Industrial Development Bank of Pakistan is one of Pakistan's oldest developments financing institution created with the primary objective of extending term finance for investment in the manufacturing sector and SME Sector of the economy.

3. SME Bank

SME bank Ltd was established to exclusively cater to the needs of the SME sector. It was created to address the needs of this niche market with specialized financial products and services that will help stimulate SME development and pro poor growth in the country.

Non Banking Financial Companies

Non-bank financial companies (NBFCs) also known as a non-bank or a non-bank. Banks are financial institutions that provide banking services without meeting the legal definition of a bank, i.e. one that does not hold a banking license. Operations are, regardless of this, still exercised under bank regulation. However this depends on the jurisdiction, as in some jurisdictions, such as New Zealand, any company can do the business of banking, and there are not banking licenses issued. Non-bank institutions frequently acts as suppliers of loans and credit facilities, supporting investments in property, providing services relating to events within peoples lives such as funding private education, wealth management and retirement planning. However they are typically not allowed to take deposits from the general public and have to find other means of funding their operations such as issuing debt instruments. In India, most NBFCs raise capital through Chit Funds.

Investment Companies

Generally, an "investment company" is a company (corporation, business trust, partnership, or Limited Liability Company) that issues securities and is primarily engaged in the business of investing in securities.

An investment company invests the money it receives from investors on a collective basis, and each investor shares in the profits and losses in proportion to the investor's interest in the investment company.

The performance of the investment company will be based on (but it won't be identical to) the performance of the securities and other assets that the investment company owns.

Brokerage Houses

Stock brokers assist people in investing, online only companies are called 'discount brokerages', companies with a branch presence are called 'full service brokerages' or 'private client services'.

Leasing Companies

A lease or tenancy is the right to use or occupy personal property or real property given by a lessor to another person (usually called the lessee or tenant) for a fixed or indefinite period of time, whereby the lessee obtains exclusive possession of the property in return for paying the lessor a fixed or determinable consideration (payment).

Insurance Companies

Insurance companies may be classified as

1. **Life insurance companies**, which sell life insurance, annuities and pensions products.
2. **Non-life or general insurance companies**, which sell other types of insurance.

Mutual Funds

An investment, which is comprised, of a pool of funds collected from many investors for the purpose of investing in securities such as stocks, bonds, money market securities and similar assets. Mutual funds are operated by money managers, which invest the fund's capital and attempt to produce capital gains and income for the fund's investors. A mutual fund's portfolio is structured and maintained to match the investment objectives stated in its prospectus.

Financial Institution Functions

Financial institutions provide a service as intermediaries of the capital and debt markets. They are responsible for transferring funds from investors to companies, in need of those funds. The presence of financial institutions facilitates the flow of monies through the economy. To do so, savings accounts are pooled to mitigate the risk brought by individual account holders in order to provide funds for loans. Such is the primary means for depository institutions to develop revenue. Should the yield curve become inverse, firms in this arena will offer additional fee-generating services including securities underwriting, sales & trading, and prime brokerage.

CENTRAL BANK

A **central bank, reserve bank** or **monetary authority**, is an entity responsible for the monetary policy of its country or of a group of member states, such as the European Central Bank (ECB) in the European Union or the Federal Reserve System in the United States of America. Its primary responsibility is to maintain the stability of the national currency and money supply, but more active duties include controlling subsidized-loan interest rates, and acting as a "bailout" lender of last resort to the banking sector during times of financial crisis (private banks often being integral to the national financial system).

It may also have supervisory powers, to ensure that banks and other financial institutions do not behave recklessly or fraudulently. A central bank is usually headed by a governor, but the titles are president, chief executive, and managing director respectively for the European Central Bank the Hong Kong Monetary Authority and the Monetary Authority of Singapore.

In most countries the central bank is state owned and has a minimal degree of autonomy, which allows for the possibility of government intervening in monetary policy. An **"Independent central bank"** is one which operates under rules designed to prevent political interference; examples include the US Federal Reserve, the Bank of England (since 1997), and the Bank of Canada, the Reserve Bank of Australia, the Banco de la República de Colombia, and the European Central Bank.

Activities and responsibilities

Functions of a central bank (not all functions are carried out by all banks):

- Implementing the basis of monetary policy
- Monopoly on the issue of banknotes
- Controls the nation's entire money supply
- The Government's banker and the bankers' bank ("Lender of Last Resort")
- Manages the country's foreign exchange and gold reserves and the Government's stock register
- Regulation and supervision of the banking industry
- Setting the official interest rate - used to manage both inflation and the country's exchange rate - and ensuring that this rate takes effect via a variety of policy mechanisms.

Monetary Policy

Central banks implement a country's chosen monetary policy. At the most basic level, this involves establishing what form of currency the country may have, whether a fiat currency, gold-backed currency, currency board or a currency union. When a country has its own national currency, this involves the issue of some form of standardized currency, which is essentially a form of promissory note: a promise to exchange the note for "money" under certain circumstances. Historically, this was often a promise to exchange the money for precious metals in some fixed amount. Now, when many currencies are fiat money, the "promise to pay" consists of nothing more than a promise to pay the same sum in the same currency.

Many central banks are "banks" in the sense that they hold assets (foreign exchange, gold, and other financial assets) and liabilities. A central bank's primary liabilities are the currency outstanding, and these liabilities are backed by the assets the bank owns. Unusually, however, central banks in jurisdictions with fiat currencies may "create" new money to back its own liabilities, to theoretically unlimited amounts.

In many countries, the central bank may use another country's currency either directly (in a currency union), or indirectly, by using a currency board. In the latter case, local currency is directly backed by the central bank's holdings of a foreign currency in a fixed-ratio; this mechanism is used, notably, in Hong Kong and Estonia.

In countries with fiat money, monetary policy may be used as a shorthand form for the interest rate targets and other active measures undertaken by the monetary authority.

Central or National

There is no standard terminology for the name of a central bank, but many countries use the "Bank of Country" form (e.g., Bank of England, Bank of Canada, and Bank of Russia). Some are styled national banks, such as the National Bank of Ukraine. In other cases they may incorporate the word "Central" (e.g. European Central Bank, Central Bank of Ireland). In many countries, there may be private banks that incorporate the term national. Many countries have state-owned banks or other quasi-government entities that have entirely separate functions, such as financing imports and exports.

In some countries, particularly in some Communist countries, the term national bank may be used to indicate both the monetary authority and the leading banking entity, such as the USSR's Gosbank (state bank). In other countries, the term national bank may be used to indicate that the central bank's goals are broader than monetary stability, such as full employment, industrial development, or other goals.

Interest Rate Interventions

Typically a central bank controls certain types of short-term interest rates. These influence the stock- and bond markets as well as mortgage and other interest rates. The European Central Bank for example announces its interest rate at the meeting of its Governing Council (in the case of the Federal Reserve, the Board of Governors).

Both the Federal Reserve and the ECB are composed of one or more central bodies that are responsible for the main decisions about interest rates and the size and type of open market operations, and several branches to execute its policies. In the case of the Fed, they are the local Federal Reserve Banks, for the ECB they are the national central banks.

Interest rate interventions are the most common and are dealt with in more detail below.

Limits of Enforcement Power

Contrary to popular perception, central banks are not all-powerful and have limited powers to put their policies into effect. Most importantly, although the perception by the public may be that the "Central bank" controls some or all interest rates and currency rates, economic theory, (and substantial empirical evidence) shows that it is impossible to do both at once in an open economy. Robert Mundell's "Impossible Trinity" is the most famous formulation of these limited powers, and postulates that it is impossible to target monetary policy (broadly, interest rates), the exchange rate (through a fixed rate) and maintain free capital movement.

Since most Western economies are now considered "Open" with free capital movement, this essentially means that central banks may target interest rates or exchange rates with credibility, but not both at once.

Even when targeting interest rates, most central banks have limited ability to influence the rates actually paid by private individuals and companies.

Even the US must engage in buying and selling to meet its targets. In the most famous case of policy failure, George Soros arbitrated the pound sterling's relationship to the ECU and (after making \$2B himself and forcing the UK to spend over \$8B defending the pound) forced it to abandon its policy. Since then he has been a harsh critic of clumsy bank policies and argued that no one should be able to do what he in fact did.

The most complex relationships are those between the yen and the US dollar, and between the Euro and its neighbors. The situation in Cuba is so exceptional as to require the Cuban peso to be dealt with simply as an exception, since the US forbids direct trade with Cuba. US dollars were ubiquitous in Cuba's economy after its legalization in 1991, but were officially removed from circulation in 2004 and replaced by the Convertible peso.

Lecture # 4

POLICY INSTRUMENTS

The main monetary policy instruments available to central banks are open market operation, bank reserve requirement, interest-rate policy, re-lending and re-discount (including using the term repurchase market), and credit policy (often coordinated with trade policy). While capital adequacy is important, it is defined and regulated by the Bank for International Settlements, and central banks in practice generally do not apply stricter rules.

To enable open market operations, a central bank must hold foreign exchange reserves (usually in the form of government bonds) and official gold reserves. It will often have some influence over any official or mandated exchange rates: Some exchange rates are managed, some are market based (free float) and many are somewhere in between ("managed float" or "dirty float").

Interest Rates

By far the most visible and obvious power of many modern central banks is to influence market interest rates; contrary to popular belief, they rarely "set" rates to a fixed number. Although the mechanism differs from country to country, most use a similar mechanism based on a central bank's ability to create as much fiat money as required.

The mechanism to move the market towards a 'target rate' (whichever specific rate is used) is generally to lend money or borrow money in theoretically unlimited quantities, until the targeted market rate is sufficiently close to the target. Central banks may do so by lending money to and borrowing money from (taking deposits from) a limited number of qualified banks, or by purchasing and selling bonds. As an example of how this functions, the Bank of Canada sets a target overnight rate, and a band of plus or minus 0.25%. Qualified banks borrow from each other within this band, but never above or below, because the central bank will always lend to them at the top of the band, and take deposits at the bottom of the band; in principle, the capacity to borrow and lend at the extremes of the band are unlimited. Other central banks use similar mechanisms.

It is also notable that the target rates are generally short-term rates. The actual rate that borrowers and lenders receive on the market will depend on (perceived) credit risk, maturity and other factors. For example, a central bank might set a target rate for overnight lending of 4.5%, but rates for (equivalent risk) five-year bonds might be 5%, 4.75%, or, in cases of inverted yield curves, even below the short-term rate. Many central banks have one primary "headline" rate that is quoted as the "Central bank rate." In practice, they will have other tools and rates that are used, but only one that is rigorously targeted and enforced.

"The rate at which the central bank lends money can indeed be chosen at will by the central bank; this is the rate that makes the financial headlines." - **Henry C.K. Liu**, in an *Asia Times* article explaining modern **central bank function** in detail He explains further that "the US central-bank lending rate is known as the Fed funds rate. The Fed sets a target for the Fed funds rate, which its Open Market Committee tries to match by lending or borrowing in the money market.... a fiat money system set by command of the central bank. The Fed is the head of the central-bank snake because the US dollar is the key reserve currency for international trade. The global money market is a US dollar market. All other currencies markets revolve around the US dollar market." Accordingly the US situation isn't typical of central banks in general.

A typical central bank has several interest rates or monetary policy tools it can set to influence markets.

- **Marginal Lending Rate** (currently 5.00% in the Euro zone) a fixed rate for institutions to borrow money from the CB. (In the US this is called the Discount rate).
- **Main Refinancing Rate** (4.00% in the Euro zone) this is the publicly visible interest rate the central bank announces. It is also known as *Minimum Bid Rate* and serves as a bidding floor for refinancing loans. (In the US this is called the Federal funds rate).
- **Deposit Rate** (3.00% in the Euro zone) the rate parties receive for deposits at the CB.

These rates directly affect the rates in the money market, the market for short term loans.

Open Market Operations

Through open market operations, a central bank influences the money supply in an economy directly. Each time it buys securities, exchanging money for the security, it raises the money supply. Conversely, selling of securities lowers the money supply. Buying of securities thus amounts to printing new money while lowering supply of the specific security.

The main open market operations are:

- Temporary lending of money for collateral securities ("**Reverse Operations**" or "**repurchase operations**", otherwise known as the "**repo**" market). These operations are carried out on a regular basis, where fixed maturity loans (of 1 week and 1 month for the ECB) are auctioned off.
- Buying or selling securities ("**Direct Operations**") on ad-hoc basis.
- Foreign exchange operations such as forex swaps.

All of these interventions can also influence the foreign exchange market and thus the exchange rate. For example the People's Bank of China and the Bank of Japan have on occasion bought several hundred billions of U.S. Treasuries, presumably in order to stop the decline of the U.S. dollar versus the Renminbi and the Yen.

Capital Requirements

All banks are required to hold a certain percentage of their assets as capital, a rate which may be established by the central bank or the banking supervisor. For international banks, including the 55 member central banks of the Bank for International Settlements, the threshold is 8% (see the Basel Capital Accords) of risk-adjusted assets, whereby certain assets (such as government bonds) are considered to have lower risk and are either partially or fully excluded from total assets for the purposes of calculating capital adequacy. Partly due to concerns about asset inflation and term repurchase agreements, capital requirements may be considered more effective than deposit/reserve requirements in preventing indefinite lending: when at the threshold, a bank cannot extend another loan without acquiring further capital on its balance sheet.

Reserve requirements

Another significant power that central banks hold is the ability to establish reserve requirements for other banks. By requiring that a percentage of liabilities be held as cash or deposited with the central bank (or other agency), limits are set on the money supply.

In practice, many banks are required to hold a percentage of their deposits as reserves. Such legal reserve requirements were introduced in the nineteenth century to reduce the risk of banks overextending themselves and suffering from bank runs, as this could lead to knock-on effects on other banks. *See also money multiplier, Ponzi scheme.* As the early 20th century gold standard and late 20th century dollar hegemony evolved, and as banks proliferated and engaged in more complex transactions and were able to profit from dealings globally on a moment's notice, these practices became mandatory, if only to ensure that there was some limit on the ballooning of money supply. Such limits have become harder to enforce. The People's Bank of China retains (and uses) more powers over reserves because the Yuan that it manages is a non-convertible currency.

Even if reserves were not a legal requirement, prudence would ensure that banks would hold a certain percentage of their assets in the form of cash reserves. It is common to think of commercial banks as passive receivers of deposits from their customers and, for many purposes, this is still an accurate view.

This passive view of bank activity is misleading when it comes to considering what determines the nation's money supply and credit. Loan activity by banks plays a fundamental role in determining the money supply. The money deposited by commercial banks at the central bank is the real money in the banking system; other versions of what is commonly thought of as money are merely promises to pay real money. These promises to pay are circulatory multiples of real money. For general purposes, people perceive money as the amount shown in financial transactions or amount shown in their bank accounts. But bank accounts record both credit and debits that cancel each other. Only the remaining central-bank money after aggregate settlement.

Final Money - can take only one of two forms:

- physical cash, which is rarely used in wholesale financial markets,
- Central-bank money.

The currency component of the money supply is far smaller than the deposit component. Currency and bank reserves together make up the monetary base, called M1 and M2.

Exchange Requirements

To influence the money supply, some central banks may require that some or all foreign exchange receipts (generally from exports) be exchanged for the local currency. The rate that is used to purchase local currency may be market-based or arbitrarily set by the bank. This tool is generally used in countries with non-convertible currencies or partially-convertible currencies. The recipient of the local currency may be allowed to freely dispose of the funds, required to hold the funds with the central bank for some period of time, or allowed to use the funds subject to certain restrictions. In other cases, the ability to hold or use the foreign exchange may be otherwise limited.

In this method, money supply is increased by the central bank when the central bank purchases the foreign currency by issuing (selling) the local currency. The central bank may subsequently reduce the money supply by various means, including selling bonds or foreign exchange interventions.

Lecture # 5

BALANCE OF TRADE

- The **balance of trade** is the difference between the monetary value of exports and imports in an economy over a certain period of time.
- A positive balance of trade is known as a **trade surplus** and consists of exporting more than is imported;
- A negative balance of trade is known as a **trade deficit** or, informally, a trade gap.

Physical balance of trade

- Monetary balance of trade is different from physical balance of trade (which is expressed in amount of raw materials). Developed countries usually import a lot of primary raw materials from developing countries at low prices.
- Often, these materials are then converted into finished products, and a significant amount of value is added

Factors that can affect BOT

1. Exchange rates
2. Trade agreements or barriers
3. Other tax, tariff and trade measures
4. Business cycle at home or abroad.

Balance of Payment

- The **Balance of Payments** (or **BOP**) measures the payments that flow between any individual country and all other countries. It is used to summarize all international economic transactions for that country during a specific time period, usually a year.
- The BOP is determined by the country's exports and imports of goods, services, and financial capital, as well as financial transfers. It reflects all payments and liabilities to foreigners (debits) and all payments and obligations received from foreigners (credits).

Current Account

- The current account is the sum of net sales from trade in goods and services, net factor income (such as interest payments from abroad), and net unilateral transfers from abroad.
- Positive net sales to abroad correspond to a **current account surplus**; a negative net sale to abroad correspond to a **current account deficit**.

Capital account (or financial account)

- The financial account is the *net change in foreign ownership of domestic assets*. If foreign ownership of domestic assets has increased more quickly than domestic ownership of foreign assets in a given year, then the domestic country has a **financial account surplus**.
- The financial account is the *net change in foreign ownership of domestic assets*. If foreign ownership of domestic assets has increased more quickly than domestic ownership of foreign assets in a given year, then the domestic country has a **financial account surplus**.

- **Balance of Payments Equilibrium**

Is defined as a condition where the sum of debits and credits from the Current Account and the Financial Account equal zero;

$$\text{Current Account} + \text{Financial Account} = 0$$

Challenges of a Central Bank

1. **Economic Growth:** Economic growth is the increase in value of the goods and services produced by an economy. It is conventionally measured as the percent rate of increase in real gross domestic product, or *GDP*.
1. **Poverty Reduction:** In politics, the fight against poverty is usually regarded as a social goal and many governments have — secondarily at least — some dedicated institutions or departments.
2. **Unemployment:** Unemployment is the condition of willing workers lacking jobs or "gainful employment". In economics, **unemployment** statistics measure the condition and extent of joblessness within an economy.
5. **Inflation:** Inflation is the persistent rise in the general price level as measured against a standard level of purchasing power. There are many varying measures of inflation in use because different prices affect different people.
6. **Stability in Forex Rate:** Central banks play an important role in the foreign exchange markets. They try to control the money supply, inflation, interest rates and often have official or unofficial target rates for their currencies.

Public Policy and Financial Stability

- It seems useful at the outset to define financial stability and to do so by defining its opposite, financial instability. The most useful concept of financial instability for central banks and other authorities involves some notion of market failure or externalities that can potentially impinge on real economic activity.
- With this definition of financial instability, a clear public policy interest arises for central banks and other authorities to act in two distinct roles in pursuing financial stability—prevention of instability and management of the consequences once markets become unstable.

Independence of Central Banks

- In this context, independence is usually defined as the central bank's operational and management independence from the government.
- World Bank, the BIS, and the IMF are strong supporters of central bank independence. Governments generally have some degree of influence over even "independent" central banks; the aim of independence is primarily to prevent short-term interference.
- For example, the chairman of the U.S. Federal Reserve Bank is appointed by the President of the U.S., and his choice must be confirmed by the Congress.

Lecture # 6

STATE BANK OF PAKISTAN

The **State Bank of Pakistan (SBP)** is the central bank of Pakistan. While its constitution, as originally lay down in the State Bank of Pakistan Order 1948, remained basically unchanged until January 1, 1974, when the bank was nationalized, the scope of its functions was considerably enlarged. The State Bank of Pakistan Act 1956, with subsequent amendments, forms the basis of its operations today. The headquarters are located in the financial capital of Pakistan, Karachi with its second headquarters in the capital, Islamabad.

History

Before independence on 14 August 1947, the Reserve Bank of India (central bank of India) was the central bank for what is now Pakistan. On 30 December 1948 the British Government's commission distributed the Bank of India's reserves between Pakistan and India - 30 percent (750 M gold) for Pakistan and 70 percent for India.

The losses incurred in the transition to independence were taken from Pakistan's share (a total of 230 million). In May, 1948 Muhammad Ali Jinnah (Founder of Pakistan) took steps to establish the State Bank of Pakistan immediately. These were implemented in June 1948, and the State Bank of Pakistan commenced operation on **July 1, 1948**.

Functions

Under the State Bank of Pakistan Order 1948, the state bank of Pakistan 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".

A large section of the state bank's duties were widened when the State Bank of Pakistan Act 1956 was introduced. It required the state 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 utilization of the country's productive resources". In February 1994, the State Bank was given full autonomy, during the financial sector reforms.

On January 21, 1997, this autonomy was further strengthened when the government issued three Amendment Ordinances (which were approved by the Parliament in May 1997). Those included were the State Bank of Pakistan Act, 1956, Banking Companies Ordinance, 1962 and Banks Nationalization Act, 1974. These changes gave full and exclusive authority to the State Bank to regulate the banking sector, to conduct an independent monetary policy and to set limit on government borrowings from the State Bank of Pakistan. The amendments to the Banks Nationalization Act brought the end of the Pakistan Banking Council (an institution established to look after the affairs of NCBs) and allowed the jobs of the council to be appointed to the Chief Executives, Boards of the Nationalized Commercial Banks (NCBs) and Development Finance Institutions (DFIs). The State Bank is having a role in their appointment and removal. The amendments also increased the autonomy and accountability of the chief executives, the Boards of Directors of banks and DFIs.

The State Bank of Pakistan also performs both the traditional and developmental functions to achieve macroeconomic goals. The traditional functions may be classified into two groups:

1. **The primary functions** including issue of notes, regulation and supervision of the financial system, bankers' bank, lender of the last resort, banker to Government, and conduct of monetary policy.
2. **The secondary functions** including the agency functions like management of public debt, management of foreign exchange, etc., and other functions like advising the government on policy matters and maintaining close relationships with international financial institutions.

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

Regulation of Liquidity

The State Bank of Pakistan has also been entrusted with the responsibility to carry out monetary and credit policy in accordance with Government targets for growth and inflation with the recommendations of the Monetary and Fiscal Policies Co-ordination Board without trying to affect the macroeconomic policy objectives.

The state bank also regulates 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. During the 1980s, Pakistan embarked upon a program of financial sector reforms, which lead to a number of fundamental changes. Due to these changed the conduct of monetary management which brought about changes to the administrative controls and quantitative restrictions to market based monetary management. A reserve money management programme has been developed, for intermediate target of M2 that would be achieved by observing the desired path of reserve money - the operating target.

Banking

The State Bank of Pakistan looks into a lot of different ranges of banking to deal with the changes in economic climate and different purchasing and buying powers. Here are some of the banking areas that the state bank looks into;

- State Bank's Shariah Board Approves Essentials and Model Agreements for Islamic Modes of Financing
- Procedure for Submitting Claims with Sbp In Respect of Unclaimed Deposits Surrendered By Banks/Dfis.
- Banking Sector Supervision in Pakistan
- Micro Finance
- Small Medium Enterprises (SMEs)
- Minimum Capital Requirements for Banks
- Remittance Facilities in Pakistan
- Opening of Foreign Currency Accounts with Banks in Pakistan under new scheme.
- Handbook of Corporate Governance
- Guidelines on Risk Management
- Guidelines on Commercial Paper
- Guidelines on Securitization
- SBP.Scheme for Agricultural Financing
- Bank Assets and Liabilities

This is a chart of trend of major assets and liabilities reported by scheduled commercial banks to the State Bank of Pakistan with figures in millions of Pakistani Rupees.

Year	Deposits	Advances	Investments
2002	1,466,019	932,059	559,542
2006	2,806,645	2,189,368	799,285

Departments

- Agricultural Credit
- Audit
- Banking Inspection
- Banking Policy
- Banking Supervision
- Corporate Services
- Economic Policy
- Exchange and Debt Management
- Exchange Policy
- Human Resource
- Information System
- Islamic Banking
- Legal Services
- Payment System
- Research
- Statistics
- Real Time Gross Settlement System (RTGS System)
- Small and Medium Enterprises

Governor

The principal officer of the SBP is the **Governor**. During December 2005, the President of Pakistan appointed Dr. Shamshad Akhtar as the new Governor of the State Bank for a three year term, to replace Dr. Ishrat Hussain, who retired on December 1, 2005.

STATE BANK OF PAKISTAN - VARIOUS DEPARTMENTS

Agricultural Credit Department

Established under Section 8(3) of SBP Act 1956, is mainly responsible to meet credit needs of agriculture that being the mainstay of Pakistan's economy generates nearly one fourth of the total out put and 44% of total employment and is the major source of foreign exchange earning.

- ◆ To operate as a focal point in SBP for all agriculture and rural finance policies, programs and projects.
- ◆ To assess/estimate the credit needs of farm & non farm sector in rural areas.

To review the issues and challenges faced and developments taking place in agriculture and rural finance both in the country and elsewhere to develop an adequate knowledge and information base for policy formulation etc

- ◆ To formulate agri & rural finance policies in consultation with stakeholders to ensure adequate flow of institutional credit in rural areas.
- ◆ To monitor growth and trends in agri /rural finance portfolio of banks & financial institutions.
- ◆ To collect periodical agri/rural finance data for analysis, policy formulation and dissemination to general public.
- ◆ To advise Federal and Provincial Governments, Banks, Cooperative Banks & agriculture chambers on agri & rural finance issues.
- ◆ To initiate and undertake information dissemination and awareness building programs for farmers and special training programs for commercial banks.
- ◆ To build SBP rural and agriculture finance capacity
- ◆ To operate as a Secretariat for Agriculture Credit Advisory Committee (ACAC)

The organization of the Department is spread over the following Divisions: -

1. Division – I Agriculture Credit Estimation & Target Monitoring Division
2. Division – II Agriculture Financing Policy Division
3. Division – III Services, Training & Development Division

Banking Inspection Department

(BID) is one of the core departments at SBP. Its mission is to strive for soundness & stability of the financial system and safeguard interest of stakeholders through proactive inspection, compatible with best international practices. BID plays a pivotal role in meeting SBP's main responsibility of supervising the financial institutions to maintain soundness of the system and protection of the interest of depositors, thereby ensuring public confidence in the system. In order to assess a financial institution, BID conducts regular on-site inspection of all scheduled banks inclusive of the foreign banks & DFIs. The present supervisory structure at the department is institution focused whereby concerned Desk In-charges have been assigned specific institutions for effective monitoring through on-site examination, off-site reports from Banking Supervision Department and various market reports. The regular on-site inspection is conducted on the basis of **CAMELS Framework**. (Capital, Asset Quality, Management, Earnings, Liquidity, Sensitivity and System Controls). **CAMELS** are an effective rating system for evaluating the soundness of

financial institutions on a uniform basis and for identifying these institutions requiring special attention or concern. Here the focus of inspection is generally on risk assessment policies & procedures of the banks and control environment to keep attached risks within acceptable limits and compliance with laws, regulations, and supervisory directives.

Risk Assessment Polices

In continuation of the inspection process, discussions are held with external auditors to review banks' internal controls, compliance with legislation & prudential standards and adequacy of provisions. Here it would be important to mention that BID works in close coordination with Off-Site Surveillance Desk at Banking Supervision Department and other departments in SBP. BID conducts the regular full scope examination of banks pursuant to an inspection schedule; however, flexibility exists in policy for frequency of inspections depending upon the need to maintain safety & soundness. **CAMELS** rating are criteria to determine the frequency of inspection of banks as weak institutions are given greater attention. Special investigations (targeted inspections) are also conducted as and when circumstances so warrant on the basis of complaints or market reports about specific institution.

Financial Markets Strategy & Conduct Department (FSCD)

FSCD is one of the three new Departments constituted on restructuring of Exchange & Debt Management Department (EDMD) and Investment Services Cell (ISC) on September 14, 2006. The Department is responsible to formulate Policies & Regulate conduct of Domestic Money, Exchange, Securities, and Derivatives Markets as well as to disseminate market data/analysis & to set-up strategies/ products for market development.

Functions:-

To fulfill above, the Department has been divided into three Divisions, each Division is sub-divided into different units.

Markets Policy & Regulations

- Review & formulate Market related Policies/Regulations vis-à-vis FEEL, CRR/SLR, Dealers Code of Conduct, Public Debt Act, Market Settlement Issues, PD System, Inter-bank Brokerage monitoring etc.
- Secretariat for the Derivatives Approval & Review Team (DART).
- Review & coordinating with Banking Inspection Department on enforcement of Treasury specific inspection comments viz existing regulations governing FX, Derivatives & Debt Markets.
- Policy issues pertaining to other departments etc.
- Coordination with relevant Market Associations, Committees & Players e.g., Sub-Committee on Treasury & Capital Markets, etc.

Market Analysis & Forecasting

- a) Exchange Rate & FX Market Analysis
- b) Analysis of Money and Debt Markets
- c) Derivatives market analysis.
- d) Preparation of monthly market update/ Quarterly Financial Market Review.
- e) Liquidity Forecasting & Data base Management of Permanent & Floating Debts
- f) Assist in formulation of Sovereign Domestic Debt plan.

- g) External Debt maturity Profile.
- h) External Debt maturity Profile.

Market & Product Development Strategies

- Product development initiatives for Sovereign Debt instruments. Derivatives products/strips, Islamic Instruments.
- Market Development projects like...Listing of GOP Securities. Automated Auction/Payment System. IFSB Standards & Islamic market Development. Market Systemic Issues and Market Benchmarks.
- Market Publications.
- Foreign Exchange /Money Market, Derivatives Market Analysis.

Lecture # 8

STATE BANK OF PAKISTAN - VARIOUS DEPARTMENTS (Contd.)**Islamic Banking Department**

- ◆ Islamic Banking Department was established on 15th September, 2003 and has been entrusted with the huge task of promoting & developing the Shariah Compliant Islamic Banking as a parallel and compatible banking system in the country.
- ◆ State Bank of Pakistan wants to develop a progressive and sound Islamic banking system that is in line and compatible with the global financial sector, providing innovative Shariah compliant products and services so as to achieve equitable economic growth.
- ◆ One of the biggest challenges being faced by this growing industry is the dearth of professional Islamic Bankers and capacity building in this regard is one of the top most priorities for the promotion of Islamic Banking.
- ◆ In order to play our regulatory and supervisory role more efficiently we are working on the areas like Risk Management, Corporate Governance, Prudential Regulations, Accounting & Shariah Standards etc. regarding Islamic Banking

Islamic Banking Department consists of following four divisions:

- Policy Division
- Shariah Compliance Division
- Business Support Division
- Shariah Board Secretariat

Islamic Banking is one of the emerging field in global financial market, having tremendous potential and growing at a very fast pace all around the world.

Domestic Market & Monetary Management Department

DMMMD is a newly constituted department of SBP. The idea of constitution of this department was to combine FX and money market activities under one roof, hence Securities department taking care of money market activities and Dealing room taking care of FX market activities were merged together on February 17, 2000.

Main Objectives

1. Monetary Operations.
2. Raising short term and long-term domestic debts for the Government.
3. Management of Government Debts
4. Providing funds to the financial institutions as lender of last resort.
5. Monitoring of money and Foreign Exchange market activities.
6. Intervention in the Foreign Exchange market.
7. Reserve Management.

The Primary functions of Domestic Market & Monetary Management Department fall into the following categories.

1. Exchange Rate Policy Management

- ❖ Stable Exchange rates and Forward Premiums at appropriate/ sustainable levels
- ❖ Sale & Purchase of third currencies at optimum prices
- ❖ Smooth & sufficiently liquid Foreign Exchange Market
- ❖ Optimal accumulation of Foreign Exchange Reserves and Forward Portfolio.

2. Monetary Policy Implementation.

- ❖ Maintenance of stable interest rates in inter-bank money market through proactive management of Money Market liquidity.
- ❖ Raising short-term government debt and developing yield curve through auction of Market treasury bills.
- ❖ Proactive management of Money Market Liquidity through Open Market Operations.
- ❖ Providing liquidity to the market through SBP 3 day's repo facility.

3. Reserve Management

- ❖ Optimal utilization of Reserve Portfolio and maximum returns on investment of surplus reserves. Hiring of investment consultant & Fund Managers for optimizing returns.

4. Debt Management.

a) Domestic Debt

- ❖ Developing the markets for government securities.
- ❖ Coordination with monetary and Fiscal Policies.
- ❖ Raising short term and long term domestic debt for the government.
- ❖ Data base management of permanent and floating debts.

b) External Debt

- ❖ Monitoring and ensuring prompt payment of external debt installments through State Bank of Pakistan and commercial banks.
- ❖ To generate reports on external debt, connectivity of Debt Management and Financial Analysis System have been established between Economic Affairs Division & SBP.

Structure of the Department

- a) Local Foreign Exchange Division.
- b) Local Money Market Division.
- c) In house Reserve Management Division.
- d) Outsourcing Reserve Management Division.
- e) Government Securities Division.
- f) Debt Management Division.
- g) General Division.

Research Department

Research Department assumes an important role by providing key inputs for economic policy formulation through its analytical reviews and research work. Clearly, superior analysis of economic policies would be reflected in sounder macroeconomic management

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by the central bank and, in turn, the evolving structure of monetary and financial system would be more stable, and resilient against internal and external shocks. Thus the Research Department is expected to contribute significantly towards the main objectives of the State Bank of Pakistan.

Finance Department SBP

Functions of Finance Department

1. Maintenance of books of accounts and preparation of financial statements of the Bank in accordance with the International Accounting Standard, as adopted by the Bank.
2. Coordination and facilitation for Business planning and budgeting function in the Bank and periodic reporting to the management and to the Board.
3. Management of Federal, Provincial, and District Governments Accounts. Policy & operations related coordination Govt. agencies.
4. Maintenance of foreign currency accounts/ investments and execution of International payments and receipts.
5. Maintenance of accounts relating to International Organizations and Donor Agencies like International Monitoring Fund, Asian Development Bank, Asian Clearing Union etc
6. Currency issuance and its overall management.

STATE BANK OF PAKISTAN - VARIOUS DEPARTMENTS (Contd.)**Banking Surveillance Department**

Health of an economy depends on the degree of safety and stability of its banking and financial system. A sound, stable, and robust banking and financial system is a pre-requisite for economic well being of a country and its populace. In Pakistan, ensuring the stability and soundness of the banking system is a statutory responsibility of State Bank of Pakistan. 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 have been assigned this important function to work jointly and severally to ensure the soundness of individual banks and of overall banking industry. The Department is responsible to supervise financial institutions in the country. The department ensures effective adherence to regulatory & supervisory policies, monitors risk profiles, evaluate operating performance of individual banks/DFIs & the industry as a whole while issuing guidelines for managing various types of risks. It also ensures that banks are adequately capitalized & have policies & systems in place to assess various risks. The department is also responsible for the implementation of the Basel II Accord in Pakistan. The function & activities of Credit Information Bureau also falls within the domain of Banking Surveillance Department. The CIB collect credit data, under section 25A of the Banking Companies Ordinance 1962, maintain its database & disseminate credit information to financial institutions online to facilitate their credit appraisal process.

Main Objectives

- To ensure effective regulatory and supervisory oversight of Banks and DFIs.
- To assess and review, periodically, performance and future outlook of banking system.
- To monitor risk profiles of banks, to prescribe guidelines etc requiring banks & DFIs to put in place adequate Risk Management Systems
- Developing detailed understanding of New Basle Capital Accord.
- To ensure compliance with Basel Core Principles of Banking Supervision.
- To provide online collection & dissemination of credit related information to financial institutions in order to facilitate their credit appraisal process.

Structure of the Department**1. Risk Management & Analysis Division**

This Division is responsible for monitoring different risks faced/assumed by individual Banks/DFIs & prescribes policies/issues guidelines etc for managing/mitigating these risks.

2. Basel Accord & Core Principles Division

The primary objective of this division is to implement the Basel II Accord in the banking sector. This involves participating in capacity building of the banking industry to understand, adapt, & implement the Basel Accord & then to also monitor compliance in this regard. The other objective is to ensure compliance with Basel Core principles of banking Supervision.

3. **Banking Sector Assessment Studies Division**

This division is primarily responsible for reviewing and assessing, on periodical basis, the banking system performance, and its future outlook. The division also conducts various stress testing exercises to assess the resilience of the banking sector to various shocks.

4. **Credit Information Bureau (CIB)**

Collects & disseminates credit data from & to financial institutions to facilitate their credit appraisal process. It maintains database of all borrowers who avail credit facilities from financial institutions & provides online access to financial institutions to submit monthly credit data & to generate CIB reports.

5. **Coordination & Administration Unit**

The primary objective of this division is to provide necessary support services to the Department's staff and officers to facilitate them in effective & efficient discharge of assigned functions/ responsibilities. It coordinates with other departments & external organizations for timely provision of support services and technological assistance.

It is also responsible for receipt/dispatch of correspondence & records of inward & outward mail, besides preparing a consolidated business plan for the department & its monitoring & follow up for effective implementation. The Division also coordinates on various training activities for imparting training to the staff/officers.

Training Programs by SBP

This much coordination among supervisory departments attempts to ensure stable & efficient banking system.

Economic Policy Department

Economic Policy Department is primarily engaged in eight fundamental activities. These include:

- Preparation of Monetary Policy Statement
- Preparation of Monetary Surveys
- Preparation of Annual Credit Plan
- Consultations with the IMF
- Computation of REER index;
- Computation of domestic public debt
- Analysis of financial markets
- Empirical research papers

The Department also deals with external sector issues and references on money, credit, and exchange rates management. For operational purposes, the Department has been divided into the following four groups:

1. **Monetary Survey & IMF Consultations Group**

- This group is responsible for preparation of Monetary Survey, details of Government budgetary borrowings, commodity operations, bank credit to private sector, public sector enterprises including (major autonomous bodies) and other items separately for SBP and Scheduled banks.
- This group is responsible for preparation of Monetary Survey, details of Government budgetary borrowings, commodity operations, bank credit to private

sector, public sector enterprises including (major autonomous bodies) and other items separately for SBP and Scheduled banks.

In addition to this, the group is also assigned the task of preparation of material for IMF Consultations, World Bank and Ministry of Finance, monitoring of Performance Criteria and disposal of queries and references.

2. **Money, Credit & Prices Group**

- The group is responsible for preparing credit plans, working papers & performs Secretariat work. Other assignments include credit targeting, credit monitoring, banking issues & reforms, Inflation watch, analysis of lending rates, large scale manufacturing developments & disposal of references on credit allocation.
- The group also prepares periodic reports/reviews on Credit assessment of Private sector, credit assessment of govt. sector, analysis of tax revenue, domestic debt, & impact analysis of various policy initiatives. The group also intends to initiate work on micro credit and SMEs.

3. **Financial Market & Exchange Rates Group**

- This group is responsible to keep constant watch & analyze developments in the financial markets
- It prepares and supplies variety of background information for circulation in meetings.
- Further, it is also assigned the task of dealing with the matters relating to exchange rate and foreign exchange reserves.

4. **External Sector Group**

The group deals with the matters relating to Pakistan's relationship with International Financial Institutions like

- **IMF**: International monetary fund.
- **IBRD**: International Bank for Reconstruction & Development.
- **ADB**: Asian development Bank.
- The issues of **WTO** and **SAARC FINANCE**.

Lecture # 10

STATE BANK OF PAKISTAN - VARIOUS DEPARTMENTS (Contd.)**Exchange Policy Department**

(EPD) one of the core departments of the State Bank is responsible for overall stability of the foreign exchange market and is engaged in the process of policy formulation and implementation. It reviews on continuous basis, the existing rules and regulations, to facilitate foreign exchange activities in the country. Foreign exchange business in Pakistan is governed / regulated under Foreign Exchange Regulations Act, 1947 (FERA, 1947). Exchange Policy Department is structured into three divisions namely:

1. Policy Division:

Policy Division is responsible primarily for dealing with policy matters in the areas of export/ import transactions, issuance of Authorized Dealer's license, Foreign Exchange Exposure Limits, Foreign Currency Accounts Scheme, Exchange Risk Cover Fee on Medium & Long Term Loans, etc

2. Investment Division:

This division primarily facilitates implementation and compliance of policy of the Government for investments in Pakistan and abroad. This is carried out by offering feedback on matters of varied natures, reviewing and updating of investment related policies and activities and operational management

3. Exchange Companies Division:

Policy formulation for establishing Exchange Companies & ensuring adequate framework for licensing, operating, effective supervision & monitoring thereof are the prime responsibilities of Exchange Companies Division. These activities are carried out in close coordination with other the Field Offices of SBP-BSC and concerned government functionaries etc. It also organizes training and development activities for the respective financial institutions and concerned bodies.

Banking Policy & Regulations Department

Due to major fundamental changes in the scope and orientation of financial systems in 1990, and the subsequent need to put in place a more prudent regulatory framework to cope with the changing conditions, Prudential Regulations were put in place first in 1992.

Since then, the Prudential Regulations have been reviewed many times and the latest version relates to three different sets covering the areas of Corporate, SMEs and Consumers financing.

Basic Purpose of Prudential Regulations

Prudential Regulations have been issued by State Bank of Pakistan to put in place a prudent regulatory framework for ensuring safety and soundness of the financial system besides protecting the interests of users of financial services.

Human Resources Department

Divisions of HRM Department

- Compensation & Benefits Division

- Employee Relations Division
- Human Resource Information System Divisions
- Performance Management Division
- Planning & Development Division
- Recruitment Division

Information Systems & Technology Department

ISTD with its capabilities, methodologies, and experience aims at technological advancement in SBP, focusing on solutions that intend to reduce operating costs, improve end-user performance, and meet overall business goals. Success competitiveness in today's marketplace requires extra effort centered upon ISTD's value to provide high-quality solutions and services, effective communication, and smooth 24/7 operations.

Audit Department

The prime objective of audit department is to examine and evaluate whether the SBP's frame work of risk management, control, and governance processes, is adequate and functioning properly. In addition, the objectives of audit department include advising and recommending senior management for improvements in internal control and risk management systems. Audit Department is performing two types of functions i.e. Financial & Operational Audit and I.T Audit. Currently, Audit has three dedicated teams for Financial & Operational audit and one team for I.T audit. In addition to this, the Department has one Compliance Cell and one Services Unit

Off-site Supervision & Enforcement Department

(OSED) is one of the newly created departments emerging in the wake of re-organization of former Banking Supervision Department under recent SBP restructuring. OSED is responsible for off-site supervision of the financial institutions coming under regulatory purview of the State Bank of Pakistan (SBP). The department also ensures effective enforcement of regulatory and supervisory policies, monitors risk profiles, evaluates operating performance of individual banks/DFIs and takes necessary enforcement actions against institutions for their non-compliance (with laws of the land and regulations put in place by the SBP) as identified by, the inspection teams of BID during their onsite examination, and/or by the supervisors of this department based on submitted returns, interaction with financial institutions and market information. Currently, over 50 financial institutions are supervised by the State Bank of Pakistan. These include banks, Development Finance Institutions (DFIs), and Microfinance Banks & institutions.

Lecture # 11

MAJOR DRIVERS OF FINANCIAL INDUSTRY**MACRO ECONOMIC PERFORMANCE OF A COUNTRY****National Income**

People of any country produce a specific quantity of different goods and services from the natural resources by the help of capital goods with in a specific period, usually one year and this is called income of a country

Concepts of National Income

1. **Gross National Product “GDP” or Gross National Income “GNI”** GDP or GNI is defined as “the total market value of all the final goods and services produced in a year.”
2. **Net National Product “NNP” or Net National Income “NNI”** “It means net value of all the goods and services produced in a country during a year is called Net National Income.”

Difference b/w GDP & GNP

1. GDP is the value of goods and services in the country during a year minus the value of inputs.
2. GNP represents GDP plus net factor income payments from abroad.

MAJOR DRIVERS OF FINANCIAL INDUSTRY**Regulating risk and the importance of risk management**

Key challenge for regulators is to find ways to manage risks adequately. They have to ensure the prudential soundness of financial institutions and the stability of the system at large. But they also have to avoid stifling innovation and limiting the growth potential of the institutions concerned.

Basel 2 Type Rules for Insurers

Challenge in regulating institutions is to reflect market structures. There are now increasing calls to apply the principles of the Basel 2 bank capital accord to insurance regulation. There is an important angle to this call. Systemic risk in a financial stability sense is not any longer confined to banks. The process of securitization has changed all that. And more recently, growing inter linkages with the insurance sector emphasize the need for a further rethink.

GLOBAL FINANCIAL SYSTEM

The **global financial system (GFS)** is a financial system consisting of institutions and regulations that act on the international level, as opposed to those that act on a national or regional level. The main players are the global institutions, such as International Monetary Fund and Bank for International Settlements, national agencies and government

departments, e.g., central banks and finance ministries, and private institutions acting on the global scale, banks and hedge funds.

HISTORY OF INTERNATIONAL FINANCIAL INSTITUTIONS

In Europe, it may have started with the first commodity exchange, the Bruges Bourse in 1309 and the first financiers and banks in the 1400–1600s in central and Western Europe. The first global financiers the Fuggers (1487) in Germany; the first stock company in England (Russia Company 1553); the first foreign exchange market (The Royal Exchange 1566, England); the first stock exchange (the Amsterdam Stock Exchange 1602). Milestones in the history of financial institutions are the Gold Standard (1871–1932), the founding of IMF, World Bank at Bretton Woods, and the abolishment of fixed exchange rates in 1973.

INTERNATIONAL FINANCIAL INSTITUTIONS

International Monetary Fund

The International Monetary Fund keeps account of international balance of payments accounts of member states. The IMF acts as a lender of last resort for members in financial distress, e.g. currency crisis, problems meeting balance of payment when in deficit and debt default. Membership is based on quotas, or the amount of money a country provides to the fund relative to the size of its role in the international trading system. The IMF describes itself as "an organization of 185 countries (Montenegro being the 185th, as of January 18, 2007), working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty". With the exception of North Korea, Cuba, Andorra, Monaco, Tuvalu, and Nauru, all UN member states participate directly in the IMF. Some are represented by other member states on a 24-member Executive Board but all member countries are members of the IMF's Board of Governors.

Membership Qualifications

Any country may apply for membership to the IMF. The application will be considered first by the IMF's Executive Board. After its consideration, the Executive Board will submit a report to the Board of Governors of the IMF with recommendations in the form of a "Membership Resolution.

The World Bank

The **World Bank** (the Bank), a part of the World Bank Group (WBG), was formally established on December 27, 1945, following the ratification of the Bretton Woods agreement. The concept was originally conceived in July 1944 at the United Nations Monetary and Financial Conference. Two years later the Bank issued its first, & smallest, loan; \$250 million to France for post-war reconstruction; an issue which has remained a primary focus, alongside reconstruction after natural disasters, humanitarian emergencies & post-conflict rehabilitation needs affecting developing & transition economies.

The World Bank, as it is commonly referred to, consists of two agencies of the five that comprise the World Bank Group:

1. The International Bank for Reconstruction & Development (IBRD)
2. The International Development Association (IDA)

Activities of World Bank

The World Bank's activities are focused on the reduction of global poverty, focusing on the achievement of the Millennium Development Goals (MDGs), goals calling for the elimination of poverty and the implementation of sustainable development. The constituent parts of the Bank, the IBRD and the IDA, achieve their aims through the provision of low or no interest loans and grants to countries with little or no access to international credit markets. The Bank is a market based non-profit organization, using its high credit rating to make up for the low interest rate of loans. The Bank not only provides financial support to its member states, but also analytical and advisory services to facilitate the implementation of the lasting economic and social improvements that are needed in many Under-developed countries, as well as educating members with the knowledge necessary to resolve their development problems while promoting economic growth.

Country Assistance Strategies

As a guideline to the World Bank's operations in any particular country, a Country Assistance Strategy is produced, in cooperation with the local government and any interested stakeholders and may rely on analytical work performed by the Bank or other parties. In the case of low income countries, the Country Assistance Strategy is derived from the country's Poverty Reduction Strategy Paper.

INTERNATIONAL FINANCIAL INSTITUTIONS

World Trade Organization

(WTO) is an international organization designed to supervise and liberalize international trade. The WTO came into being on January 1, 1995, and is the successor to the General Agreement on Tariffs and Trade (GATT), which was created in 1947, and continued to operate for almost five decades as a *de facto* international organization. The WTO is governed by a Ministerial Conference, which meets every two years; a General Council, which implements the conference's policy decisions and is responsible for day-to-day administration; and a director-general, who is appointed by the Ministerial Conference. The WTO's headquarters are in Geneva, Switzerland.

Criticism on WTO

Although the stated aim of the **WTO** is to promote free trade and stimulate economic growth, some believe that globally free trade results in the rich (both people and countries) becoming richer, while the poor are getting poorer. Martin Khor, Director of the Third World Network, argues that the **WTO** does not manage the global economy impartially, but in its operation has a systematic bias toward rich countries and multinational corporations, harming smaller countries which have less negotiation power. He argues that developing countries have not benefited from the **WTO** Agreements of the Uruguay Round, because (among other reasons): market access in industry has not improved; these countries have no gains yet from the phasing out of textiles quotas; non-tariff barriers such as anti-dumping measures have increased; domestic support and export subsidies for agricultural products in the rich countries remain high. Other critics have characterized the decision making in the **WTO** as complicated, ineffective, unrepresentative, and non-inclusive, and they have proposed the establishment of a small, informal steering committee (a "consultative board") that can be delegated responsibility for developing consensus on trade issues among the member countries.

Role of WTO in Pakistan Trade Environment

Pakistan is one of the founder Members of the WTO since 1995, and its predecessor organization the GATT set up in 1948. We are following an export led growth strategy and as such market access is of vital importance for our businesses. The increase in preferential arrangements and free trade areas between some members is also eroding our market access. Therefore in order to maintain current markets and gain new ones for our exportable goods and services we are dependent on the WTO to get tariff and non tariff barriers lowered on an MFN basis. Such MFN liberalization effectively levels the playing field for competitive suppliers.

Pakistan has been actively engaged in the Doha round of trade talks that were launched in the Qatari capital in November 2001. Aptly named the "Doha Development Agenda", this round of trade talks has been focusing on removing distortions in the world agriculture markets and attaining enhanced market access for both products and service providers from Pakistan.

Since 2001, there have been two more ministerial conferences in Cancun in 2003 and Hong Kong in 2005 respectively. There have been many ups and downs in the road to a successful conclusion to the Doha round that takes into account the myriad interests of the developing membership. There was a breakdown of talks in the summer of 2006 which led many observers to be skeptical of the entire process. However, sustained efforts by the

membership led to a partial resumption of the talks in November 2006 & full resumption since January 2007 after the annual meeting of the World economic forum at Davos.

Asian Development Bank

(ADB) is a regional development bank established in 1966 to promote economic and social development in Asian and Pacific countries through loans and technical assistance. It is a multilateral development financial institution owned by 67 members, 48 from the region and 19 from other parts of the globe. ADB's vision is a region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their citizens.

The work of the Asian Development Bank (ADB) is aimed at improving the welfare of the people in Asia and the Pacific, particularly the 1.9 billion who live on less than \$2 a day. Despite many success stories, Asia and the Pacific remains home to two thirds of the world's poor. All projects funded by the Asian Development Bank are evaluated to assess their development effectiveness. There are two levels of evaluation—self evaluation and independent evaluation.

All projects are self-evaluated by the relevant ADB operations department in a project completion report. ADB's project completion reports are publicly disclosed and are available on ADB's Internet site. Client governments are also required to prepare their own project completion reports.

ADB Projects in Pakistan

ADB started its operations for Pakistan in 1968. As of 31 December 2001, ADB's cumulative assistance to Pakistan totaled some \$11.5 billion, of which \$8.0 billion had been disbursed. Cumulatively, 47 percent of this assistance has been from our soft window, the Asian Development Fund (ADF), while the balance 53 percent came from our Ordinary Capital Resources (OCR) window. In addition, we have provided cumulative grant technical assistance of \$92 million.

Investment projects have a common theme of poverty reduction and recent examples include:

1. **Trade, Export Promotion and Industry Programme (TEPI - US\$300 million)** approved in March 1999 focuses on providing support to the Government for trade liberalization and modernization of trade policies. The Program was completed in July 2002;
2. **Micro-finance Sector Development Programme (MFSDP-US\$ 150 million)** approved in December 2000 focuses on the development of sustainable rural microfinance services through commercial banking & credit unions to provide access to easy loans, assisted establishment of the Khushhali Bank. The Program is still ongoing;
3. **Energy Sector Restructuring Programme (ESRP-US\$ 355 million)** approved in December 2000 focuses on a major reform of the energy sector by putting in place a self sustaining, efficient and competitive power sector. The Program is currently ongoing;

4. **Decentralization Support Program (DSP- US\$300 million)** approved in November 2002 supports the ongoing decentralization process and related reforms of the Government;
5. **Rural Finance Sector Development Programme (RFSDP- US\$250 million)** approved in December 2002 is providing easy access to loans by the rural population, provision of finance for the poor, expansion of rural finance, promotion of SMEs, and restructuring of the (ADBP);
6. **Punjab Road Sector Development Project - US\$150 million** was approved in 2002 to build up the existing road structure, provincial highways, capacity building of executing agencies in Punjab. The Project has commenced recently.

Paris Club

The **Paris Club** is an informal group of financial officials from 19 of the world's richest countries, which provides financial services such as debt restructuring, debt relief, and debt cancellation to indebted countries and their creditors. Debtors are often recommended by the International Monetary Fund after alternative solutions have failed. Pakistan first went to the Paris Club in January 1999 for rescheduling of bilateral loans, which were contracted up to September 30, 1997.

The country was granted debt service relief of \$ 3 billion for the first consolidation period, which extended from January 1, 1999 to December 31, 2000.

At the end of this period, Pakistan signed a second rescheduling agreement in January 2001, which covered debt service payments due in the period from January 1, 2001 to September 30, 2001.

In 2004, the Club decided to write-off the debts of Iraq, as the rebuilding of Iraq is incomparable. After the 2004 Indian Ocean earthquake, the Paris Club decided to suspend temporarily some of the repayment obligations of the affected countries.

In order to secure comparable treatment of its debt due to all its external public or private creditors, Pakistan commits itself to seek promptly from all its external creditors debt reorganization arrangements on terms comparable to those set forth in the present Agreed Minute, while trying to avoid discrimination among different categories of creditors.

Consequently, Pakistan commits itself to accord all categories of creditors -and in particular creditor countries not participating in the present Agreed Minute, and private creditors- a treatment not more favorable than that accorded to the Participating Creditor Countries for credits of comparable maturity.

For the purpose of the comparison between the arrangements concluded by the Islamic Republic of Pakistan with its creditors not listed in the present Agreed Minute on the one hand, and with the Participating Creditor Countries on the other hand, all relevant elements will be taken into account, including the real exposure of the creditors not participating in the present Agreed Minute, the level of cash payments received by those creditors from the Islamic Republic of Pakistan as compared to their share of the Islamic Republic of Pakistan's external debt, the nature and characteristics of all treatment applied, including debt buy backs, and all characteristics of the reorganized claims. And in particular their repayment terms whatever forms they take and in general the financial relations between the Islamic Republic of Pakistan and the creditors not listed in the present Agreed Minute.

The Islamic Republic of Pakistan will inform in writing the Chairman of the Paris Club not later than September 1, 2002 of the progress made in negotiations with other creditors, as well as of the contents of the negotiations. the Islamic Republic of Pakistan will further inform in writing regularly the Chairman of the Paris Club of the status of its negotiations with other creditors, as well as of the payments made to them. Pakistan receives economic aid from several sources as loans and grants. The International Monetary Fund (IMF), World Bank (WB), Asian Development Bank (ADB), etc provides long term loans to Pakistan. Pakistan also receives bilateral aid from developed and oil-rich countries.

PAKISTAN ECONOMIC AID & DEBT

The Asian Development Bank will provide close to \$ 6 billion development assistance to Pakistan during 2006-9. The World Bank unveiled a lending program of up to \$6.5 billion for Pakistan under a new four-year, 2006-2009, aid strategy showing a significant increase in funding aimed largely at beefing up the country's infrastructure. Japan will provide \$500 million annual economic aid to Pakistan.

The major causes of poverty in Pakistan

- Lack of employment opportunities, which in the rural setting is caused by the absence of rural-urban linkages.
- A slowdown in the pace of economic growth in the 1990s
- With the burgeoning debt obligations, a decline in the public sector development program.

Key challenges facing the Government of Pakistan

1. Restoring economic growth-constrained further by a drought-affected agriculture sector
2. Managing the large debt burden with international financial institutions.
3. Promoting domestic and foreign investors' confidence
4. Increasing exports to generate foreign exchange,
5. Maintaining a level of social development spending to stem the deteriorating social indicators.
6. Law and Order, or Terrorism

Future Prospects for Pakistan's Economy

Pakistan's long term prospects will depend upon the interplay of evolution in political and social developments, economic policies to be pursued, the quality of governance and institutions, and most important investment in the human capital. It has become quite obvious from both Pakistan's own history and the experience of the developing countries that sustained economic growth and poverty reduction cannot take place merely on the strength of economic policies. Political stability, social cohesion, supporting institutions, and good governance are equally important ingredients coupled with both external environments for achieving economic success.

Macroeconomic Stability

Pakistan must strive to maintain its present level of macroeconomic stability. The most important thing needed is the will power of the ruling elite and the continuity of structural reforms undertaken by the military government. The country is now on the path to macroeconomic stability and is less vulnerable to external shocks than it was a decade ago.

There has been improvement in all of the major macroeconomic indicators. The growth rate of the economy, which was under 4 percent during the 1990s, has shown considerable improvement.

Strengthening Institutions

Recent empirical evidence suggests that sound economic policies cannot make any difference in the lives of the common citizens if the country does not have strong institutions to implement such policies. Pakistan inherited a strong civil service, judiciary, and police, which satisfied the demands of millions of people. But as its population expanded, the nature of governance became more complex and the capacity of these institutions did not keep pace with the emerging demands of the economy. These institutions were weakened by a succession of non-professional peoples. Finally, there is a need to improve the institutions of inter-provincial harmony to help in eradicating inter-provincial competition and jealousy. The Council of Common Interest, National Economic Council, and National Finance Commission are three institutions that are concerned with the distribution of the resources among the provinces. If these institutions were strengthened, policies that favor one province over another would not be adopted, which has been quite common in the past.

Lecture # 14

INCREASING FOREIGN DIRECT INVESTMENT

Pakistan must increase Foreign Direct Investment, if it intends to enhance the growth of its economy. The experience of the developing countries is that FDI is directly related to economic growth. Two recent examples from the developing world are China and India.

The following factors have proven to be critical for attracting foreign investment:

1. World-class physical infrastructure
2. A secure law and order situation
3. Skilled and productive labor
4. Innovative capacities
5. Agglomeration of efficient suppliers, competitors
6. A well-developed institutional infrastructure

Foreign Interest in Local Financial Markets

With the rapid growth in Pakistan's economy, foreign investors are taking a keen interest in the corporate sector of Pakistan. In the recent years, majority stakes in many corporations have been acquired by multinational groups.

Enhancing and Sustaining a Growing GDP

There have been two problems with the GDP growth rate in Pakistan. First, Pakistan has not been able to sustain growth over the long term. Sometimes Pakistan grows at a rate of around 7 percent and sometimes it retreats to a 3 percent growth rate.

Second, the growth rate of the economy in Pakistan has not been linked to improvement in human development factors. Basic indicators like education, health, poverty, safe drinking water, etc., have been neglected in Pakistan. The "trickle down theories" and market forces of the 1970s and 1980s have failed to provide relief for the general public. A need exists to link the growth rate of the economy to improvement in human development. The basic argument is that a higher growth rate is of limited utility if it does not benefit the population as a whole, including the poor.

How can Pakistan improve and sustain its growth rate?

Production in agriculture must be enhanced because of its large share of the GDP. Agricultural production can be improved by taking two kinds of measures. First, the government must provide facilities to small and medium landowners to cultivate their lands. These facilities may include the provision of seeds, fertilizers, machinery, and water. Second, the government must play an important role in determining the prices of the goods produced in the agriculture sector. It is really discouraging to farmers when they are not getting adequate prices for their products, exacerbating rural flight to urban areas.

Industrial Sector

In the industrial sector, the government must place emphasis on the development of small and medium industries. The government can facilitate this by providing targeted loans to this sector. Pakistan can substantially increase export earnings from light industry in the areas of carpet and textiles, sports equipment, dairy products, etc. The sick heavy industrial units promoted in the past should be rationalized, because they have become a burden on the economy. India is a classic case study of effective transition in this regard.

Inter-provincial harmony in Pakistan

There is a need to create inter-provincial harmony in Pakistan. In the past there has been a perception of deprivation and exploitation of the smaller provinces by the larger ones. Inter-provincial tensions have revolved around issues of resource distribution, investment and employment, water issues, etc. These factors hinder the growth rate of the economy. Pakistan needs to create inter-provincial harmony to achieve better growth.

Achieving a Favorable Balance of Trade

Pakistan's trade balance has been in deficit most of the time since the country's independence. Despite much effort by successive governments to liberalize trade, Pakistan's trade regime still has many barriers that are preventing it from being successful. Pakistan has faced various problems in trying to integrate its economy with world markets. The opponents of economic integration with world markets argue that it will lead to de-industrialization of Pakistan. The basic problem for Pakistan is that its exports are mostly raw materials, which are subject to severe price fluctuations in international market prices. The main exports of Pakistan, cotton and rice, are less competitive in international markets.

Managing the Debt

The external debt can be managed by taking the following policy measures:

- 1) Controlling the non-development expenditures of the government, which are currently consuming around 70 percent of public revenue
- 2) Accelerating and sustaining the GDP growth rate
- 3) Introducing an effective judicial system that strengthens accountability. This will help in reducing economic corruption and mismanagement.
- 4) Continuing austerity measures and containing current expenditures on the part of the government.
- 5) Providing more incentive to Pakistani citizens abroad and foreign residents of Pakistan to transfer their currency into the country. Foreign remittances will help in building up the foreign exchange reserves, thereby reducing the demand on the public debt.

Economic Resilience

Despite this record of sustained growth, Pakistan's economy had, until a few years ago, been characterized as unstable and highly vulnerable to external and internal shocks. However, the economy proved to be unexpectedly resilient in the face of multiple adverse events concentrated into a four-year period.

- ◆ The Asian financial crisis;
- ◆ Economic sanctions — according to Colin Powell, Pakistan was "sanctioned to the eyeballs";
- ◆ Global recession;
- ◆ Severe rioting in the port city of Karachi;
- ◆ Heightened perceptions of risk as a result of military tensions with India — with as many as a million troops on the border, and predictions of impending (potentially nuclear) war;
- ◆ The post-9/11 military action in neighboring Afghanistan, with a massive influx of refugees from that country;
- ◆ The 2005 Pakistan earthquake

Conclusion

Despite these adverse events, Pakistan's economy kept growing, and economic growth accelerated towards the end of this period. This resilience has led to a change in perceptions of the economy, with leading international institutions such as the IMF, World Bank, and the ADB praising Pakistan's performance in the face of adversity.

ROLE OF COMMERCIAL BANKS

A **bank** is a commercial or state institution that provides financial services, including issuing money in various forms, receiving deposits of money, lending money and processing transactions and the creating of credit.

A commercial bank accepts deposits from customers and in turn makes loans, even in excess of the deposits; a process known as fractional-reserve banking. Some banks (called Banks of issue) issue banknotes as legal tender. A **commercial bank** is usually defined as an institution that both accepts deposits and makes loans; there are also financial institutions that provide selected banking services without meeting the legal definition of a bank. Many banks offer ancillary financial services to make additional profit; for example, most banks also rent safe deposit boxes in their branches. Currently in most jurisdictions **commercial banks are regulated** & require permission to operate. Operational authority is granted by bank regulatory authorities who provide rights to conduct the most fundamental banking services such as accepting deposits and making loans.

Purpose of a bank:

Banks have influenced economies & politics for centuries. Historically, the **primary purpose of a bank** was to provide loans to trading companies. Banks provided funds to allow businesses to purchase inventory, and collected those funds back with interest when the goods were sold.

Commercial Lending:

For centuries, the banking industry only dealt with businesses, not consumers. Commercial lending today is a very intense activity, with banks carefully analyzing the financial condition of their business clients to determine the level of risk in each loan transaction.

Banking Services:

Banking services have expanded to include services directed at individuals, and risks in these much smaller transactions are pooled.

A Bank's Profit

A **bank generates a profit** from the differential between the level of interest it pays for deposits and other sources of funds, and the level of interest it charges in its lending activities. This difference is referred to as the **spread** between the cost of funds and the loan interest rate. Historically, profitability from lending activities has been cyclic and dependent on the needs and strengths of loan customers. In recent history, investors have demanded a more stable

revenue stream and banks have therefore placed more emphasis on transaction fees, primarily loan fees but also including service charges on array of deposit activities and ancillary services (international banking, foreign exchange, insurance, investments, wire transfers, etc.). However, lending activities still provide the bulk of a commercial bank's income.

The name **bank** derives from the Italian word **banco** "**desk/bench**", used during the Renaissance by Florentine bankers, who used to make their transactions above a desk covered by a green tablecloth.

However, there are traces of banking activity even in the Babylonian times, and indeed a book about the history of banking is named: ***Banking, from Babylon to Wall Street***.

Services Typically Offered by Banks

Although the basic type of services offered by a bank depends upon the type of bank and the country, services provided usually include:

1. **Taking deposits** from their customers and issuing current (Pak) or checking (US) accounts and savings accounts to individuals and businesses.
2. **Extending loans** to individuals and businesses.
3. **Cashing cheque**
4. **Facilitating money transactions** such as wire transfers and cashier's checks
5. **Issuing credit cards**, ATM cards, and debit cards
6. **Storing valuables**, particularly in a safe deposit box
7. Consumer & commercial **financial advisory services**
8. **Pension & retirement planning**

Financial transactions can be performed through many different channels:

1. **A branch**, banking centre or financial centre is a retail location where a bank or financial institution offers a wide array of face to face service to its customers.
2. **ATM** is a computerized telecommunications device that provides a financial institution's customers a method of financial transactions in a public space without the need for a human clerk or bank teller
3. **Mail** is part of the postal system which itself is a system wherein written documents typically enclosed in envelopes, and also small packages containing other matter, are delivered to destinations around the world
4. **Telephone banking** is a service provided by a financial institution which allows its customers to perform transactions over the telephone.
5. **Online banking** is a term used for performing transactions, payments etc. over the Internet through a bank, credit union or building society's secure website.

Types of banks

Banks' activities can be divided into retail banking, dealing directly with individuals and small businesses; business banking, providing services to mid-market business; corporate banking, directed at large business entities; and investment banking, relating to activities on the financial markets.

Most banks are profit-making, private enterprises. However, some are owned by government, or are non-profits.

Central banks are non-commercial bodies or government agencies often charged with controlling interest rates and money supply across the whole economy. They generally provide liquidity to the banking system and act as Lender of last resort in event of a crisis.

- **Commercial bank:** the term used for a normal bank to distinguish it from an investment bank. After the Great Depression, the U.S. Congress required that banks only engage in banking activities, whereas investment banks were limited to capital market activities. Since the two no longer have to be under separate ownership, some use the term "commercial bank" to refer to a bank or a division of a bank that mostly deals with deposits and loans from corporations or large businesses.
- **Community Banks:** locally operated financial institutions that empower employees to make local decisions to serve their customers and the partners
- **Community development banks:** regulated banks that provide financial services and credit to underserved markets or populations.
- **Postal savings banks:** savings banks associated with national postal systems.
- **Private Banks:** manage the assets of high net worth individuals.
- **Offshore Banks:** banks located in jurisdictions with low taxation and regulation. Many offshore banks are essentially private banks.
- **Savings bank:** in Europe, savings banks take their roots in the 19th or sometimes even 18th century. Their original objective was to provide easily accessible savings products to all strata of the population. In some countries, savings banks were created on public initiative, while in others socially committed individuals created foundations to put in place the necessary infrastructure. Nowadays, European savings banks have kept their focus on retail banking: payments, savings products, credits and insurances for individuals or small and medium-sized enterprises.
- Apart from this retail focus, they also differ from commercial banks by their broadly decentralized distribution network, providing local and regional outreach and by their socially responsible approach to business and society.
- **Building societies and Lands-banks:** conduct retail banking.
- **Ethical banks:** banks that prioritize the transparency of all operations and make only what they consider to be socially-responsible investments.

ROLE OF COMMERCIAL BANKS

Types of investment banks

- **Investment banks "underwrite"** (guarantee the sale of) stock and bond issues, trade for their own accounts, make markets, and advise corporations on capital markets activities such as mergers and acquisitions.
- **Merchant banks** were traditionally banks which engaged in trade financing. The modern definition, however, refers to banks which provide capital to firms in the form of shares rather than loans. Unlike Venture capital firms, they tend not to invest in new companies

Banks in the Economy

Role in the money supply

A bank raises funds by attracting deposits, borrowing money in the inter-bank market, or issuing financial instruments in the money market or a capital market. The bank then lends out most of these funds to borrowers. However, it would not be prudent for a bank to lend out all of its balance sheet. It must keep a certain proportion of its funds in reserve so that it can repay depositors who withdraw their deposits.

Bank reserves are typically kept in the form of a deposit with a central bank. This is called fractional-reserve banking and it is a central issue of monetary policy.

Note that under Basel I (and the new round of Basel II), banks no longer keep deposits with central banks, but must maintain defined capital ratios

Size of Global Banking Industry

Worldwide assets of the largest 1,000 banks grew 15.5% in 2005 to reach a record \$60.5 trillion. This follows a 19.3% increase in the previous year. EU banks held the largest share, 50% at the end of 2005, up from 38% a decade earlier.

The growth in Europe's share was mostly at the expense of Japanese banks whose share more than halved during this period from 33% to 13%. The share of US banks also rose, from 10% to 14%. Most of the remainder was from other Asian and European countries.

The US had by far the most banks (7,540 at end-2005) and branches (75,000) in the world. The large number of banks in the US is an indicator of its geography and regulatory structure, resulting in a large number of small to medium sized institutions in its banking system.

Japan had 129 banks and 12,000 branches. In 2004, Germany, France, and Italy had more than 30,000 branches each—more than double the 15,000 branches in the UK.

Bank Crisis

- ◆ Banks are susceptible to many forms of risk which have triggered occasional systemic crises. Risks include liquidity risk (the risk that many depositors will

request withdrawals beyond available funds), credit risk (the risk that those who owe money to the bank will not repay), Interest rate risk (the risk that the bank will become unprofitable if rising interest rates force it to pay relatively more on its deposits than it receives on its loans), among others. Banking crises have developed many times throughout history when one or more risks materialize for a banking sector as a whole. Prominent examples include the U.S. Savings and Loan crisis in 1980s and early 1990s, the Japanese banking crisis during the 1990s, the bank run that occurred during the Great Depression, and the recent liquidation by the central Bank of Nigeria, where about 25 banks were liquidated.

Challenges within the Banking Industry

Economic Environment

The changing economic environment has a significant impact on banks and thrifts as they struggle to effectively manage their interest rate spread in the face of low rates on loans, rate competition for deposits and the general market changes, industry trends and economic fluctuations.

Growth Strategies

It has been a challenge for banks to effectively set their growth strategies with the recent economic market. A rising interest rate environment may seem to help financial institutions, but the effect of the changes on consumers and businesses is not predictable and the challenge remains for banks to grow and effectively manage the spread to generate a return to their shareholders.

The Management of the Banks

The management of the banks' asset portfolios also remains a challenge in today's economic environment. Loans are a bank's primary asset category and when loan quality becomes suspect, the foundation of a bank is shaken to the core. While always an issue for banks, declining asset quality has become a big problem for financial institutions. There are several reasons for this, one of which is the lax attitude some banks have adopted because of the years of "good times." The potential for this is exacerbated by the reduction in the regulatory oversight of banks and in some cases depth of management. Problems are more likely to go undetected, resulting in a significant impact on the bank when they are recognized. In addition, banks, like any business, struggle to cut costs and have consequently eliminated certain expenses, such as adequate employee training programs. Banks also face a host of other challenges such as aging ownership groups. Across the country, many banks' management teams and board of directors are aging. Banks also face ongoing pressure by shareholders, both public and private, to achieve earnings and growth projections. Regulators place added pressure on banks to manage the various categories of risk. Banking is also an extremely competitive industry.

Competing in the financial services industry has become tougher with the entrance of such players as insurance agencies, credit unions, check cashing services, credit card companies, etc. Bank regulations are a form of government regulation which subject banks to certain requirements, restrictions, and guidelines, aiming to uphold the soundness and integrity of the financial system. The combination of the instability of banks as well as their important facilitating role in the economy led to banking being thoroughly regulated.

The amount of capital a bank is required to hold is a function of the amount and quality of its assets. Major Banks are subject to the Basel Capital Accord promulgated by the **Bank for International Settlements**.

In addition, banks are usually required to purchase deposit insurance to make sure smaller investors are not wiped out in the event of a bank failure. Another reason banks are thoroughly regulated is that ultimately, no government can allow the banking system to fail.

ROLE OF COMMERCIAL BANKS

Public perceptions of banks

In United States history, the National Bank was a major political issue during the presidency of Andrew Jackson. Jackson fought against the bank as a symbol of greed and profit-mongering, antithetical to the democratic ideals of the United States.

Currently, many people consider that various banking policies take advantage of customers. In Canada, for example, the New Democratic Party has called for the abolition of user fees for automated teller transactions. Other specific concerns are policies that permit banks to hold deposited funds for several days, to apply withdrawals before deposits or from greatest to least, which is most likely to cause the greatest overdraft, that allow backdating funds transfers and fee assessments, and that authorize electronic funds transfers despite an overdraft.

In response to the perceived greed and socially-irresponsible all-for-the-profit attitude of banks, in the last few decades a new type of bank called ethical banks have emerged, which only make socially-responsible investments (for instance, no investment in the arms industry) and are transparent in all its operations.

In the US, credit unions have also gained popularity as an alternative financial resource for many consumers. Also, in various European countries, cooperative banks are regularly gaining market share in retail banking.

Profitability

Large banks in the United States are some of the most profitable corporations, especially relative to the small market shares they have. This amount is even higher if one counts the credit divisions of companies like Ford, which are responsible for a large proportion of those companies' profits.

In the past 10 years in the United States, banks have taken many measures to ensure that they remain profitable while responding to ever-changing market conditions. First, this includes the Gramm-Leach-Bliley Act, which allows banks again to merge with investment and insurance houses. Merging banking, investment, and insurance functions allows traditional banks to respond to increasing consumer demands for "one-stop shopping" by enabling cross-selling of products (which, the banks hope, will also increase profitability). Second, they have expanded the use of risk-based pricing from business lending to consumer lending, which means charging higher interest rates to those customers that are considered to be a higher credit risk and thus increased chance of default on loans. This helps to offset the losses from bad loans, lowers the price of loans to those who have better credit histories, and offers credit products to high risk customers who would otherwise been denied credit. Third, they have sought to increase the methods of payment processing available to the general public and business clients. These products include debit cards, pre-paid cards, smart-cards, and credit cards. These products make it easier for consumers to conveniently make transactions and smooth their consumption over time (in some countries with under-developed financial systems, it is still common to deal strictly in cash, including carrying suitcases filled with cash to purchase a home). However, with convenience there is also increased risk that consumers will mismanage their financial resources and accumulate excessive debt. Banks make money from card products through interest payments and fees charged to consumers and transaction fees to companies that accept the cards.

The banking industry's main obstacles to increasing profits are existing regulatory burdens, new government regulation, and increasing competition from non-traditional financial institutions.

Society for Worldwide Inter-bank Financial Transactions

("SWIFT") operates a worldwide financial messaging network. Messages are securely and reliably exchanged between banks and other financial institutions. SWIFT also markets software and services to financial institutions, much of it for use on the SWIFT Network, and ISO 9362 bank identifier codes are popularly known as "SWIFT codes". The majority of international inter-bank messages use the SWIFT network. As of April 2006 SWIFT linked almost 8,000 financial institutions in 205 countries. SWIFT does not facilitate funds transfer. Financial institutions would need a corresponding banking relationship for financial transactions.

SWIFT is a cooperative society under Belgian law and it is owned by its member financial institutions. SWIFT has offices around the world. SWIFT headquarters are located in La-Hulpe, Belgium, near Brussels.

It was founded in Brussels in 1973, supported by 239 banks in 15 countries. It started to establish common standards for financial transactions and a shared data processing system and worldwide communications network. Fundamental operating procedures, rules for liability etc., were established in 1975 and the first message was sent in 1977.

SWIFT Services

There are four key areas that SWIFT services fall under within the financial marketplace, Securities, Treasury & Derivatives, Trade Services, and Payments & Cash Management.

COMMERCIAL BANKING IN PAKISTAN

The banking sector in Pakistan has been going through a comprehensive but complex and painful process of restructuring since 1997. It is aimed at making these institutions financially sound and forging their links firmly with the real sector for promotion of savings, investment and growth. Although a complete turnaround in banking sector performance is not expected till the completion of reforms, signs of improvement are visible. The almost simultaneous nature of various factors makes it difficult to disentangle signs of improvement and deterioration.

Commercial banks have been exposed and withstood several types of pressure since 1997.

Some of these are:

1. Multipronged reforms introduced by the central bank,
2. Freezing of foreign currency accounts,
3. Continued stagnation in economic activities and low growth and
4. Drive for accountability and loan recovery. All these have brought a behavioral change both among the borrowers as well as the lenders. The risk aversion has been more pronounced than warranted.

Commercial banks operating in Pakistan can be divided into four categories:

1. Nationalized Commercial Banks (NCBs),
2. Privatized Banks,
3. Private Banks and
4. Foreign Banks.

While preparing this report efforts have been made to evaluate the performance of each group which enjoy certain strengths and weaknesses as per procedure followed by State Bank of Pakistan (SBP). The central bank has been following a supervisory framework, CAMEL, which involves the analysis of six indicators which reflect the financial health of financial institutions.

These are:

1. Capital Adequacy,
2. Asset Quality,
3. Management Soundness,
4. Earnings and Profitability,
5. Liquidity and
6. Sensitivity to Market Risk.

Capital adequacy

To protect the interest of depositors as well as shareholders, SBP introduced the risk based system for capital adequacy in late 1998. Banks are required to maintain 8 per cent capital to Risk Weighted Assets (CRWA) ratio. Banks were required to achieve a minimum paid-up capital to Rs 500 million by December 31, 1998. This requirement has been raised to one billion rupee and banks have been given a deadline up to January 1, 2003 to comply with this.

The ratio has deteriorated after 1998. However, it was fallout of economic sanctions imposed on Pakistan after it conducted nuclear tests. The shift in SBP policy regarding investment in securities also led to a fall in ratio. However, most of the banks have been able to maintain above the desired ratio as well as direct their investment towards more productive private sector advances. Higher provisioning against non-performing loans (NPLs) has also contributed to this decline. However, this is considered a positive development.

Asset quality

Asset quality is generally measured in relation to the level and severity of non-performing assets, recoveries, adequacy of provisions and distribution of assets. Although, the banking system is infected with large volume of NPLs, its severity has stabilized to some extent. The rise over the years was due to increase in volume of NPLs following enforcement of more vigorous standards for classifying loans, improved reporting and disclosure requirements adopted by the SBP.

In case of NCBs this improvement is much more pronounced given their share in total NPLs. In case of privatized and private banks, this ratio went up considerably and become a cause of concern. However, the level of infection in foreign banks is not only the lowest but also closes to constant.

The ratio of net NPLs to net advances, another indicator of asset quality, for all banks has declined. Marked improvement is viable in recovery efforts of banks. This has been

remarkable in the case of NCBs, in terms of reduction in the ratio of loan defaults to gross advances. Although, privatized banks do not show significant improvement, their ratio is much lower than that of NCBs. Only exception is the group of private banks for which the ratio has gone up due to bad performance of some of the banks in the group. However, it is still the lower, except when compared with that of foreign banks.

Management soundness

Given the qualitative nature of management, it is difficult to judge its soundness just by looking at financial accounts of the banks. Nevertheless, total expenditure to total income and operating expenses to total expenses help in gauging the management quality of any commercial bank.

Pressure on earnings and profitability of foreign and private banks caused their expenditure to income ratio to rise in 1998. However, it started tapering down as they adjusted their portfolios. An across the board increase in administrative expenses to total expenditure is visible from the year 1999. The worst performers in this regard are the privatized banks, mostly because of high salaries and allowances.

Earnings and profitability

Strong earnings and profitability profile of banks reflects the ability to support present and future operations. More specifically, this determines the capacity to absorb losses, finance its expansion program, pay dividend to its shareholders, and build up adequate level of capital. Being front line of defense against erosion of capital base from losses, the need for high earnings and profitability can hardly be overemphasized. Although different indicators are used to serve the purpose, the best and most widely used indicator is return on assets (ROA). Net interest margin is also used. Since NCBs have significantly large share in the banking sector, their performance overshadows the other banks. However, profit earned by this group resulted in positive value of ROA of banking sector during 2000, despite losses suffered by ABL.

Pressure on earnings was most visible in case of foreign banks in 1998. The stress on earnings and profitability was inevitable despite the steps taken by the SBP to improve liquidity. Not only did liquid assets to total assets ratio declined sharply, earning assets to total assets also fell. T-Bill portfolio of banks declined considerably, as they were less remunerative. Foreign currency deposits became less attractive due to the rise in forward cover charged by the SBP. Banks reduced return on deposits to maintain their spread. However, they were not able to contain the decline in ROA due to declining stock and remuneration of their earning assets.

Liquidity

Movement in liquidity indicators since 1997 indicates the painful process of adjustments. Ratio of liquid assets to total assets has been on a constant decline. This was consciously brought about by the monetary policy changes by the SBP to manage the crisis-like situation created after 1998. Both the cash reserve requirement ((CRR) and the statutory liquidity requirement (SLR) were reduced in 1999. These steps were reinforced by declines in SBP's discount rate and T-Bill yields to help banks manage rupee withdrawals and still meet the credit requirement of the private sector.

Foreign banks have gone through this adjustment much more quickly than other banks. Their decline in liquid assets to total assets ratio, as well as the rise in loan to deposit ratio, are much steeper than other groups. Trend in growth of deposits shows that most painful

part of the adjustment is over. This is reflected in the reversal of decelerating deposit growth into accelerating one in year 2000.

Sensitivity to market risk

Rate sensitive assets have diverged from rate sensitive liabilities in absolute terms since 1997. The negative gap has widened. Negative value indicates comparatively higher risk sensitivity towards liability side, while decline in interest rates may prove beneficial.

Deposit Mobilization

Deposit mobilization has dwindled considerably after 1997. Deposits as a proportion of GDP have been going down. Growth rate of overall deposits of banks has gone down. However, the slow down seems to have been arrested and reversed in year 2000.

Group-wise performance of deposit mobilization is the reflection of the varying degree with which each group has been affected since 1998. Foreign banks were affected the most due to their heavy reliance of foreign currency deposits. They experience 14 per cent erosion in 1999. However, they were able to achieve over 2 per cent growth in year 2000. Similar recovery was shown by private banks.

Deposit mobilization by NCBs seems to be waning after discontinuation of their rupee deposit schemes linked with lottery prizes. Growth in their deposits was on the decline. Despite the decline NCBs control a large share in total deposits. Aggressive posture of private banks in mobilizing more deposits in year 2000 is clearly reflected in their deposit growth, from 1.9 per cent in year 1999 to 21.7 per cent in year 2000. This has also helped them in increasing their share in total deposits to over 14 per cent in year 2000.

Due to the shift in policy, now banks are neither required nor have the option to place their foreign currency deposits with the SBP. Although, the growth in foreign currency deposits increases the deposit base, it does not add to their rupee liquidity. The increasing share of foreign currency deposits in total base is a worrying development. In order to check this trend, SBP made it compulsory for the banks not to allow foreign currency deposits to exceed 20 per cent of their rupee deposits effective from January 1, 2002.

Credit extension

Bulk of the advances extended by banks is for working capital which is self-liquidating in nature. However, due to an easing in SBP's policy, credit extension has exceeded deposit mobilization. This is reflected in advances growing at 12.3 per cent in year 1999 and 14 per cent in year 2000.

Group-wise performance of banks in credit extension reveals three distinct features.

1. Foreign banks curtailed their lending,
2. Continued dominance by NCBs and
3. Aggressive approach being followed by private banks. Private banks were the only group that not only maintained their growth in double-digit but also pushed it to over 31 per cent in year 2000. With this high growth, they have surpassed foreign banks, in terms of their share in total advances in year 2000.

Banking spreads

Over the years there has been a declining trend both in lending and deposit rates. Downward trend in lending rates was due to SBP policy. The realized trend in lending rates was in line with monetary objectives of SBP, though achieved with lags following the sharp reduction in T-Bill yields in year 1999, needed to induce required change in investment portfolio of banks.

Downward trend in deposit rates was almost inevitable. One can argue that banks should have maintained, if not increased, their deposit rates to arrest declining growth in total deposits. However, this was not possible at times of eroding balance sheet; steady earnings were of prime importance. Consequently banks tried to find creative ways of mobilizing deposits at low rates. However, due to inefficiencies of the large banks, the spread has remained high.

ROLE OF COMMERCIAL BANKS

Asset composition

Assets of banking sector, as per cent of GDP, have been on the decline. Slowdown in asset growth was also accompanied by changing share of different groups. Negative growth in the assets of foreign banks during 1998 and 1999 was the prime reason behind declining growth in overall assets of the banking sector. Share of NCBs have been decreasing since private banks were allowed to operate in 1992. In terms of asset share, private banks are now as large as foreign banks.

Problem bank management

The central bank is the sole authority to supervise, monitor and regulate financial institutions. It is also responsible to safeguard the interest of depositors and shareholders of these institutions. Lately, SBP took actions against two private banks which became a threat to viability of the financial system in the country. These were Indus Bank and Prudential Commercial Bank. On the basis of detailed investigations, the license of Indus Bank was cancelled on September 11, 2000. After successful negotiations, management and control of Prudential Bank handed over to Saudi-Pak group.

Outlook

Commercial banks have been going through the process of restructuring. There are efforts to reduce lending rates. The SBP has been successful in implementing its policies. Most of the banks have been able to adjust to new working environment. The proposed increase in capital base will provide further impetus to financial system in the country.

In the post September 11 era, the GoP borrowing from SBP and commercial banks is expected to come down substantially and private sector borrowing to increase. However, a temporary decline in repayment ability of borrowers may increase provisioning for the year 2001. The situation is expected to improve in year 2002. Unless efforts are made by banks to shrink spread, depositors will not be able to get return which corresponds with the rate of inflation in the country. Privatization of NCBs is expected to be delayed due to external factors. However, it is an opportunity for the banks to further clean their slate. Pakistan's banking sector like many other developing countries had been faced with several problems and difficulties such as:

Most of the financial assets and deposits were owned by nationalized commercial banks (NCBs) which suffered from a highly bureaucratic approach, overstaffing, unprofitable branches and poor customer service.

1. NCBs along with specialized banks such as ADBP, IDBP and Development financial institutions such as NDFC had a high ratio of non-performing loans.
2. Banking industry faced a high tax rate, which affected its profitability and attractiveness for new entrants.
3. There was a proliferation of banks and some of them were undercapitalized, poorly managed with a scanty distribution network.
4. Agriculture, small and medium enterprises, Housing sectors were underserved and the middle class and low income group had limited access to bank credit.

5. Banks had typically focused on trade and corporate financing with a narrow range of products and had not diversified into consumer and mortgage financing for which there is an ample unsatisfied demand.
6. Poor quality of human resources, weak internal controls, non-merit based recruitments, high administrative costs and undue interference of unions in decisions making process affected the performance of public sector financial institutions adversely.

BANKING SECTOR REFORMS

Banking sector reforms were aimed at addressing these and other constraints. Although there is no room for complacency and a lot needs to be done it is fair to say that substantial progress has been made to improve the health and soundness of the banking sector in recent years. There are still few weak and vulnerable institutions but overall the banking sector in Pakistan is much stronger today compared to five years ago or in comparison to other countries in the region. What are the factors responsible for this improvement? A large number of reforms have either been undertaken or under way.

1. Privatization of NCBs

The nationalized commercial banks are being privatized and their domination of the banking sector is likely to be reduced from almost 100 percent in 1991 to about 20 percent by December 2003. The shares of Muslim Commercial Bank are all in the private sector. United Bank has been sold to a consortium of private investors. Privatization of Habib Bank Ltd., is under way and is scheduled to be completed by end December, 2003. 23.5 percent of shares of National Bank have been floated through Stock Market mainly aimed at small retail investors. The NCBs have been restructured and professional management inducted which works under the supervision of independent Boards of Directors drawn from the private sector.

2. Corporate governance.

Strong corporate governance is absolutely essential if the banks have to operate in a transparent manner and protect the depositors' interests. The SBP has taken several measures in the last four years to put in place good governance practices to improve internal controls and bring about a change in the organizational culture. The salient features of this structure are:

- a. Banking license of one of the commercial banks which was found in violation of the prudential regulations and norms was cancelled for the first time in the history of Pakistan after following the due process. This decision was upheld by Peshawar High Court.
- b. Ownership and management were changed at two private commercial banks, one of which had committed breach through unauthorized transfer of funds from the bank to associated companies.
- c. A number of cases of willful bank defaulters were referred to National Accountability Bureau (NAB) for taking legal actions and recovering the amounts due.

- d. The appointments of Board members, Chief Executive Officers and key Executives of all banks have to be screened so that they meet the fit and proper test prescribed by the SBP.
- e. Family representation on the Board of Directors of the banks where they hold majority ownership has been limited to 25 percent of the total membership of the Board.
- f. To avoid possible conflict of interest and use of insider information the Directors, executives and traders working in Brokerage companies will no longer serve on the Boards of Directors of the banks.
- g. External auditors are evaluated annually and classified in various categories based on their performance and other prescribed criteria. Two large audit firms were debarred from auditing the banks and only after showing improvement in their performance placed in a category lower than they originally belonged to.
- h. A detailed set of guidelines for the Board of Directors to effectively oversee the management of the banks and develop policies has been issued. A training course on Corporate Governance was organized for the members of the Boards of banks and their Chief Executives.
- i. The disclosure requirements for banks have been strengthened and now they are required to prepare their annual financial statements in accordance with the International Accounting Standards. They are also required to publish quarterly and half-yearly accounts to provide information to their stakeholders for taking well informed decisions.
- j. In order to institutionalize the decision making process and to provide guidance to staff, the banks are required to formulate and implement well-defined policies in credit, investment, recovery of write-offs, human resources, audit and compliance, risk management, etc. k. To provide guidance to banks in identifying, measuring, monitoring and controlling various risks and to make them proactive, a detailed set of guidelines on risk management has been issued.

3. Capital Strengthening.

Capital requirements of the banking sector have to be adequate in relation to the risk weighted assets and conform to the Basle Accord. To further strengthen their competitive ability, both domestically and internationally and to encourage the economies of scale, the minimum paid-up capital requirements of the banks have been raised. The banks were required to increase their paid-up capital from Rs 500 million to Rs 1 billion by 1st January 2003 failing which they will no longer be allowed to carry out full banking activities as scheduled banks. This has resulted in mergers and consolidation of many financial institutions and weeding out of several weaker banks from the financial system.

4. Improving Asset quality.

The stock of non-performing loans (NPLs) has been tackled in several ways. The gross NPLs amount to Rs 252 billion and account for 22 percent of the advances of the banking system and DFIs. However, there has been aggressive provisioning carried out during the

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last three years. More than 60 percent of the NPLs are fully provided for and net NPLs to net advances ratio has thus declined to less than 10 percent. Efforts are being made to further reduce this ratio through the active involvement of Corporate & Industrial Restructuring Corporation (CIRC) and the Committee on Revival of Sick Units (CRSU). The settlement reached between loss category loan holders and banks under State Bank circular No.29 will further reduce the volume of NPLs and allow the sick industrial units to revive while at the same time enable the banks to clean up their balance sheets. The positive development is that the quality of new loans disbursed since 1997 has improved and recovery rate is 95 percent.

5. Liberalization of foreign exchange regime

Pakistan has further liberalized its foreign exchange regime and ensured partial Capital account Convertibility by allowing foreign exchange companies to operate and Pakistani Corporate sector to acquire equity abroad.

6. Consumer Financing

The State Bank has removed restrictions imposed on nationalized commercial banks for consumer financing. The positive experience of auto financing gives a lot of hope that the middle class of this country will be able to access consumer durables through banks. This will at the same time boost the manufacturing of TVs, air-conditioners, VCRs, washing and drying machines, deep freezers etc. in the country. Credit and Debit Cards are also gaining popularity and the numbers of card holders have doubled during the last two years.

7. Mortgage Financing

A number of incentives have been provided to encourage mortgage financing by the banks. The upper limit has been raised from Rs 5 million to Rs 10 million. Tax deduction on interest payments on mortgage have been allowed up to a ceiling of Rs.500, 000. The new recovery law is also aimed at expediting repossession of property by the banks. The banks have been allowed to raise long term funds through rated and listed debt instruments like TFCs to match their long term mortgage assets with their liabilities.

8. Legal Reforms

Legal difficulties and time delays in recovery of defaulted loans have been removed through a new ordinance i.e. The Financial Institutions (Recovery of Finances) Ordinance, 2001. The new recovery laws ensures expeditious recovery of stuck up loans by the right of foreclosure and sale of mortgaged property with or without intervention of court and automatic transfer of case to execution proceeding. A Banking Laws Reforms Commission is reviewing, revising and consolidating the banking laws and drafting new laws such as bankruptcy law.

9. Prudential Regulations

The prudential regulations in force were mainly aimed at corporate and business financing. The SBP in consultation with the Pakistan Banking Association and other stakeholders has developed a new set of regulations which cater to the specific separate needs of corporate, consumer and SME financing. The new prudential regulations will enable the banks to expand their scope of lending and customer outreach.

10. Micro financing

To provide widespread access to small borrowers particularly in the rural areas the licensing and regulatory environment for Micro Credit and Rural financial institutions have been relaxed and unlike the commercial banks these can be set up at district, provincial and national levels with varying capital requirements. There is less stringency and more facilitative thrust embedded in the prudential regulations designed for this type of institutions. Khushali Bank and the First Microfinance Bank in the private sector have already started working under this new regulatory environment. Khushali Bank has already reached a customer base of 125,000 mainly in poorer districts of the country and its recovery rate is above 95 percent.

11. SME Financing.

The access of small and medium entrepreneurs to credit has been a major constraint to expansion of their business and up gradation of their technology. A Small and Medium Enterprise (SME) Bank has been established to provide leadership in developing new products such as program loans, new credit appraisal, and documentation techniques, and nurturing new skills in SME lending which can then be replicated and transferred to other banks in the country. Program lending, for example, can help up gradation of power looms to shuttle less looms in Faisalabad area and contribute to the achievement of goal set under Textile Vision 2005. The new

Prudential regulations for SMEs do not require collateral but asset conversion cycle and cash flow generation as the basis for loan approval. The State Bank is also contemplating to develop capacity building among a select group of banks for SME lending. This will revitalize the lending to SMEs particularly export oriented ones.

ROLE OF COMMERCIAL BANKING

12. Legal Reforms

Legal difficulties and time delays in recovery of defaulted loans have been removed through a new ordinance i.e. The Financial Institutions (Recovery of Finances) Ordinance, 2001. The new recovery laws ensures expeditious recovery of stuck up loans by the right of foreclosure and sale of mortgaged property with or without intervention of court and automatic transfer of case to execution proceeding. A Banking Laws Reforms Commission is reviewing, revising, and consolidating the banking laws and drafting new laws such as bankruptcy law.

13. Taxation

The corporate tax rates on banks were exorbitantly high in Pakistan thus adversely affecting their profitability and attractiveness as an avenue for investment and new equity injection. The Government has already reduced the tax rate from 58 percent to 44 percent during the last three years and it is envisaged that the rate will be reduced gradually and brought at par with the corporate tax rate of 35 percent in the next three years. This will in turn help in reducing the spread between the deposit rate and lending rate and benefit financial savers.

14. Agriculture Credit

A complete revamping of Agriculture Credit Scheme has been done recently with the help of commercial banks. The scope of the Scheme which was limited to production loans for inputs has been broadened to the whole value chain of agriculture sector.

We have, with the grace of Allah, become a surplus country in food grains, livestock etc. and thus the needs of agriculture sector have also expanded. The SBP has included financing for silos, god-owns, refrigerated vans, agro processing and distribution under the cover of this scheme. This broadening of the scope as well the removal of other restrictions have enabled the commercial banks to increase their lending for agriculture by a multiple of four times compared to FY 1999-00 thus mainstreaming agriculture lending as part of their corporate business. Unlike the previous years when they were prepared to pay penalties for under performance they have set up higher targets for this year. The private commercial banks have also agreed to step in and increase their lending to agriculture.

15. E-Banking

The banks are being encouraged to move towards Electronic banking. There is a big surge among the banks including NCBs to upgrade their technology and on-line banking services. During the last three years there is a large expansion in the ATMs has been witnessed and at present about 500 ATMs are now working throughout the country. The decision mandating the banks to join one of either two ATM switches available in the country will provide a further boost. Progress in creating automated or on-line branches of banks has been quite significant so far and it is expected that by 2004 a majority of the bank branches will be on-line or automated. Utility bills payment and remittances would be handled through ATMs, Kiosks or Personal Computers reducing both time and cost. Investment in information technology is being undertaken by the banks to enhance efficiency, reduce transaction costs and promote E-Commerce. It has been estimated that a banking transaction through ATM costs one fourth as much a transaction conducted over the counter in a traditional branch –

and the similar transaction over the internet costs a mere **fraction** of the traditional teller costs.

16. Human Resources

The banks have recently embarked on merit-based recruitment to build up their human resource base – an area which has been neglected so far. The private banks have taken lead in this respect by holding competitive examinations, interviews and selecting the most qualified candidates. The era of appointment on the basis of sifarish and nepotism has come to an end. This new generation of bankers will usher in a culture of professionalism and rigor in the banking industry and produce bankers of stature who will provide the leadership in the future.

17. Credit Rating

To facilitate the depositors to make informed judgments about placing their savings with the banks, it has been made mandatory for all banks to get themselves evaluated by credit rating agencies. These ratings are then disclosed to the general public by the SBP and also disseminated to the Chambers of Commerce and Trade bodies. Such public disclosure will allow the depositors to choose between various banks. For example, those who wish to get higher return may opt for banks with B or C rating. But those who want to play safe may decide to stick with only AAA or AA rated banks.

18. Supervision and Regulatory Capacity

The banking supervision and regulatory capacity of the Central Bank has been strengthened. Merit – based recruitment, competency – enhancing training, performance – linked promotion, technology – driven process, induction of skilled human resources and greater emphasis on values such as integrity, trust, team work have brought about a structural transformation in the character of the institution. The responsibility for supervision of non-bank finance companies has been separated and transferred to Securities Exchange Commission. The SBP itself has been divided into two parts – one looking after central banking and the other after retail banking for the government.

19. Payment Systems

Finally, the country's payment system infrastructure is being strengthened to provide convenience in transfer of payments to the customers. The Real-Time Gross Settlement (RTGS) system will process large value and critical transactions on real time while electronic clearing systems will be established in all cities.

These reforms will go a long way in further strengthening the Banking sector but a vigilant supervisory regime by the State Bank will help steer the future direction.

Commercial Banking in a Free Society

Although we can say a great deal about the institutions of a free society, and why they are desirable, speculating about the specific ways in which people will choose to organize themselves within such institutions is always a tricky matter

- After all, the whole justification for the institutions of a free society is that only through its institutions can human beings discover progressively better ways of dealing with scarcity (of both goods and knowledge)
- And thus improve both our material and non-material welfare. Our ignorance of the

details of a free society is precisely why having a free society is so important.

The banking industry is especially suited for just this kind of analysis. If we want to know what commercial banking might look like in a free society, we need only turn to contemporary regulation and the historical record to begin to piece together a coherent story.

Private Deposit Insurance

- Banks in a free society might choose to purchase privately supplied deposit insurance as a way to reassure customers. They might also enter into inter-bank mutual aid agreements, or be insured through clearinghouses.
- Historically, banks have used these and other methods to convey trust to customers. Before deposit insurance banks would advertise their balance sheets and list the members of their boards of directors.
- Providing this kind of information was a way to establish their trustworthiness to actual and potential depositors. With deposit insurance, banks need not do this.
- It is reasonable to expect that banks in a free society will use these ways, and discover new and imaginative ones, of creating the trust on which all banking systems rest.
- Banks in a free society will be literally nothing special. What makes banking so un-free today is that banks are treated differently from other business enterprises.
- The rule of law that would characterize a free society would demand that banks be treated no differently than other firms. If they are fraudulent or use force, then they need to face the consequences. Otherwise, any sort of voluntary arrangement banks make with customers will be allowed.
- The result will not only be a more free banking system, but a more efficient, safe, and productive one.

BRANCH BANKING IN PAKISTAN

A branch, banking centre or financial centre is a retail location where a bank or financial institution offers a wide array of face to face service to its customers.

Remittances:**Demand Draft**

It's a written order, drawn by one branch of a bank upon another branch of the same bank, upon other bank under special arrangement to pay a certain sum of money to or to the order of a specified person."

Parties Involved

1. Purchaser
2. Issuing Branch
3. Drawee Branch
4. Payee/ Beneficiary

Pay Order

A Pay Order is a written authorization for Pmt, Made in a receipt from issued & Payable by the bank, to the person named & addressed therein on his giving a proper discharge thereon.

Parties Involved

1. Purchaser
2. Issuing / Paying Branch
3. Payee

Telegraphic Transfer

"T.T instructions regarding PMT are sent to Drawee branch in a coded language and under confidential number known as TEST Number."

Parties Involved

1. Applicant
2. Remitting or Drawing Branch
3. Drawee Branch
4. Beneficiary /Payee

Mail Transfer

Like T.T funds can be remitted by MT for the Cr of the payee a/c or the Beneficiary can be advised to receive the PMT from Drawee branch either in cash on proper identification or through his banker."

Parties Mail Transfer

1. Applicant
2. Drawing Branch

3. Drawee Branch
4. Beneficiary

Online Fund Transfer

It's also a fund transfer but only by Online within the Branches.

Parties Involved

1. Applicant (a/c in Bank)
2. Beneficiary (a/c in Bank)
3. 2 Branches of Bank (online)

Account Opening Department

Types of Account

1. Individual
2. Joint Account
3. Sole Proprietorship
4. Club & Societies
5. Joint Stock Companies
6. Agents

Operations & Status of Accounts

Nature of Accounts

1. Current Account
2. Profit & Loss Sharing
3. Current foreign currency
4. Saving Foreign Currency
5. Term Deposits
6. BBA "Basic Banking Account"

Deposit

Commercial Bank deposit products offer you an array of privileges and services. Designed with your banking needs and comfort in mind, these convenient accounts prove that, at Commercial Banks, banking is about a shared long-term relationship between bank and you.

◆ Current Account

The Current Account allows you the facility of unlimited withdrawals up to the extent of the balance in your account. Sometimes there will be no tax deducted on the funds that you choose to keep in these accounts.

◆ Savings or PLS Account

The Savings Account allows you the facility of unlimited withdrawals (up to the extent of the balance in your account), while accruing profit on your deposit everyday. You can have the profit paid to you monthly, quarterly, annually or as per your requirement. The passbook is the traditional document to keep track of earnings in a savings account.

◆ Term Deposit

The Term Deposit offers you the dual benefit of attractive returns with high liquidity, with options to take your profit monthly, quarterly, annually or at maturity. A **time deposit** (also known as a **term deposit**, particularly in Canada, Australia and New Zealand) is a money deposit at a banking institution that cannot be withdrawn for a certain "term" or period of time. When the term is over it can be withdrawn or it can be held for another term. Generally speaking, the longer the term the better the yield on the money. A certificate of deposit is a time-deposit product. A deposit of funds in a savings institution under an agreement stipulating that

- a. The funds must be kept on deposit for a stated period of time,
- b. The institution may require a minimum period of notification before a withdrawal is made.

◆ Foreign Currency

You have the option of opening Current, Savings and Term Deposit accounts in different foreign currencies – Like US Dollar, Pound Sterling, Japanese Yen, and Euros. This entitles you to avail all the convenience of local currency accounts including:

1. Unlimited cash withdrawals up to the balance in your account
2. Deposits facility
3. Profit accrued on a daily basis
4. Automatic rollover of deposits

As per State Bank of Pakistan circulars/regulations

◆ Demand account

1. The cheque is the traditional mode of payment for a demand account.
2. A **demand account** or **demand deposit** (North America: **checking account**, UK and Commonwealth: **current account**) is a deposit account held at a bank or other financial institution,
3. For the purpose of securely and quickly providing frequent access to funds *on demand*, through a variety of different channels.

Commercial Banks Loan Facilities:

A **loan** is a type of debt. All material things can be lent but this article focuses exclusively on monetary loans. Like all debt instruments, a loan entails the redistribution of financial assets over time, between the **lender** and the **borrower**.

The borrower initially receives an amount of money from the lender, which they pay back, usually but not always in regular installments, to the lender. This service is generally provided at a cost, referred to as interest on the debt.

A borrower may be subject to certain restrictions known as loan covenants under the terms of the loan. Legally, a loan is a contractual promise of a debtor to repay a sum of money in exchange for the promise of a creditor to give another sum of money.

◆ Secured Loan

A mortgage loan is a very common type of debt instrument, used by many individuals to purchase housing. In this arrangement, the money is used to purchase the property. The financial institution, however, is given security - a lien on the title to the house - until the mortgage is paid off in full. If the borrower defaults on the loan, the bank would have the legal right to repossess the house and sell it, to recover sums owing to it. In some instances, a loan taken out to purchase a new or used car may be secured by the car; in much the same way as a mortgage is secured by housing. The duration of the loan period is considerably shorter often corresponding to the useful life of the car.

There are two types of auto loans, direct and indirect.

1. A direct auto loan is where a bank gives the loan directly to a consumer.
2. An indirect auto loan is where a car dealership acts as an intermediary between the bank or financial institution and the consumer

Other Types of Loans

1. Credit card debt
2. Personal loans
3. Bank overdrafts
4. Corporate bonds

Personal finance

Personal finance is the application of the principles of finance to the monetary decisions of an individual or family unit. It addresses the ways in which individuals or families obtain, budget, save and spend monetary resources over time, taking into account various financial risks and future life events. Components of personal finance might include checking and savings accounts, credit cards and consumer loans, investments in the stock market, retirement plans, social security benefits, insurance policies, and income tax management. Personal Finance is a parameter driven product for catering to the needs of the general public belonging to different segments. One can avail unlimited opportunities through Bank's Personal Finance. With unmatched finance features in terms of loan amount, payback period and most affordable monthly installments, Bank's Personal Finance makes sure that one gets the most out of his/her loan. Once a good credit history is established, the door to opportunity opens much wider.

Mortgage Finance

Offers the convenience of owning a house of choice, while living in it at its rental value. The installment plan has carefully designed to suit both the budget & accommodation requirements. It has been designed for enhancing financing facility initially for employees of corporate companies for purchase/ construction/ renovation of house.

Business Finance

In pursuance of the National objectives to revive the economy of the country, Bank is providing loans to small and medium size business enterprises under Bank's Business Finance Scheme. Goal is to offer a loan, which enables business community to receive the financing required by them based on their cash flows. Valued customers can enjoy the convenience of getting financing on attractive terms with the minimum processing turnaround time.

ROLE OF COMMERCIAL BANKS IN MICRO FINANCE SECTOR

Microfinance in its broadest terms can be defined as provision of a range of financial services such as deposits, loans, payment services, money transfers and insurance to poor and low income households, and their micro enterprises (**Source: Asian Development bank report on microfinance development strategy**). While a commercial bank is a financial institution that offers a broad range of deposit accounts, including checking, savings, and time deposits, and extends loans to individuals and businesses.

The decision as to whether the commercial banks be involved in microfinance is a sensitive and debatable issue which requires a deep analysis of many factors.

Primarily, the microfinance customers are large in number, scattered in far-flung areas with very minute transaction sizes. Only government or state bank alone cannot reach out to millions of potential Microfinance beneficiaries; a whole well knitted network with almost doorstep reach is required, which is only possible when the commercial banks will be involved in microfinance. In Pakistan it is estimated that as many as 5.6 million households need microfinance services but these services reach only to less than 1 percent, most probably because of the absence of commercial banks from the microfinance sector. (**Source: Pakistan microfinance Network PMN**) This way a poor person just need to visit his local commercial bank to get access to microfinance benefits, which will help reduce many economic problems.

One criticism over involving the commercial banks in microfinance is that commercial banks will charge higher interest rates, further lower the standard of living and will exploit the public. The ground realities are totally different; empirical evidence has demonstrated that participants in microfinance programs have improved their living standards at both the individual and household level, and that this has provided increased educational opportunities for children. For example, the clients of the Bangladesh Rural Advancement Committee increased household expenditures by 28% and assets by 112%. It was also demonstrated that Bangladeshi children were sent to school in larger numbers and stayed for a longer time – almost all girls in Grameen Bank (A commercial bank!) client households had some schooling, compared with the rate of 60% in non-client households. (**Source: World Bank group, 30 August 2005**) No doubt on the other hand the loans provided by the commercial banks to the microfinance beneficiaries are a bit expensive, its not to discourage the poor but there is a sound reason behind it; Providing financial services to poor people is quite expensive, especially in relation to the size of the transactions involved. A \$100 dollar loan, for example, requires the same personnel and resources as a \$2,000 one thus increasing per unit transaction costs. Loan officers must visit the client's home or place of work, evaluate creditworthiness on the basis of interviews with the client's family and references, and in many cases, follow through with visits to reinforce the repayment culture. It can easily cost US\$25 to make a micro loan. While that might not seem unreasonable in absolute terms, it might represent 25% of the value of the loan amount, and force the institution to charge a “high” rate of interest to cover its cost of loan administration.

If commercial banks are to be involved in the micro finance by no means it would be a wrong decision for them as regard to their primary aim, profitability. Yes it can. Data from the Micro Banking Bulletin reports that 63 of the world's top MFIs had an average rate of return, after adjusting for inflation and after taking out subsidies programs might have received, of about 2.5% of total assets. This compares favorably with returns in the commercial banking sector and gives credence to the hope of many that microfinance can be sufficiently attractive to mainstream into the retail banking sector. Many feel that once

microfinance becomes mainstreamed, massive growth in the numbers of clients can be achieved.

According to a recent analysis conducted by the Consultative Group to Assist the Poor (CGAP), the compound annual growth rate of the world's leading microfinance providers over the last five years has been a whopping 15%. Worldwide, these leading Microfinance institutions are nearly twice as profitable as the leading commercial banks. The trend is not new. In fact, in the last decade, microfinance has been a more stable business than commercial banking in emerging markets. During Indonesia's 1997 financial crisis, for example, commercial bank portfolios imploded, but loan repayment among Bank Rakyat Indonesia's three million-plus micro-borrowers barely declined at all. During the more recent Bolivian and Colombian banking crises, microfinance portfolios suffered slightly, but remained substantially healthier than commercial bank portfolios, and the microfinance institutions remained more profitable. *(Source: The banker, 04 July 2005)*

There are 70million savings and loan accounts in the world in micro finance sector and about 80 percent of these accounts are savings rather than loans, suggesting that poor entrepreneurs often have to save to accumulate capital for investment rather than the faster if higher-route of borrowing it. Thus it's absolutely favorable for the commercial banks to operate in the micro finance sector. For example in India ICICI bank, which has a large network of local branches, entered the micro finance market in 2001 and increased its portfolio from US \$16m to US \$63m in two years. *(Source: Financial Times, 14 September 2005)*

I see the commercial banks in micro finance in action, independently...without any government back, mandate or subsidy.

On the whole microfinance is not an area commercial banks want to overtake. The majority of commercial banks that undertook microfinance lending were because it was required of them by their governments. Research findings came from in-depth interviews with over 40 bankers in 22 banks in India, the Philippines and Australia, and from speaking with 17 other banks in the other seven countries covered in the study. A great deal of microfinance undertaken by commercial banks was found, but it was undertaken because of government mandates to lend to this sector rather than for business reasons.

(Source: The Role of Commercial Banks in Microfinance: Asia-Pacific Region Ruth Goodwin-Groen, 1998)

The involvement of commercial banks in micro finance is important because all those micro finance programs, which were directly run or backed by the government, faced a total failure. Sustainability and scale in microfinance by commercial banks were only found in the market-based programs when assessed on the basis of achieving both high portfolio quality and significant scale of outreach to the poor, most of the commercial bank microfinance programs that were mandated by governments can only be considered as failures. The exceptions were those programs that charged a commercial rate of interest. They had a higher portfolio quality than other programs but they were still not profitable. This almost universal failure is not explained by the different policy contexts across the Asia-Pacific region. Further, because microfinance has not been a profitable business, government mandates have been unsuccessful in encouraging commercial banks to become involved in microfinance. The banks must have the incentive to design better products for micro entrepreneurs, which can be profitable.

A real world example of a successful micro finance commercial bank is of BRI's Unit Desa system (its microfinance arm) has the best financial results of any microfinance institution in the world. In 1996-97 it earned a profit of \$170 million on loans of \$1.7 billion to 2.5 million clients, with no subsidies. This is an approximate return on performing assets of 10 per cent – a very competitive rate by commercial standards. The success of BRI's Unit Desa systems can be attributed primarily to the fact that the system has adhered to the fundamentals of banking and finance for the rural micro entrepreneurs, including the provision of competitive savings services. The microfinance savings and loans of the Unit Desa system perform consistently for BRI and continue to grow quickly. BRI's microfinance business may not compete with the most spectacular returns, but it does achieve these strategic goals. **(Source: *The Role of Commercial Banks in Microfinance: Asia-Pacific Region* Ruth Goodwin-Groen, 1998)**

The types of commercial bank involvement in microfinance can be classified as; government-subsidized lending programs channeled through the banks, government mandated lending targets met by banks subsidizing interest rates, government-mandated lending targets with banks charging commercial interest rates and microfinance as a profitable business. Only the last one “micro finance as a profitable business” has seen success. Thus the involvement of commercial banks in micro finance sector should not be based on any government mandate, subsidy or target. The sole benefit of the society as well as commercial banks is the adoption of micro finance as a business. **(Source: *The Role of Commercial Banks in Microfinance: Asia-Pacific Region* Ruth Goodwin-Groen, 1998)**

Involving commercial banks in micro finance would be a step to take these services at the doorstep of the potential customer, because if only some government agency or state bank is involved the extensiveness as regard to area covered cannot be brought.

On the other hand commercial banks need not to make any special arrangements to cater for micro finance operations. Only a new “micro finance” counter might be needed in the existing branches. Thus there would be no high setup cost for the commercial banks to venture into this sector.

In short I see micro finance as a very promising sector for commercial banks and on the other hand simultaneously it would help the standard of living to rise; and attached with it the literacy rate, employment level, socio-economic development would also take place.

Mutual funds

What are mutual funds?

An investment vehicle which is comprised of a pool of funds collected from many investors for the purpose of investing in securities such as stocks, bonds, money market securities, and similar assets. Mutual funds are operated by money managers, who invest the fund's capital and attempt to produce capital gains and income for the fund's investors. A mutual fund's portfolio is structured and maintained to match the investment objectives stated in its prospectus.

In business encyclopedia

Mutual funds belong to a group of financial intermediaries known as investment companies, which are in the business of collecting funds from investors and pooling them for the purpose of building a portfolio of securities according to stated objectives. They are also known as open-end investment companies. Other members of the group are closed-end investment companies (also known as closed-end funds) and unit investment trusts. In the United States, investment companies are regulated by the Securities and Exchange Commission under the Investment Company Act of 1940.

Mutual funds are generally organized as corporations or trusts, and, as such, they have a board of directors or trustees elected by the shareholders. Almost all aspects of their operations are externally managed. They engage a management company to manage the investment for a fee, generally based on a percentage of the fund's average net assets during the year. The management company may be an affiliated organization or an independent contractor. They sell their shares to investors either directly or through other firms such as broker-dealers, financial planners, employees of insurance companies, and banks. Even the day-to-day administration of a fund is carried out by an outsider, which may be the management company or an unaffiliated third party.

The management company is responsible for selecting an investment portfolio that is consistent with the objectives of the fund as stated in its prospectus and managing the portfolio in the best interest of the shareholders. The directors of the fund are responsible for overall governance of the fund; they are expected to establish procedures and review the performance of the management company and others who perform services for the fund.

Mutual funds are known as open-end investment companies because they are required to issue shares and redeem (buy back) outstanding shares upon demand. Closed-end funds, on the other hand, issue a certain number of shares but do not stand ready to buy back their own shares from investors. Their shares are traded on an exchange or in the over-the-counter market. They cannot increase or decrease their outstanding shares easily. A feature common of both mutual funds and closed-end funds is that they are managed investment companies, because they can change the composition of their portfolios by adding and deleting securities and altering the amount invested in each security. Unit investment trusts are not managed investment companies like the mutual funds because their portfolio consists of a fixed set of securities for life. They stand ready, however, to buy back their shares.

History of Mutual Funds

Massachusetts Investors Trust was founded on **March 21, 1924**, and, after one year, had **200 shareholders** and **\$392,000** in **assets**. The entire industry, which included a few closed-end funds, represented less than \$10 million in 1924.

The stock market crash of 1929 slowed the growth of mutual funds. In response to the stock market crash, Congress passed the Securities Act of 1933 and the Securities Exchange Act of 1934. These laws require that a fund be registered with the Securities and Exchange Commission (SEC) and provide prospective investors with a prospectus that contains required disclosures about the fund, the securities themselves, and fund manager. The SEC helped draft the Investment Company Act of 1940, which sets forth the guidelines with which all SEC-registered funds today must comply.

With renewed confidence in the stock market, mutual funds began to blossom. By the end of the 1960s, there were approximately 270 funds with \$48 billion in assets. The first retail index fund, the First Index Investment Trust, was formed in 1976 and headed by John Bogle, who conceptualized many of the key tenets of the industry in his 1951 senior thesis at Princeton University. It is now called the Vanguard 500 Index Fund and is one of the largest mutual funds ever with in excess of \$100 billion in assets.

One of the largest contributors of mutual fund growth was individual retirement account (IRA) provisions added to the Internal Revenue Code in 1975, allowing individuals (including those already in corporate pension plans) to contribute \$2,000 a year. Mutual funds are now popular in employer-sponsored defined contribution retirement plans (401(k)s), IRAs and Roth IRAs.

As of April 2006, there are 8,606 mutual funds that belong to the Investment Company Institute (ICI), the national association of investment companies in the United States, with combined assets of \$9.207 trillion.

Types of international mutual funds

◆ Open-end fund

The term ***mutual fund*** is the common name for an open-end investment company. Being open-ended means that, at the end of every day, the fund issues new shares to investors, and buys back shares from investors wishing to leave the fund.

Mutual funds may be legally structured as corporations or business trusts but in either instance are classed as *open-end investment companies* by the SEC.

Other funds have a limited number of shares; these are either closed-end funds or unit investment trusts, neither of which a mutual fund is.

◆ Exchange-traded funds

A relatively new innovation, the exchange traded fund (ETF), is often formulated as an open-end investment company. ETFs combine characteristics of both mutual funds and closed-end funds. An ETF usually tracks a stock index (see Index funds). Shares are issued or redeemed by institutional investors in large blocks (typically of 50,000). Investors typically purchase shares in small quantities through brokers at a small premium or discount to the net asset value; this is how the institutional investor makes its profit. Because the institutional investors handle the majority of trades, ETFs are more efficient than traditional mutual funds (which are continuously issuing new securities and redeeming old ones, keeping detailed records of such issuance and redemption transactions, and, to effect such

transactions, continually buying and selling securities and maintaining liquidity position) and therefore tend to have lower expenses. ETFs are traded throughout the day on a stock exchange, just like closed-end funds.

Exchange traded funds are also valuable for foreign investors who are often able to buy and sell securities traded on a stock market, but who, for regulatory reasons, are unable to participate in traditional US mutual funds.

◆ Equity funds

Equity funds, which consist mainly of stock investments, are the most common type of mutual fund. Equity funds hold 50 percent of all amounts invested in mutual funds in the United States. Often equity funds focus investments on particular strategies and certain types of issuers.

◆ Bond funds

Bond funds account for 18% of mutual fund assets. Types of bond funds include term funds, which have a fixed set of time (short-, medium-, or long-term) before they mature. Municipal bond funds generally have lower returns, but have tax advantages and lower risk. High-yield bond funds invest in corporate bonds, including high-yield or junk bonds. With the potential for high yield, these bonds also come with greater risk.

◆ Money market funds

Money market funds hold 26% of mutual fund assets in the United States. Money market funds entail the least risk, as well as lower rates of return. Unlike certificates of deposit (CDs), money market shares are liquid and redeemable at any time. The interest rate quoted by money market funds is known as the 7 Day SEC Yield.

◆ Funds of funds

Funds of funds (FoF) are mutual funds which invest in other underlying mutual funds (i.e., they are funds comprised of other funds). The funds at the underlying level are typically funds which an investor can invest in individually. A fund of funds will typically charge a management fee which is smaller than that of a normal fund because it is considered a fee charged for asset allocation services. The fees charged at the underlying fund level do not pass through the statement of operations, but are usually disclosed in the fund's annual report, prospectus, or statement of additional information. The fund should be evaluated on the combination of the fund-level expenses and underlying fund expenses, as these both reduce the return to the investor.

Most FoFs invest in affiliated funds (i.e., mutual funds managed by the same advisor), although some invest in funds managed by other (unaffiliated) advisors. The cost associated with investing in an unaffiliated underlying fund is most often higher than investing in an affiliated underlying because of the investment management research involved in investing in fund advised by a different advisor. Recently, FoFs have been classified into those that are actively managed (in which the investment advisor reallocates frequently among the underlying funds in order to adjust to changing market conditions) and those that are passively managed (the investment advisor allocates assets on the basis of on an allocation model which is rebalanced on a regular basis).

The design of FoFs is structured in such a way as to provide a ready mix of mutual funds for investors who are unable to or unwilling to determine their own asset allocation model. Fund companies such as TIAA-CREF, Vanguard, and Fidelity have also entered this market to provide investors with these options and take the "guess work" out of selecting funds. The allocation mixes usually vary by the time the investor would like to retire: 2020, 2030, 2050, etc. The more distant the target retirement date, the more aggressive the asset mix.

◆ Hedge funds

Hedge funds in the United States are pooled investment funds with loose SEC regulation and should **not** be confused with mutual funds. Certain hedge funds are required to register with SEC as investment advisers under the Investment Advisers Act. The Act does not require an adviser to follow or avoid any particular investment strategies, nor does it require or prohibit specific investments. Hedge funds typically charge a management fee of 1% or more, plus a "performance fee" of 20% of the hedge fund's profit. There may be a "lock-up" period, during which an investor cannot cash in shares.

Usage of Mutual Funds

Mutual funds can invest in many different kinds of securities. The most common are cash, stock, and bonds, but there are hundreds of sub-categories. Stock funds, for instance, can invest primarily in the shares of a particular industry, such as technology or utilities. These are known as sector funds. Bond funds can vary according to risk (e.g., high-yield or junk bonds, investment-grade corporate bonds), type of issuers (e.g., government agencies, corporations, or municipalities), or maturity of the bonds (short- or long-term). Both stock and bond funds can invest in primarily U.S. securities (domestic funds), both U.S. and foreign securities (global funds), or primarily foreign securities (international funds).

Most mutual funds' investment portfolios are continually adjusted under the supervision of a professional manager, who forecasts the future performance of investments appropriate for the fund and chooses those which he or she believes will most closely match the fund's stated investment objective. A mutual fund is administered through a parent management company, which may hire or fire fund managers.

Mutual funds are liable to a special set of regulatory, accounting, and tax rules. Unlike most other types of business entities, they are not taxed on their income as long as they distribute substantially all of it to their shareholders. Also, the type of income they earn is often unchanged as it passes through to the shareholders. Mutual fund distributions of tax-free municipal bond income are also tax-free to the shareholder. Taxable distributions can be either ordinary income or capital gains, depending on how the fund earned those distributions.

Mutual funds vs. other investments

Mutual funds offer several advantages over investing in individual stocks. For example, the transaction costs are divided among all the mutual fund shareholders, who also benefit by having a third party (professional fund managers) apply their expertise, dedicate their time to manage and research investment options. However, despite the professional management, mutual funds are not immune to risks. They share the same risks associated with the investments made. If the fund invests primarily in stocks, it is usually subject to the same ups and downs and risks as the stock market.

Share classes

Many mutual funds offer more than one class of shares. For example, you may have seen a fund that offers "Class A" and "Class B" shares. Each class will invest in the same pool (or investment portfolio) of securities and will have the same investment objectives and policies. But each class will have different shareholder services and/or distribution arrangements with different fees and expenses. These differences are supposed to reflect different costs involved in servicing investors in various classes; for example, one class may be sold through brokers with a front-end load, and another class may be sold direct to the public with no load but a "12b-1 fee" included in the class's expenses (sometimes referred to as "Class C" shares). Still a third class might have a minimum investment of \$10,000,000 and be available only to financial institutions (a so-called "institutional" share class). In some cases, by aggregating regular investments made by many individuals, a retirement plan (such as a 401(k) plan) may qualify to purchase "institutional" shares (and gain the benefit of their typically lower expense ratios) even though no members of the plan would qualify individually. As a result, each class will likely have different performance results.

A multi-class structure offers investors the ability to select a fee and expense structure that is most appropriate for their investment goals (including the length of time that they expect to remain invested in the fund).

Lecture # 23

Mutual Funds**Criticism of managed mutual funds**

Historically, only a small percentage of actively managed mutual funds, over long periods of time, have returned as much, or more than comparable index mutual funds. This, of course, is a criticism of one type of mutual fund over another.

- Another criticism concerns sales commissions on load funds, an upfront or deferred fee as high as 8.5 percent of the amount invested in a fund (although the average up-front load is no more than 5% normally). *(Mutual Funds have to qualify to charge the maximum allowed by law, which is 8.5% and most of them DO NOT qualify for this.)
- In addition, no-load funds typically charge a 12b-1 fee in order to pay for shelf space on the exchange the investor uses for purchase of the fund, but they do not pay a load directly to a mutual fund broker, who sells it.
- Critics point out those high sales commissions can sometimes represent a conflict of interest, as high commissions benefit the sales people but hurt the investors. Although in reality, "A shares", which appear to have the highest up front load, (around 5%) are the "cheapest" for the investor, if the investor is planning on 1) keeping the fund for more than 5 years, 2) investing more than 100,000 in one fund family, which likely will qualify them for "break points", which is a form of discount, or 3) staying with that "fund family" for more than 5 years, but switching "funds" within the same fund company. In this case, the up front load is best for the client, and at times "outperforms" the "no load" or "B or C shares".
- High commissions can sometimes cause sales people to recommend funds that maximize their income. This can be easily solved, buy working with a "registered investment advisor" instead of a "broker", where the investment advisor can charge strictly for advise, and not charge a "load, or commission" for their work, at all.

This is a discussion of criticism, and solutions regarding one mutual fund over another. 12b-1 fees, which are found on most "no load funds", can motivate the fund company to focus on advertising to attract more and more new investors, as new investors would also cause the fund assets to increase, thus increasing the amount of money that the mutual fund managers make.

Mutual fund managers and companies need to disclose by law, if they have a conflict of interest due to the way they are paid. In particular fund managers may be encouraged to take more risks with investor's money than they ought to: Fund flows (and therefore compensation) towards successful, market beating funds are much larger than outflows from funds that lose to the market. Fund managers may therefore have an incentive to purchase high risk investments in the hopes of increasing their odds of beating the market and receiving the high inflows, with relatively less fear of the consequences of losing to the market.

Many analysts, however, believe that the larger the pool of money one works with, the harder it is to manage actively, and the harder it is to squeeze good performance out of it. This is true, due to the fact that there are only so many companies that one can identify to put the money into (buy shares of) that fit with the "style" of the mutual fund, due to what is disclosed in the prospectus. Thus some fund companies can be focused on attracting new customers, and forget to "close" their mutual funds to new customers, when they get too big, to invest the assets properly, thereby hurting its existing investors' performance. A great deal of a fund's costs is flat and fixed costs, such as the salary for the manager. Thus it can

be more profitable for the fund to try to allow it to grow as large as possible, instead of limiting its assets. Most fund companies have closed some funds to new investors to maintain the integrity of the funds for existing investors. If the funds reach more than 1 billion dollars, many times, these funds, have gotten too large, before they are closed, and when this happens, the funds tend to not have a place to put the money and can and tend to lose value.

Other criticisms of mutual funds are that some funds illegally are guilty of market timing (although many fund companies tightly control this) and that some fund managers, also illegal, accept extravagant gifts in exchange for trading stocks through certain investment banks, which presumably charge the fund more for transactions than would non-gifting investment bank. This practice, although done, is completely illegal. As a result, all fund companies strictly limit -- or completely bar -- such gifts.

Scandals of mutual funds

In September 2003, the United States mutual fund industry was beset by a scandal in which several major fund companies permitted and facilitated "late trading" and "market timing".

Mutual-fund families in the United States

A family of mutual funds is a group of funds that are marketed under one or more brand names, usually having the same distributor (the company which handles selling and redeeming shares of the fund in transactions with investors), and investment advisor (which is usually a corporate cousin of the distributor).

There are several hundred families of registered mutual funds in the United States, some with a single fund and others offering dozens. Many fund families are units of a larger financial services company such as an asset manager, bank, brokerages, or insurance company. Additionally, multiple funds in a family can be part of the same corporate structure; that is, one underlying corporation or business trust may divide itself into more than one fund, each of which issues shares separately.

Mutual Funds in Pakistan

Mutual Funds were introduced in Pakistan in 1962, with the public offering of National Investment (Unit) Trust (NIT) which is an open-end mutual fund in the public sector. This was followed by the establishment of the Investment Corporation of Pakistan (ICP) in 1966, which subsequently offered a series of closed-end mutual funds. Up to date, twenty six (26) closed-end ICP mutual funds have been floated. Initially there was both public and private sector participation in the management of these funds, but with the nationalization in the seventies, the government role become more dominant and today these mutual funds are totally in the public sector. Later, the government also allowed the private sector to establish mutual funds. Currently there exists one open-ended and eleven closed-ended mutual funds under private sector management.

Rules Govern Mutual Funds in Pakistan

There are two rules govern mutual funds in Pakistan, which are:

- Investment Companies and Investment Advisors' Rules, 1971. (govern closed-end mutual funds)
- Asset Management Companies Rules, 1995. (govern open-ended mutual funds)

These rules however only apply to private sector operated mutual funds and are not applicable to NIT and ICP mutual funds.

Money Market Fund

We begin with a discussion of money market funds for several reasons:

1. They are the safest for the trainee investor;
2. They are the easiest, least complicated to follow and understand;
3. Almost without exception, every mutual fund investment company offers money market funds;
4. Money market funds represent an indispensable investment tool for the beginning investor.
5. They are the most basic and conservative of all the mutual funds available;

Money market funds should be considered by investors seeking stability of principal, total liquidity, and earnings that are as high, or higher, than that Available through bank certificates of deposit. And unlike bank cash deposits, money market funds have no early withdrawal penalties.

Specifically, a money market fund is a mutual fund that invests its assets only in the most liquid of money instruments. The portfolio seeks stability by investing in very short-term, interest-bearing instruments issued by the state and local governments, banks, and large corporations. The money invested is a loan to these agencies, and the length of the loan might range from overnight to one week or, in some cases, as long as 90 days. These debt certificates are called "money market instruments"; because they can be converted into cash so readily, they are considered the equivalent of cash.

To understand why money market mutual funds is recommended as an ideal investment, let me reemphasize just seven of the advantages they offer:

1. Safety of principal, through diversification and stability of the short-term portfolio investments
2. Total and immediate liquidity, by telephone or letter
3. Better yields than offered by banks, 1% to 3% higher
4. Low minimum investment, some as low as \$100
5. Professional management, proven expertise
6. Generally, no purchase or redemption fees, no-load funds

Income Funds

The objective of income mutual funds is to seek a high level of current income commensurate with each portfolio's risk potential. In other words, the greater the risk, the greater the potential for generous income yields; but the greater the risk of principal loss as well.

The risk / reward potential are low to high, depending upon the type of securities that make up the fund's portfolio. The risk is very low when the fund is invested in government obligations, blue chip corporations, and short-term agency securities. The risk is high when a fund seeks higher yields by investing in long-term corporate bonds, offered by new, undercapitalized, risky companies.

Who should invest in income funds?

- Investors seeking current income higher than money market rates, who are willing to accept moderate price fluctuations
- Investors willing to "balance" their equity (stock) portfolios with a fixed income investment
- Investors who want a portfolio of taxable bonds with differing maturity dates
- Investors interested in receiving periodic income on a regular basis

Income and Growth Funds

The primary purposes of income and growth funds are to provide a steady source of income and moderate growth. Such funds are ideal for retirees needing a supplement source of income without forsaking growth entirely.

Growth and Income Funds

The primary objectives of growth and income funds are to seek long-term growth of principal and reasonable current income. By investing in a portfolio of stocks believed to offer growth potential plus market or above - market dividend income, the fund expects to investors seeking growth of capital and moderate income over the long term (at least five years) would consider growth and income funds. Such funds require that the investor be willing to accepts some share-price volatility, but less than found in pure growth funds

Lecture # 24

Mutual Funds**Balanced Funds**

The basic objectives of balanced funds are to generate income as well as long-term growth of principal. These funds generally have portfolios consisting of bonds, preferred stocks, and common stocks. They have fairly limited price rise potential, but do have a high degree of safety, and moderate to high income potential.

Investors who desire a fund with a combination of securities in a single portfolio, and who seek some current income and moderate growth with low-level risk, would do well to invest in balanced mutual funds. Balanced funds, by and large, do not differ greatly from the growth and income funds described above.

Growth Funds

Growth funds are offered by every investment company. The primary objective of such funds is to seek long-term appreciation (growth of capital). The secondary objective is to make one's capital investment grow faster than the rate of inflation. Dividend income is considered an incidental objective of growth funds.

Growth funds are best suited for investors interested primarily in seeing their principal grow and are therefore to be considered as long-term investments - held for at least three to five years. Jumping in and out of growth funds tends to defeat their purpose. However, if the fund has not shown substantial growth over a three - to five-year period, sell it (redeem your shares) and seek a growth fund with another investment company. Candidates likely to participate in growth funds are those willing to accept moderate to high risk in order to attain growth of their capital and those investors who characterize their investment temperament as "fairly aggressive.

Index Funds

The intent of an index fund is basically to track the performance of the stock market. If the overall market advances, a good index fund follows the rise. When the market declines, so will be the index fund. Index funds' portfolios consist of securities listed on the popular stock market indices.

It is also the intent of an index fund to materially reduce expenses by eliminating the fund portfolio manager. Instead, the fund merely purchases a group of stocks that make up the particular index it deems the best to follow. The stocks in an index fund portfolio rarely change and are weighted the same way as its particular market index. Thus, there is no need for a portfolio manager. The securities in an index mutual fund are identical to those listed by the index it tracks, thus, there is little or no need for any great turnover of the portfolio of securities. The funds are "passively managed" in a fairly static portfolio. An index fund is always fully invested in the securities of the index it tracks.

An index mutual fund may never outperform the market but it should not lag far behind it either. The reduction of administrative cost in the management of an index fund also adds to its profitability

Sector Funds

As was discussed earlier, most mutual funds have fairly broad-based, diversified portfolios. In the case of sector funds, however, the portfolios consist of investment from only one

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sector of the economy. Sector funds concentrate in one specific market segment; for example, energy, transportation, precious metals, health sciences, utilities, leisure industries, etc. In other words, they are very narrowly based.

Investors in sector funds must be prepared to accept the rather high level of risk inherent in funds that are not particularly diversified. Any measure of diversification that may exist in sector funds is attained through a variety of securities, albeit in the same market sector. Substantial profits are attainable by investors astute enough to identify which market sector is ripe for growth - not always an easy task.

Specialized Funds

Specialized funds resemble sector funds in most respects. The major difference is the type of securities that make up the fund's portfolio. For example, the portfolio may consist of common stocks only, foreign securities only, bonds only, new stock issues only, over - the - counter securities only, and so on.

Those who are still novices in the investment arena should avoid both specialized and sector funds or the time being and concentrate on the more traditional, diversified mutual funds instead

Islamic Funds

In case of Islamic Funds, the investment made in different instruments is to be in line with the Islamic Shairah Rules. The Fund is generally to be governed by an Islamic Shariah Board. And then there is a purification process that needs to be followed, as some of the money lying in reserve may gain interest, which is not desirable in case of Islamic investments.

Risks in Mutual Fund Investing

There is some degree of risk in every investment. Although it is reduced considerably in mutual fund investing. Do not let the specter of risk stop you from becoming a mutual fund investor. However, it behaves all investors to determine for them the degree of risk they are willing to accept in order to meet their objectives before making a purchase. Knowing of potential risks in advance will help you avoid situations in which you would not be comfortable. Understanding the risk levels of the various types of mutual funds at the outset will help you avoid the stress that might result from a thoughtless or a hasty purchase.

Let us now examine the risk levels of the various types of mutual funds.

- Low Level Risks
- Moderate level Risks
- High Level Risks

Measuring Risks

LOW-LEVEL RISKS

Mutual funds characterized as low-level risks fall into here categories

1. Money market funds
2. Treasury bill funds
3. Insured bond funds

MODERATE-LEVEL RISKS

Mutual funds considered moderate-risk investments may be found in at least the eight types categorized below.

1. Income funds
2. Balanced funds
3. Growth and income funds
4. Growth funds
5. Short-term bond funds (taxable and tax-free)
6. Intermediate bond funds (taxable and tax-free)
7. Insured government/municipal bond funds
8. Index funds.

HIGH-LEVEL RISKS

The types of funds listed below have the potential for high gain, but all have high risk levels as well.

1. Aggressive growth funds
2. International funds
3. Sector funds
4. Specialized funds
5. Precious metals funds
6. high-yield bond funds (taxable and tax-free)
7. Commodity funds
8. Option funds

MEASURING RISK

As you become a more experienced investor, you may want to examine other, more technical, measures to determine risk factors in your choice of funds.

Beta coefficient is a measure of the fund's risk relative to the overall market. For example, a fund with a beta coefficient of 2.0 means that it is likely to move twice as fast as the general market – both up and down. High beta coefficients and high risk go hand in hand.

Alpha coefficient is a comparison of a fund's risk (beta) to its performance. A positive alpha is good. For example, an alpha of 10.5 means that the fund manager earned an average of 10.5% more each year than might be expected, given the fund's beta.

Interest rates and inflation rates are other factors that can be used to measure investment risks. For instance, when interest rates are going up, bond funds will usually be declining, and vice versa. The rate of inflation has a decided effect on funds that are sensitive to inflation factors; for example, funds that have large holdings in automaker stocks, real estate securities, and the like will be adversely affected by inflationary cycles.

R-Square factor is a measure of the fund's risk as related to its degree of diversification.

The information is supplied here merely to acquaint you with the terminology in the event you should wish to delve more deeply into complex risk factors. The more common risk factors previously described are all you really need to know for now, and perhaps for years to come.

Mutual Funds

Cost of Ownership

1. Management Fee

All mutual funds, including no-load funds, have certain fixed expenses that are built into their per share net asset value. These expenses are the actual costs of doing business.

They are deducted from the assets of the fund. It is advisable to check the prospectus to determine the percentage of the fund's total net assets that is paid out for expenses.

Additionally, shareholder services provided by the fund, investment adviser's fees, bank custodian fees, and fund underwriter costs also come out of the fund's assets. These charges vary from fund to fund; however, they are clearly spelled out in the prospectus.

On a per-share basis, however, management expenses are usually quite small, because they are spread over the tens of thousands, or the millions, of shareholders in the fund.

The formula for determining the cost of a fund's management expenses is simple: From the current value of the fund's total assets subtract liabilities and expenses, and divide the result by the number of outstanding shares. The fund's prospectus and /or annual reports often provide this data. Management fees and expenses are usually expressed as a ratio of expenses paid out to total assets. Generally, the prospectus will show these expense ratios.

2. Redemption Fee

All load funds levy a sales charge when purchasing shares. Some load and some no-load funds also charge a redemption fee when you take money out (redeem shares). The redemption fee is a percentage of the amount redeemed, usually 0.05% (1/2 of 1%).

Avoid funds with redemption fees. There are excellent funds available that will meet your objectives and do not levy redemption fees.

Generally redemption fees are levied only with the intent to cut down on the number of redemptions the fund experiences. The bottom line is that you are entitled to the full value of the shares you redeem.

3. Switching Fee

Most, if not all, open-end mutual funds permit you to transfer all or any part of your investment from one fund to another fund within its family. This kind of transfer is commonly called "switching".

For many years there was no charge required switching funds. In recent years, however, some funds have started to charge for switching. It is usually a flat fee. The few funds that

are charging the investor for this service say it is to discourage too frequent moving in and out of funds. Constant switching of funds increases the administrative costs involved in keeping track of customer accounts made.

4. Maintenance Fee

Be on the lookout for a fee that is being assessed against the shareholder's account(s) directly. It is called an "account maintenance" fee. According to prospectuses of the funds that levy this fee, it is to "offset the costs of maintaining shareholder accounts."

The fee is deducted from the dividends to cover the maintenance fee, enough shares or fractions of shares will be automatically redeemed from the account to make up the difference.

Avoid funds that charge the investor a separate maintenance fee. The list below shows a list of usual and justifiable fees charged by virtually all mutual funds. Expect to pay these fees; they are minimal and necessary. On the other hand, the other fees about which for which you need to take caution is not, in most cases, justifiable.

Customary Fees Charged by Most Mutual Fund Companies

1. Investment Advisory Fees:

The fund pays a set fee, stated in the prospectus, for investment management. This allows the fund the use of the advisor's investment research staff, equipment, and other resources. Administrative and accounting services, such as data processing, pricing of fund shares, and preparing financial statements, are included in this fee.

2. Transfer Agent Fees:

The fund pays a set fee for each account for maintaining shareholder records and generating shareholder statements, plus answering your phone inquiries and correspondence.

3. Audit Fees and Expenses:

Each fund is audited annually by an internationally recognized, independent accounting firm which is not affiliated with the fund.

4. Custodian Fees and Expenses:

The Fund's assets, represented by stock certificates and other documents, are held by an outside source for safe keeping.

5. Directors' Fees and Expenses:

The Fund's directors are compensated for their time and travel. The Board meets at least quarterly, as a whole and in subcommittees, to review the fund's business. (Directors or officers who are employed by the fund receive no compensation from the fund for serving as directors.)

6. Registration Fee:

The SEC and various state securities agencies charge fees permitting a fun's shares to be sold.

Reports to Shareholders:

Annual, semiannual, and interim reports are printed and mailed to shareholders on a periodic basis.

Investment Fraud

Information is an investor's best tool when it comes to investing wisely and avoiding fraud. And the best way to gather information is to ask questions- about both the investment and the person or firm selling it. It doesn't matter if you are a beginner or have been investing for many years; it's never too early or too late to start asking questions.

Too many investors who've suffered losses at the hands of swindlers could have avoided trouble if they had only asked basic questions from the start.

This section will help you recognize and avoid different types of investment fraud. You'll also learn what questions to ask before investing, where to get information about companies, who to call for help, and what to do if you run into trouble.

Lecture # 26

Mutual Funds**Navigating the Investing Frontier: Where the Frauds Are**

Many fraudsters rely on the telephone to carry out their investment scams. Using a technique known as cold calling (so-called because a caller telephones a person with whom they have not had previous contact), these fraudsters will hound you to buy stocks in small, unknown companies that are highly risky or, sometimes, part of a scam. In recent years, the Internet has also become increasingly attractive to fraudsters because it allows an individual or company to communicate with a large audience without spending a lot of time, effort, or money.

You should be skeptical of any offers you learn about from a cold caller or through the Internet. Here's what you need to know about cold calling and Internet fraud.

Cold calling

For many businesses, including securities firms, cold calling serve as a legitimate way to reach potential customers. Honest brokers use cold calling to find clients for the long term. They ask questions to understand your financial situation and investment goals before recommending that you buy anything.

Dishonest brokers use cold calling to find "quick hits." Some set up "boiler rooms" where high-pressure salespeople use banks of telephones to call as many potential investors as possible. Aggressive cold callers speak from persuasive scripts that include retorts for your every objection. As long as you stay on the phone, they'll keep trying to sell. And they won't let you get a word in edgewise. Our advice is to avoid making any direct investments over the phone.

Internet Fraud

The Internet serves as an excellent tool for investors, allowing them to easily and inexpensively research investment opportunities. But the Internet is also an excellent tool for fraudsters. That's why you should always think twice before you invest your money in any opportunity

you learn about through the Internet. Anyone can reach tens of thousands of people by building an Internet Web site, posting a message on an online message board, entering a discussion in a live "chat" room, or sending mass e-mails. It's easy for fraudsters to make their messages look real and credible. But it's nearly impossible for investors to tell the difference between fact and fiction.

Types of Investment Fraud

The types of investment fraud seen online mirror the frauds perpetrated over the phone or through the mail. Here are the most common investment schemes and the "red flags" you should watch for:

- **The "PUMP and DUMP" rip-off**

It's common to see messages posted on the Internet that urge readers to buy a stock quickly or to sell before the price goes down. Cold callers often call using the same sort of pitch. Often the promoters will claim to have "inside" information about an impending development or an "infallible" combination of economic and stock market data to pick stocks. In reality, they may be insiders or paid promoters who stand to gain by selling their shares after the stock price is pumped up by gullible investors. Once these fraudsters sell their shares and stop hyping the stock, the price typically falls and investors lose their money. Fraudsters frequently use this ploy with small, thinly traded companies because it's easier to manipulate a stock when there's little or no information available about the company.

- **The Pyramid Scheme**

In the classic "pyramid" scheme, participants attempt to make money solely by recruiting new participants into the program. The hallmark of these schemes is the promise of sky-high returns in a short period of time for doing nothing other than handing over your money and getting others to do the same. Money coming in from new recruits is used to pay off early stage investors. But eventually the pyramid will collapse. At some point, the schemes get too big, the promoter cannot raise enough money from new investors to pay earlier investors, and many people lose their money. Table 1 shows how pyramid schemes can become impossible to sustain.

How to Avoid Investment Fraud

To invest wisely and avoid investment scams, research each investment opportunity thoroughly and ask questions. Get the facts before you invest, and only invest money you can afford to lose. You can avoid investment scams by asking-and getting answers to-these three simple questions:

1. Is the investment registered?

Many investment scams involve unregistered securities. So you should always find out whether the company has registered its securities with the SEC or your state securities regulators. You can do this by checking the SEC's website database or by calling SEC. Some smaller companies don't have to register their securities offerings with the SEC, so always make background check and ask for referrals etc.

2. Is the person licensed and law-abiding?

Try and find out whether the person or firm selling the investment is properly licensed and whether they've had run-ins with regulators or received serious complaints from investors. This information may be difficult to get in Pakistan.

3. does the investment sound too good to be true?

If it does, it probably is. High-yield investments tend to involve extremely high risk. Never invest in an opportunity that promises "guaranteed" or "risk-free" returns. Watch out for claims of astronomical yields in a short period of time. Be skeptical of "offshore" or foreign investments. And beware of exotic or unusual sounding investments. Make sure you fully understand the investment before you part with your hard-earned money. Always ask for-

and carefully read the company's prospectus. You should also read the most recent reports the company has filed with its regulators and pay attention to the company's financial statements, particularly if they do not say they have been audited or certified by an accountant.

Mutual Funds - The Logic behind Investing in Them

Mutual funds are investment companies that pool money from investors at large and offer to sell and buy back its shares on a continuous basis and use the capital thus raised to invest in securities of different companies. This article helps you to know in depth on:

- Is it possible to diversify investment if invested in mutual funds?
- Find more on the working of mutual fund
- Know more about the legal aspects in relation to the mutual funds

At the beginning of this millennium, mutual funds outnumbered all the listed securities in New York Stock Exchange. Mutual funds have an upper hand in terms of diversity and liquidity at lower cost in comparison to bonds and stocks. The popularity of mutual funds may be relatively new but not their origin which dates back to 18th century. Holland saw the origination of mutual funds in 1774 as investment trusts before spreading to Anglo-Saxon countries in its current form by 1868. We will discuss now as to what are mutual funds before going on to seeing the advantages of mutual funds. Mutual funds are investment companies that pool money from investors at large and offer to sell and buy back its shares on a continuous basis and use the capital thus raised to invest in securities of different companies. The stocks these mutual funds have are very fluid and are used for buying or redeeming and/or selling shares at a net asset value. Mutual funds possess shares of several companies and receive dividends in lieu of them and the earnings are distributed among the share holders.

Are Mutual Funds Risk Free and what are the Advantages?

One must not forget the fundamentals of investment that no investment is insulated from risk. Then it becomes interesting to answer why mutual funds are so popular. To begin with, we can say mutual funds are relatively risk free in the way they invest and manage the funds. The investment from the pool is well diversified across securities and shares from various sectors. The fundamental understanding behind this is not all corporations and sectors fail to perform at a time. And in the event of a security of a corporation or a whole sector doing badly then the possible losses from that would be balanced by the returns from other shares. This logic has seen the mutual funds to be perceived as risk free investments in the market. Yes, this is not entirely untrue if one takes a look at performances of various mutual funds. This relative freedom from risk is in addition to a couple of advantages mutual funds carry with them. So, if you are a retail investor and planning an investment in securities, you will certainly want to consider the advantages of investing in mutual funds.

- Lowest per unit investment in almost all the cases
- Your investment will be diversified
- Your investment will be managed by professional money managers.

There is no one method of classifying mutual funds risk free or advantageous. However we can do the same by way of classifying mutual funds as per their functioning and the type of funds they offer to investors. This Course makes you aware on:

- What are the reasons that make the close ended mutual funds more attractive?
- What are the factors that determine the prices of exchange traded funds?
- Find out the features of open ended mutual funds

Lecture # 27

Mutual Funds**Investing In International Mutual Funds**

Investing in international mutual funds has two faces:

- First is buying funds from US based companies that buy and manage portfolio in internationally listed stocks/securities. These companies are governed by regulations of SEC (Securities and Exchange Commission)
- Second is buying mutual funds from international non US companies.

A word of caution before investing even in best international mutual funds - Unlike domestic mutual funds investment, international investments entail additional risk factors such as economic and political in addition to risk of FOREX value (simply put: foreign currency exchange value) fluctuations.

Why Should You Invest In International Opportunities?

The number of funds in international investing is on the rise. We can cite a few reasons for this.

- Removal of trade barriers and expanding of economies have sparked off growth in many non-US companies.
- Some of the major industries of the world are dominated by non US companies.
- Over 72% of the world stocks are listed outside US.
- Greater and true diversification and opportunity to capitalize on best overseas companies.

Investing in international mutual funds is gaining popularity for various reasons. Rising political stability merging or opening of borders and currencies are some of the reasons. Vibrant and upcoming economies and non US corporations becoming financially stronger by the day are some of the reasons. In addition you get true diversification, balance and opportunities.

Best guide for selecting the right mutual funds

Selecting best mutual funds mean a lot more than deciding by indices and their past performances. However, you need to remember one thing that there is no quick gratification in investments of any kind. This article tells you regarding:

- How can you select a mutual fund for investment?
- Is it important to pick up companies that are performing above average?
- Is it advisable to compare mutual funds across category?

When your investment purpose is for saving for retirement, then risk minimization should be your mantra. And one of the best avenues for you to invest now is mutual funds as they have an average of 50 stocks in each portfolio for diversification and cushioning the risks.

Selecting best mutual funds mean a lot more than deciding by indices and their past performances. However, you need to remember one thing that there is no quick gratification in investments of any kind.

Let us discuss the dos and don'ts of selecting the best mutual funds. These points should serve as guidelines for making decision on whether your pick is among the best in the industry or not.

Dos in Selecting the Best Mutual Fund

1. Draw down your investment objective. There are various schemes suitable for different needs. For example retirement plan, capital growth etc. Also get clear about your time frame for investment and returns. Equity funds are not advisable for short term because of their long term nature. You can consider money market and floating rate funds for short term gains. This equals asking - What kind of mutual fund is right for me?
2. Once you have decided on a plan or a couple of them, collect as much information as possible on them from different sources offering them. Funds' prospectus and advisors may help you in this.
3. Pick out companies consistently performing above average. Mutual funds industry indices are helpful in comparing different funds as well as different plans offered by them. Some of the industry standard fund indices are Nasdaq 100, Russel 2000, S&P fund index and DSI index with the latter rating the Socially Responsible Funds only. Also best mutual funds draw good results despite market volatility.
4. Get a clear picture of fees & associated cost, taxes (for non-tax free funds) for all your short listed funds and how they affect your returns. Best mutual funds have lower cost out go.
5. Best mutual funds maximize returns and minimize risks. A number called as Sharpe Ratio explains whether a fund is risk free based on its expected returns compared against a risk free money market fund.
6. Some funds have the advantage of low minimum initial investments. You can start investing even with \$250 a month. This is advisable for building asset bases over a long period with small regular investments.

Best Tips to do an Analysis of Mutual Funds

Before investing in mutual funds a proper analysis is required. While all analyses' efforts are aimed at maximizing returns and minimizing risks, it is the latter that gains importance as the single most fundamental criterion to compare mutual funds. This article makes you aware of:

- How can you do a mutual fund analysis?
- Important is the risk factor analysis?
- Why is it important to track the record of mutual fund companies?

Investing in mutual funds is not a child's play unless one does a mutual funds' analysis. At least it is not as easy as picking top performers going by indices and investing in them. While all analyses' efforts are aimed at maximizing returns and minimizing risks, it is the

latter that gains importance as the single most fundamental criterion to compare mutual funds.

Look At the Portfolio of Your Pick of Funds

Most of the plans will have invested in multiple stocks or securities for diversification. Critical point here is in what proportion they have invested in different stocks. Giving a higher weight-age to a high returning stock leaves less opportunity for broader allocation and may back fire when market is bearish (plummeting steadily). Also higher returning stocks carry high element of risk.

The Optimum Portfolio Size

What should be the optimum portfolio size (assortment investments under one plan) for your pick of fund? Well, opinions are divided about this, but it is crucial to look into the specifics of stock bets and sectors you will be exposed to. Higher exposure to specific sectors may see you loosing out on broad based rallies in the bourses (stock markets). Optimally 65 % to 85% may be allocated in stocks from different sectors for diversification plus growth and the balance being in typical bond and money market instruments.

Is Your Pick of Funds Really Diversified

Notice that the competing plans, though from different fund companies, perform almost on par as if they have a correlation. They indeed have. So, does it mean you have diversified by spreading your money amongst them? Well, think again. Similar plans have similar pattern of their holdings of stocks and with a similar portfolio. This means, in actual effect you are not diversifying. They all go up and down almost as if they do it in tandem. For clear diversification, pick those with different portfolios though they are similar plans (ex: growth, index, or dividend paying etc).

Check Out the Facts before Jumping into Mutual Funds

If you thought for a moment, you will see an enormous growth in mutual fund industry in the United States in recent years. A fact sheet gives you a bounty of information about the fund. It helps you decide on a particular fund and how to tell an ethical mutual fund from a non ethical one. This article covers:

- What are the points that help you in pre-selecting the mutual funds?
- Are the parameters that help you in comparing the performance of the mutual funds?
- What are the points to be analyzed while comparing the risk factors of various mutual funds?

If you thought for a moment, you will see an enormous growth in mutual fund industry in the United States in recent years. This is enticing more individuals to invest either directly or through retirement funds like 401(k) plans (a savings plan for retirement to be funded by the employees and employers in equal proportions. These funds are tax free till they are with drawn and also the contributions are deducted before tax). But come to think of it, for a number of innocent investors, the brochures are just the reminders of their investments. And the case is no different with fact sheets too. They elicit a quick check of their investment necessities, status or the like. In fact it needs to be regarded as a communication of better and more information that concerns the nature of investments the funds make.

The U.S. Securities and Exchange Commission (SEC) has some clause about the need for communicating facts by a fund to all its share holders.

What is a Fact Sheet for Buying Mutual Funds

A fact sheet gives you a bounty of information about the fund. It helps you decide on a particular fund and how to tell an ethical mutual fund from a non ethical one. Given below are some important facts that you should know as an investor in Mutual Funds.

How to Pre-Select a Mutual Fund

Before you zero in for investment, make a short list of funds that are broadly doing well. For doing this assessing following points may help:

- Try to match your financial profile to a fund's characteristics and risk or reward history. Your profile may not permit you to invest in high paying funds if they have a high risk element. Reading the funds' prospectus in detail will give an insight into their portfolio and investment pattern. It is obvious that high returns are almost always associated with risky investments. Any down turn of fortune can see you loosing your principle haplessly.
- Find out whether the fund's investment philosophy satisfies yours. If you have an inclination for social causes or looking for a steady build up of principle without much risk, look for funds that are socially responsible and/or investing in government bonds and T-Bills. Assess whether the fund's costs, fees and loads are too much or in line with your estimation.

You may not need a portfolio of more than 8-10 funds from different companies to sufficiently diversify your fund allocation objectives. This helps you average out and to a certain extent stabilize returns (especially when your objective is regular income). Select specific funds in your chosen categories to meet your needs.

Lecture # 28

Role of Investment Banks**Investment banks**

It helps companies and governments (or their agencies) raise money by issuing and selling securities in the capital markets (both equity and debt).

Almost all investment banks also offer strategic advisory services for mergers, acquisitions, divestiture, or other financial services for clients, such as the trading of derivatives, fixed income, and foreign exchange, commodity, and equity securities.

Trading securities for cash or securities (i.e., facilitating transactions, market-making), or the promotion of securities (i.e., underwriting, research, etc.) is referred to as "sell side."

The "buy side" constitutes the pension funds, mutual funds, hedge funds, and the investing public who consume the products and services of the sell-side in order to maximize their return on investment. Many firms have both buy and sell side components.

Organizational structure of an investment bank**The main activities and units**

The primary function of an investment bank is buying and selling products both on behalf of the bank's clients and also for the bank itself. Banks undertake risk through proprietary trading, done by a special set of traders who do not interface with clients and through Principal Risk, risk undertaken by a trader after he or she buys or sells a product to a client and does not hedge his or her total exposure. Banks seek to maximize profitability for a given amount of risk on their balance sheet.

An investment bank is split into the so-called **Front Office**, **Middle Office** and **Back Office**.

Front Office

- **Investment Banking** is the traditional aspect of investment banks which involves helping customers raise funds in the Capital Markets and advising on mergers and acquisitions. Investment banking may involve subscribing investors to a security issuance, coordinating with bidders, or negotiating with a merger target. Other terms for the Investment Banking Division include Mergers & Acquisitions (M&A) and Corporate Finance (often pronounced "corpfm").
- **Investment management** is the professional management of various securities (shares, bonds, etc.) and other assets (e.g. real estate), to meet specified investment goals for the benefit of the investors. Investors may be institutions (insurance companies, pension funds, corporations etc.) or private investors (both directly via investment contracts and more commonly via collective investment schemes eg. mutual funds) .
- **Sales and Trading** is often the most profitable area of an investment bank, responsible for the majority of revenue of most investment banks In the process of market making, traders will buy and sell financial products with the goal of making an incremental amount of money on each trade. Sales is the term for the investment banks sales force, whose primary job is to call on institutional and high-net-worth

investors to suggest trading ideas (on caveat emptor basis) and take orders. Sales desks then communicate their clients' orders to the appropriate trading desks, who can price and execute trades, or structure new products that fit a specific need.

- **Research** is the division which reviews companies and writes reports about their prospects, often with "buy" or "sell" ratings. While the research division generates no revenue, its resources are used to assist traders in trading, the sales force in suggesting ideas to customers, and investment bankers by covering their clients. In recent years the relationship between investment banking and research has become highly regulated, reducing its importance to the investment bank.
- **Structuring** has been a relatively recent division as derivatives have come into play, with highly technical and numerate employees working on creating complex structured products which typically offer much greater margins and returns than underlying cash securities.

Middle Office

- **Risk Management** involves analyzing the market and credit risk that traders are taking onto the balance sheet in conducting their daily trades, and setting limits on the amount of capital that they are able to trade in order to prevent 'bad' trades having a detrimental effect to a desk overall. Another key Middle Office role is to ensure that the above mentioned economic risks are captured accurately (as per agreement of commercial terms with the counterparty), correctly (as per standardized booking models in the most appropriate systems) and on time (typically within 30 minutes of trade execution). In recent years the risk of errors has become known as "operational risk" and the assurance Middle Offices provide now includes measures to address this risk. When this assurance is not in place, market and credit risk analysis can be unreliable and open to deliberate manipulation.

Back Office

- **Operations** involve data-checking trades that have been conducted, ensuring that they are not erroneous, and transacting the required transfers. While some believe it provides the greatest job security with the bleakest career prospects of the divisions within an investment bank, many have outsourced operations. It is however a critical part of the bank that involves managing the financial information of the bank and ensures efficient capital markets through the financial reporting functions. In recent years due to increased competition in finance related careers, college degrees are now mandatory at most Tier 1 investment banks. A finance degree has proved significant in understanding the depth of the deals and transactions that occur across all the divisions of the bank.
- **Technology:** every major investment bank has considerable amounts of in-house software, created by the Technology team, who are also responsible for Computer and Telecommunications-based support. Technology has changed considerably in the last few years as more sales and trading desks are using electronic trading platforms. These platforms can serve as auto-executed hedging to complex model driven algorithms.

Size of industry

Global investment banking revenue increased for the third year running in 2005, to \$52.8bn. This was up 14% on the previous year, but 7% below the 2000 peak. The recovery in the

global economy and capital markets resulted in an increase in M&A activity, which has been the primary source of investment banking revenue in recent years. Credit spreads are tightening and intense competition within the field has ensured that the banking industry is on its toes.

The US was the primary source of investment banking income in 2005, with 51% of the total, a proportion which has fallen somewhat during the past decade. Europe (with Middle East and Africa) generated 31% of the total, slightly up on its 30% share a decade ago. Asian countries generated the remaining 18%. Between 2002 and 2005, fee income from Asia increased by 98%. This compares with a 55% increase in Europe, and a 46% increase in the US, during this time period.

Recent evolution of the business

New products

Investment banking is one of the most global industries and is hence continuously challenged to respond to new developments and innovation in the global financial markets. Throughout the history of investment banking, many have theorized that all investment banking products and services would be commoditized. New products with higher margins are constantly invented and manufactured by bankers in hopes of winning over clients and developing trading know-how in new markets. However, since these can usually not be patented or copyrighted, they are very often copied quickly by competing banks, pushing down trading margins.

For example, trading bonds and equities for customers is now a commodity business but structuring and trading derivatives is highly profitable. Each OTC contract has to be uniquely structured and could involve complex pay-off and risk profiles. Listed option contracts are traded through major exchanges, such as the CBOE, and are almost as commoditized as general equity securities.

In addition, while many products have been commoditized, an increasing amount of profit within investment banks has come from proprietary trading, where size creates a positive network benefit (since the more trades an investment bank does, the more it knows about the market flow, allowing it to theoretically make better trades and pass on better guidance to clients).

Vertical Integration

In the US, the Glass-Steagall Act, initially created in the wake of the Stock Market Crash of 1929, prohibited banks from both accepting deposits and underwriting securities which led to segregation of Investment Banks from Commercial Banks. Glass-Steagall was repealed by the Gramm-Leach-Bliley Act in 1999.

Another development in recent years has been the vertical integration of debt securitization. Previously, investment banks had assisted lenders in raising more lending funds and having the ability to offer longer term fixed interest rates by converting the lenders' outstanding loans into bonds. For example, a mortgage lender would make a house loan, and then use the investment bank to sell bonds to fund the debt, the money from the sale of the bonds can be used to make new loans, while the lender accepts loan payments and passes the payments on to the bondholders. This process is called securitization. However, lenders have begun to securitize loans themselves especially in the areas of mortgage loans. Because of this, and because of the fear that this will continue, many Investment Banks have focused on becoming lenders themselves making loans with the goal of securitizing them. In fact, in the areas of commercial mortgages, many Investment Banks lend at loss leader interest rates in order to make money securitizing the loans, causing them to be a very popular financing option for commercial property investors and developers.

Possible conflicts of interest

Potential conflicts of interest may arise between different parts of a bank, creating the potential for financial movements that could be market manipulation. Authorities that regulate investment banking (the FSA in the United Kingdom and the SEC in the United States) require that banks impose a Chinese wall which prohibits communication between investment banking on one side and research and equities on the other.

Some of the conflicts of interest that can be found in investment banking are listed here:

- Historically, equity research firms were founded and owned by investment banks. One common practice is for equity analysts to initiate coverage on a company in order to develop relationships that lead to highly profitable investment banking business. In the 1990s, many equity researchers allegedly traded positive stock ratings directly for investment banking business. On the flip side of the coin: companies would threaten to divert investment banking business to competitors unless their stock was rated favorably. Politicians acted to pass laws to criminalize such acts. Increased pressure from regulators and a series of lawsuits, settlements, and prosecutions curbed this business to a large extent following the 2001 stock market tumble.
- Many investment banks also own retail brokerages. Also during the 1990s, some retail brokerages sold consumers securities which did not meet their stated risk profile. This behavior may have led to investment banking business or even sales of surplus shares during a public offering to keep public perception of the stock favorable.
- Since investment banks engage heavily in trading for their own account, there is always the temptation or possibility that they might engage in some form of front running. Front running is the illegal practice of a stock broker executing orders on a security for their own account (and thus affecting prices) before filling orders previously submitted by their customers.

Lecture # 29

Letter of Credit**Commercial Letter of Credit**

Commercial letters of credit have been used for centuries to facilitate payment in international trade. Their use will continue to increase as the global economy evolves.

Letters of credit used in international transactions are governed by the International Chamber of Commerce Uniform Customs and Practice for Documentary Credits. The general provisions and definitions of the International Chamber of Commerce are binding on all parties. Domestic collections in the United States are governed by the Uniform Commercial Code.

A commercial letter of credit is a contractual agreement between banks, known as the issuing bank, on behalf of one of its customers, authorizing another bank, known as the advising or confirming bank, to make payment to the beneficiary. The issuing bank, on the request of its customer, opens the letter of credit. The issuing bank makes a commitment to honor drawings made under the credit. The beneficiary is normally the provider of goods and/or services. Essentially, the issuing bank replaces the bank's customer as the payee.

Elements of a Letter of Credit

- A payment undertaking given by a bank (issuing bank)
- On behalf of a buyer (applicant)
- To pay a seller (beneficiary) for a given amount of money
- On presentation of specified documents representing the supply of goods
- Within specified time limits
- Documents must conform to terms and conditions set out in the letter of credit
- Documents to be presented at a specified place

Beneficiary

The beneficiary is entitled to payment as long as he can provide the documentary evidence required by the letter of credit. The letter of credit is a distinct and separate transaction from the contract on which it is based. All parties deal in documents and not in goods. The issuing bank is not liable for performance of the underlying contract between the customer and beneficiary. The issuing bank's obligation to the buyer, is to examine all documents to insure that they meet all the terms and conditions of the credit. Upon requesting demand for payment the beneficiary warrants that all conditions of the agreement have been complied with. If the beneficiary (seller) conforms to the letter of credit, the seller must be paid by the bank.

Issuing Bank

The issuing bank's liability to pay and to be reimbursed from its customer becomes absolute upon the completion of the terms and conditions of the letter of credit. Under the provisions of the Uniform Customs and Practice for Documentary Credits, the bank is given a reasonable amount of time after receipt of the documents to honor the draft.

The issuing banks' role is to provide a guarantee to the seller that if compliant documents are presented, the bank will pay the seller the amount due and to examine the documents, and only pay if these documents comply with the terms and conditions set out in the letter of credit.

Typically the documents requested will include a commercial invoice, a transport document such as a bill of lading or airway bill and an insurance document; but there are many others. Letters of credit deal in documents, not goods.

Advising Bank

An advising bank, usually a foreign correspondent bank of the issuing bank will advise the beneficiary. Generally, the beneficiary would want to use a local bank to insure that the letter of credit is valid. In addition, the advising bank would be responsible for sending the documents to the issuing bank. The advising bank has no other obligation under the letter of credit. If the issuing bank does not pay the beneficiary, the advising bank is not obligated to pay.

Confirming Bank

The correspondent bank may confirm the letter of credit for the beneficiary. At the request of the issuing bank, the correspondent obligates itself to insure payment under the letter of credit. The confirming bank would not confirm the credit until it evaluated the country and bank where the letter of credit originates. The confirming bank is usually the advising bank.

Letter of Credit Characteristics

- **Negotiability**

Letters of credit are usually negotiable. The issuing bank is obligated to pay not only the beneficiary, but also any bank nominated by the beneficiary. Negotiable instruments are passed freely from one party to another almost in the same way as money. To be negotiable, the letter of credit must include an unconditional promise to pay, on demand or at a definite time. The nominated bank becomes a holder in due course. As a holder in due course, the holder takes the letter of credit for value, in good faith, without notice of any claims against it. A holder in due course is treated favorably under the UCC.

The transaction is considered a straight negotiation if the issuing bank's payment obligation extends only to the beneficiary of the credit. If a letter of credit is a straight negotiation it is referenced on its face by "we engage with you" or "available with ourselves". Under these conditions the promise does not pass to a purchaser of the draft as a holder in due course.

- **Revocability**

Letters of credit may be either revocable or irrevocable. A revocable letter of credit may be revoked or modified for any reason, at any time by the issuing bank without notification. A revocable letter of credit cannot be confirmed. If a correspondent bank is engaged in a transaction that involves a revocable letter of credit, it serves as the advising bank.

Once the documents have been presented and meet the terms and conditions in the letter of credit, and the draft is honored, the letter of credit cannot be revoked. The revocable letter of credit is not a commonly used instrument. It is generally used to provide guidelines for shipment. If a letter of credit is revocable it would be referenced on its face.

The irrevocable letter of credit may not be revoked or amended without the agreement of the issuing bank, the confirming bank, and the beneficiary. An irrevocable letter of credit from the issuing bank insures the beneficiary that if the required documents are presented and the terms and conditions are complied with, payment will be made. If a letter of credit is irrevocable it is referenced on its face.

- **Transfer and Assignment**

The beneficiary has the right to transfer or assign the right to draw, under a credit only when the credit states that it is transferable or assignable. Credits governed by the Uniform Commercial Code (Domestic) maybe transferred an unlimited number of times. Under the Uniform Customs Practice for Documentary Credits (International) the credit may be transferred only once. However, even if the credit specifies that it is nontransferable or no assignable, the beneficiary may transfer their rights prior to performance of conditions of the credit.

- **Sight and Time Drafts**

All letters of credit require the beneficiary to present a draft and specified documents in order to receive payment. A draft is a written order by which the party creating it, orders another party to pay money to a third party. A draft is also called a bill of exchange.

There are two types of drafts: sight and time. A sight draft is payable as soon as it is presented for payment. The bank is allowed a reasonable time to review the documents before making payment.

A time draft is not payable until the lapse of a particular time period stated on the draft. The bank is required to accept the draft as soon as the documents comply with credit terms. The issuing bank has a reasonable time to examine those documents. The issuing bank is obligated to accept drafts and pay them at maturity.

- **Standby Letter of Credit**

The standby letter of credit serves a different function than the commercial letter of credit. The commercial letter of credit is the primary payment mechanism for a transaction. The standby letter of credit serves as a secondary payment mechanism. A bank will issue a standby letter of credit on behalf of a customer to provide assurances of his ability to perform under the terms of a contract between the beneficiaries. The parties involved with the transaction do not expect that the letter of credit will ever be drawn upon.

The standby letter of credit assures the beneficiary of the performance of the customer's obligation. The beneficiary is able to draw under the credit by presenting a draft, copies of invoices, with evidence that the customer has not performed its obligation. The bank is obligated to make payment if the documents presented comply with the terms of the letter of credit.

Standby letters of credit are issued by banks to stand behind monetary obligations, to insure the refund of advance payment, to support performance and bid obligations, and to insure the completion of a sales contract. The credit has an expiration date.

The standby letter of credit is often used to guarantee performance or to strengthen the credit worthiness of a customer. In the above example, the letter of credit is issued by the bank and held by the supplier. The customer is provided open account terms. If payments are made in accordance with the suppliers' terms, the letter of credit would not be drawn on. The seller pursues the customer for payment directly. If the customer is unable to pay, the seller presents a draft and copies of invoices to the bank for payment.

The domestic standby letter of credit is governed by the Uniform Commercial Code. Under these provisions, the bank is given until the close of the third banking day after receipt of the documents to honor the draft.

Procedures for Using the Tool

The following procedures include a flow of events that follow the decision to use a Commercial Letter of Credit. Procedures required to execute a Standby Letter of Credit are less rigorous. The standby credit is a domestic transaction. It does not require a correspondent bank (advising or confirming). The documentation requirements are also less tedious.

Step-by-step process:

Buyer and seller agree to conduct business. The seller wants a letter of credit to guarantee payment.

Buyer applies to his bank for a letter of credit in favor of the seller.

Buyer's bank approves the credit risk of the buyer, issues and forwards the credit to its correspondent bank (advising or confirming). The correspondent bank is usually located in the same geographical location as the seller (beneficiary).

- Advising bank will authenticate the credit and forward the original credit to the seller (beneficiary).
- Seller (beneficiary) ships the goods, then verifies and develops the documentary requirements to support the letter of credit. Documentary requirements may vary greatly depending on the perceived risk involved in dealing with a particular company.
- Seller presents the required documents to the advising or confirming bank to be processed for payment.
- Advising or confirming bank examines the documents for compliance with the terms and conditions of the letter of credit.
- If the documents are correct, the advising or confirming bank will claim the funds by:
 - Debiting the account of the issuing bank.
 - Waiting until the issuing bank remits, after receiving the documents.
 - Reimburse on another bank as required in the credit.
- Advising or confirming bank will forward the documents to the issuing bank.
- Issuing bank will examine the documents for compliance. If they are in order, the issuing bank will debit the buyer's account.
- Issuing bank then forwards the documents to the buyer.

Standard Forms of Documentation

When making payment for product on behalf of its customer, the issuing bank must verify that all documents and drafts conform precisely to the terms and conditions of the letter of credit. Although the credit can require an array of documents, the most common documents that must accompany the draft include:

Commercial Invoice

The bill for the goods and services is called. It includes a description of merchandise, price, FOB origin, and name and address of buyer and seller. The buyer and seller information must correspond exactly to the description in the letter of credit. Unless the letter of credit specifically states otherwise, a generic description of the merchandise is usually acceptable in the other accompanying documents.

Bill of Lading

A document evidencing the receipt of goods for shipment and issued by a freight carrier engaged in the business of forwarding or transporting goods. The documents evidence control of goods. They also serve as a receipt for the merchandise shipped and as evidence of the carrier's obligation to transport the goods to their proper destination.

Warranty of Title

A warranty given by a seller to a buyer of goods that states that the title being conveyed is good and that the transfer is rightful. This is a method of certifying clear title to product transfer. It is generally issued to the purchaser and issuing bank expressing an agreement to indemnify and hold both parties harmless.

Letter of Indemnity

Specifically indemnifies the purchaser against a certain stated circumstance. Indemnification is generally used to guaranty that shipping documents will be provided in good order when available.

Common Defects in Documentation

About half of all drawings presented contain discrepancies. A discrepancy is an irregularity in the documents that causes them to be in non-compliance to the letter of credit. Requirements set forth in the letter of credit cannot be waived or altered by the issuing bank without the express consent of the customer. The beneficiary should prepare and examine all documents carefully before presentation to the paying bank to avoid any delay in receipt of payment. Commonly found discrepancies between the letter of credit and supporting documents include:

- Letter of Credit has expired prior to presentation of draft.
- Bill of Lading evidences delivery prior to or after the date range stated in the credit.
- Stale dated documents.
- Changes included in the invoice not authorized in the credit.

- Inconsistent description of goods.
- Insurance document errors.
- Invoice amount not equal to draft amount.
- Ports of loading and destination not as specified in the credit.
- Description of merchandise is not as stated in credit.
- A document required by the credit is not presented.
- Documents are inconsistent as to general information such as volume, quality, etc.
- Names of documents not exact as described in the credit. Beneficiary information must be exact.
- Invoice or statement is not signed as stipulated in the letter of credit.

When a discrepancy is detected by the negotiating bank, a correction to the document may be allowed if it can be done quickly while remaining in the control of the bank. If time is not a factor, the exporter should request that the negotiating bank return the documents for corrections.

If there is not enough time to make corrections, the exporter should request that the negotiating bank send the documents to the issuing bank on an approval basis or notify the issuing bank by wire, outline the discrepancies, and request authority to pay. Payment cannot be made until all parties have agreed to jointly waive the discrepancy.

Tips for Exporters

- Communicate with your customers in detail before they apply for letters of credit.
- Consider whether a confirmed letter of credit is needed.
- Ask for a copy of the application to be fax to you, so you can check for terms or conditions that may cause you problems in compliance.
- Upon first advice of the letter of credit, check that all its terms and conditions can be complied with within the prescribed time limits.
- Many presentations of documents run into problems with time-limits. You must be aware of at least three time constraints - the expiration date of the credit, the latest shipping date and the maximum time allowed between dispatch and presentation.
- If the letter of credit calls for documents supplied by third parties, make reasonable allowance for the time this may take to complete.
- After dispatch of the goods, check all the documents both against the terms of the credit and against each other for internal consistency.

Letter of Credit and International Trade

A **letter of credit** is a document issued mostly by a financial institution which usually provides an irrevocable payment undertaking (it can also be revocable, confirmed, unconfirmed, transferable or others e.g. back to back: revolving but is most commonly irrevocable/confirmed) to a beneficiary against complying documents as stated in the Letter of Credit. Letter of Credit is abbreviated as an **LC** or **L/C**, and often is referred to as a **documentary credit**, abbreviated as **DC** or **D/C**, **documentary letter of credit**, or simply as **credit** (as in the UCP 500 and UCP 600). Once the beneficiary or a presenting bank acting on its behalf, makes a presentation to the issuing bank or confirming bank, if any, within the expiry date of the LC, comprising documents complying with the terms and conditions of the LC, the applicable UCP and international standard banking practice, the issuing bank or confirming bank, if any, is obliged to honor irrespective of any instructions from the applicant to the contrary. In other words, the obligation to honor (usually payment) is shifted from the applicant to the issuing bank or confirming bank, if any. Non-banks can also issue letters of credit however parties must balance potential risks.

The LC can also be the source of payment for a transaction, meaning that an exporter will get paid by redeeming the letter of credit. Letters of credit are used nowadays primarily in international trade transactions of significant value, for deals between a supplier in one country and a wholesale customer in another. They are also used in the land development process to ensure that approved public facilities (streets, sidewalks, storm water ponds, etc.) will be built. The parties to a letter of credit are usually a **beneficiary** who is to receive the money, the **issuing bank** of whom the applicant is a client, and the **advising bank** of whom the beneficiary is a client. Since nowadays almost all letters of credit are irrevocable, (i.e. cannot be amended or cancelled without prior agreement of the beneficiary, the issuing bank, and the confirming bank, if any). However, the applicant is not a party to the letter of credit. In executing a transaction, letters of credit incorporate functions common to giros and Traveler's cheque. Typically, the documents a beneficiary has to present in order to avail him of the credit are commercial invoice, bill of lading, insurance documents. However, the list and form of documents is open to imagination and negotiation and might contain requirements to present documents issued by a neutral third party evidencing the quality of the goods shipped.

Terminology

The English name “letter of credit” derives from the French word “accréditif”, a power to do something, which in turn is derivative of the Latin word “accreditivus”, meaning trust. This in effect reflects the modern understanding of the instrument. When a seller agrees to be paid by means of a letter of credit s/he is looking at a reliable bank that has an obligation to pay them the amount stipulated in the credit notwithstanding any defense relating to the underlying contract of sale. This is as long as the seller performs their duties to an extent that meets the credit terms.

How it works

Imagine that a business called the Acme Electronics from time to time imports computers from a business called Bangalore Computers, which banks with the India Business Bank. Acme holds an account at the Commonwealth Financials. Acme wants to buy \$500,000 worth of merchandise from Bangalore Computers, who agree to sell the goods and give

Acme 60 days to pay for them, on the condition that they are provided with a 90-day LC for the full amount. The steps to get the letter of credit would be as follows:

- Acme goes to The Commonwealth Financials and requests a \$500,000 letter of credit, with Bangalore Computers as the beneficiary.
- The Commonwealth Financials can issue an LC either on approval of a standard loan underwriting process or by Acme funding it directly with a deposit of \$500,000 plus fees between 1% and 8%.
- The Commonwealth Financials sends a copy of the LC to the India Business Bank, which notifies the Bangalore Computers that payment is ready and they can ship the merchandise Acme has ordered with the full assurance of payment to them.
- On presentation of the stipulated documents in the letter of credit and compliance with the terms and conditions of the letter of credit, the Commonwealth Financials transfers the \$500,000 to the India Business Bank, which then credits the account to the Bangalore Computers by that amount.
- Note that banks deal only with documents under the letter of credit and not the underlying transaction.
- Many exporters have misunderstood that the payment is guaranteed after receiving the LC. The issuing bank is obligated to pay under the letter of credit only when the stipulated documents are presented and the terms and conditions of the letter of credit have been met accordingly.

Legal principles governing documentary credits

One of the primary peculiarities of the documentary credit is that the payment obligation is abstract and independent from the underlying contract of sale or any other contract in the transaction. Thus the bank's obligation is defined by the terms of the credit alone, and the sale contract is irrelevant. The defenses of the buyer arising out of the sale contract do not concern the bank and in no way affect its liability. Article 3(a) UCP states this principle clearly. Article 4 the UCP further states that banks deal with documents only, they are not concerned with the goods (facts). Accordingly, if the documents tendered by the beneficiary, or his agent, appear to be in order, then in general the bank is both entitled and obliged to pay without further qualifications.

The policies behind adopting the abstraction principle are purely commercial and reflect a party's expectations: firstly, if the responsibility for the validity of documents was thrown onto banks, they would be burdened with investigating the underlying facts of each transaction and would thus be less inclined to issue documentary credits as the transaction would involve great risk and inconvenience. Secondly, documents required under the credit could in certain circumstances be different from those required under the sale transaction; banks would then be placed in a dilemma in deciding which terms to follow if required to look behind the credit agreement. Thirdly, the fact that the basic function of the credit is to provide the seller with the certainty of receiving payment, as long as he performs his documentary duties, suggests that banks should honor their obligation notwithstanding allegations of misfeasance by the buyer. Finally, courts have emphasized that buyers always have a remedy for an action upon the contract of sale, and that it would be a calamity for the business world if, for every breach of contract between the seller and buyer, a bank were required to investigate said breach.

The "principle of strict compliance" also aims to make the bank's duty of effecting payment against documents easy, efficient and quick. Hence, if the documents tendered under the

credit deviate from the language of the credit the bank is entitled to withhold payment even if the deviation is purely terminological. The general legal maxim *de minimis non curat lex* has no place in the field of documentary credits.

The price of LCs

The applicant pays the LC fee to the bank, and may in turn charge this on to the beneficiary. From the bank's point of view, the LC they have issued can be called upon at any time (subject to the relevant terms and conditions), and the bank then looks to reclaim this from the applicant.

Legal Basis for Letters of Credit

Although documentary credits are enforceable once communicated to the beneficiary, it is difficult to show any consideration given by the beneficiary to the banker prior to the tender of documents. In such transactions the undertaking by the beneficiary to deliver the goods to the applicant is not sufficient consideration for the bank's promise because the contract of sale is made before the issuance of the credit, thus consideration in these circumstances is past. In addition, the performance of an existing duty under a contract cannot be a valid consideration for a new promise made by the bank: the delivery of the goods is consideration for enforcing the underlying contract of sale and cannot be used, as it were, a second time to establish the enforceability of the bank-beneficiary relation.

Legal writers have analyzed every possible theory from every legal angle and failed to satisfactorily reconcile the bank's undertaking with any contractual analysis. The theories include: the implied promise, assignment theory, the novation theory, reliance theory, agency theories, estoppels and trust theories, anticipatory theory, and the guarantee theory. Davis, Treitel, Goode, Finkelstein and Ellinger have all accepted the view that documentary credits should be analyzed outside the legal framework of contractual principles, which require the presence of consideration. Accordingly, whether the documentary credit is referred to as a promise, an undertaking, a chose in action, an engagement or a contract, it is acceptable in English jurisprudence to treat it as contractual in nature, despite the fact that it possesses distinctive features, which make it sui generis.

Even though a couple of countries and US states (see e.g. Article 5 of the Uniform Commercial Code) have tried to create statutes to establish the rights of the parties involved in letter of credit transactions, most parties subject themselves to the Uniform Customs and Practices (UCP) issued by the International Chamber of Commerce (ICC) in Paris. The ICC has no legislative authority, rather, representatives of various industry and trade groups from various countries get together to discuss how to revise the UCP and adapt them to new technologies. The UCP are quoted according to the publication number the ICC gives them. The UCP 600 are ICC publication No. 600 and will take effect July 1, 2007. The previous revision was called UCP 500 and became effective 1993. Since the UCP are not laws, parties have to include them into their arrangements as normal contractual provisions. It is interesting to see that in the area of international trade the parties do not rely on governmental regulations, but rather prefer the speed and ease of auto-regulation.

Risks in International Trade

- A Credit risk is a risk from a change in the credit of an opposing business.
- An Exchange risk is a risk from a change in the foreign exchange rate.
- A Force majeure risk is

- o A risk in trade incapability caused by a change in a country's policy, and
 - o A risk caused by a natural disaster.
- Other risks are mainly risks caused by a difference in law, language or culture. In these cases, the cargo might be found late because of a dispute in import and export dealings.

Lecture # 31

Foreign Exchange & Financial Institutions

The **foreign exchange (currency or forex or FX) market** exists wherever one currency is traded for another. It is by far the largest financial market in the world, and includes trading between large banks, central banks, currency speculators, multinational corporations, governments, and other financial markets and institutions. The average daily trade in the global forex and related markets currently is over US\$ 3 trillion. Retail traders (individuals) are a small fraction of this market and may only participate indirectly through brokers or banks, and are subject to forex scams.

Market size and liquidity

The foreign exchange market is unique because of

- its trading volume,
- the extreme liquidity of the market,
- the large number of, and variety of, traders in the market,
- its geographical dispersion,
- its long trading hours: 24 hours a day (except on weekends),
- The variety of factors that affect exchange rates.
- the low margins of profit compared with other markets of fixed income (but profits can be high due to very large trading volumes)

According to the BIS, average daily turnover in traditional foreign exchange markets is estimated at \$3,210 billion. Daily averages in April for different years, in billions of US dollars, are presented on the chart below:

This \$1.88 trillion in global foreign exchange market "traditional" turnover was broken down as follows:

- \$1,005 billion in spot transactions
- \$362 billion in outright forwards
- \$1,714 billion in forex swaps
- \$129 billion estimated gaps in reporting

In addition to "traditional" turnover, \$2.1 trillion was traded in derivatives.

Exchange-traded forex futures contracts were introduced in 1972 at the Chicago Mercantile Exchange and are actively traded relative to most other futures contracts. Forex futures volume has grown rapidly in recent years, and accounts for about 7% of the total foreign exchange market volume, according to The Wall Street Journal Europe (5/5/06, p. 20).

Average daily global turnover in traditional foreign exchange market transactions totaled \$2.7 trillion in April 2006 according to IFSL estimates based on semi-annual London, New York, Tokyo and Singapore Foreign Exchange Committee data. Overall turnover, including non-traditional foreign exchange derivatives and products traded on exchanges, averaged around \$2.9 trillion a day. This was more than ten times the size of the combined daily turnover on all the world's equity markets. Foreign exchange trading increased by 38% between April 2005 and April 2006 and has more than doubled since 2001. This is largely due to the growing importance of foreign exchange as an asset class and an increase in fund

management assets, particularly of hedge funds and pension funds. The diverse selection of execution venues such as internet trading platforms has also made it easier for retail traders to trade in the foreign exchange market.

Because foreign exchange is an OTC market where brokers/dealers negotiate directly with one another, there is no central exchange or clearing house. The biggest geographic trading center is the UK, primarily London, which according to IFSL estimates has increased its share of global turnover in traditional transactions from 31.3% in April 2004 to 32.4% in April 2006. RPP

The ten most active traders account for almost 73% of trading volume, according to The Wall Street Journal Europe, (2/9/06 p. 20). These large international banks continually provide the market with both bid (buy) and ask (sell) prices. The bid/ask spread is the difference between the price at which a bank or market maker will sell ("ask", or "offer") and the price at which a market-maker will buy ("bid") from a wholesale customer. This spread is minimal for actively traded pairs of currencies, usually 0–3 pips. For example, the bid/ask quote of EUR/USD might be 1.2200/1.2203. Minimum trading size for most deals is usually \$100,000.

These spreads might not apply to retail customers at banks, which will routinely mark up the difference to say 1.2100 / 1.2300 for transfers, or say 1.2000 / 1.2400 for banknotes or travelers' checks. Spot prices at market makers vary, but on EUR/USD are usually no more than 3 pips wide (i.e. 0.0003). Competition has greatly increased with pip spreads shrinking on the major pairs to as little as 1 to 2 pips.

Market participants

Unlike a stock market, where all participants have access to the same prices, the forex market is divided into levels of access. At the top is the inter-bank market, which is made up of the largest investment banking firms. Within the inter-bank market, spreads, which are the difference between the bids and ask prices, are razor sharp and usually unavailable, and not known to players outside the inner circle. As you descend the levels of access, the difference between the bids and ask prices widens (from 0-1 pip to 1-2 pips only for major currencies like the Euro). This is due to volume. If a trader can guarantee large numbers of transactions for large amounts, they can demand a smaller difference between the bid and ask price, which is referred to as a better spread. The levels of access that make up the forex market are determined by the size of the "line" (the amount of money with which they are trading). The top-tier inter-bank market accounts for 53% of all transactions. After that there are usually smaller investment banks, followed by large multi-national corporations (which need to hedge risk and pay employees in different countries), large hedge funds, and even some of the retail forex market makers. According to Galati and Melvin, "Pension funds, insurance companies, mutual funds, and other institutional investors have played an increasingly important role in financial markets in general, and in FX markets in particular, since the early 2000s." (2004) In addition, he notes, "Hedge funds have grown markedly over the 2001–2004 period in terms of both number and overall size" Central banks also participate in the forex market to align currencies to their economic needs.

Banks

The inter-bank market caters for both the majority of commercial turnover and large amounts of speculative trading every day. A large bank may trade billions of dollars daily. Some of this trading is undertaken on behalf of customers, but much is conducted by proprietary desks, trading for the bank's own account.

Until recently, foreign exchange brokers did large amounts of business, facilitating inter-bank trading and matching anonymous counterparts for small fees. Today, however, much of this business has moved on to more efficient electronic systems, such as EBS (now owned by ICAP), Reuters Dealing 3000 Matching (D2), the Chicago Mercantile Exchange, Dukascopy - Swiss FX Marketplace, FXMarketSpace, Bloomberg, and TradeBook(R). The broker squawk box lets traders listen in on ongoing inter-bank trading and is heard in most trading rooms, but turnover is noticeably smaller than just a few years ago.

Central banks

National central banks play an important role in the foreign exchange markets. They try to control the money supply, inflation, and/or interest rates and often have official or unofficial target rates for their currencies. They can use their often substantial foreign exchange reserves to stabilize the market. Milton Friedman argued that the best stabilization strategy would be for central banks to buy when the exchange rate is too low, and to sell when the rate is too high — that is, to trade for a profit based on their more precise information. Nevertheless, the effectiveness of central bank "stabilizing speculation" is doubtful because central banks do not go bankrupt if they make large losses, like other traders would, and there is no convincing evidence that they do make a profit trading.

The mere expectation or rumor of central bank intervention might be enough to stabilize a currency, but aggressive intervention might be used several times each year in countries with a dirty float currency regime. Central banks do not always achieve their objectives. The combined resources of the market can easily overwhelm any central bank. Several scenarios of this nature were seen in the 1992–93 Enron collapse, and in more recent times in Southeast Asia.

Investment management firms

Investment management firms (who typically manage large accounts on behalf of customers such as pension funds and endowments) use the foreign exchange market to facilitate transactions in foreign securities. For example, an investment manager with an international equity portfolio will need to buy and sell foreign currencies in the spot market in order to pay for purchases of foreign equities. Since the forex transactions are secondary to the actual investment decision, they are not seen as speculative or aimed at profit-maximization.

Some investment management firms also have more speculative specialist currency overlay operations, which manage clients' currency exposures with the aim of generating profits as well as limiting risk. Whilst the number of this type of specialist firms is quite small, many have a large value of assets under management (AUM), and hence can generate large trades.

Hedge funds

Hedge funds, such as George Soros's Quantum fund have gained a reputation for aggressive currency speculation since 1990. They control billions of dollars of equity and may borrow billions more, and thus may overwhelm intervention by central banks to support almost any currency, if the economic fundamentals are in the hedge funds' favor.

Retail forex brokers

Retail forex brokers or market makers handle a minute fraction of the total volume of the foreign exchange market. According to CNN, one retail broker estimates retail volume at

\$25–50 billion daily, which is about 2% of the whole market and it has been reported by the CFTC website that un-experienced investors may become targets of forex scams.

Trading characteristics

There is no unified or centrally cleared market for the majority of FX trades, and there is very little cross-border regulation. Due to the over-the-counter (OTC) nature of currency markets, there are rather a number of interconnected marketplaces, where different currency instruments are traded. This implies that there is not a *single* dollar rate but rather a number of different rates (prices), depending on what bank or market maker is trading. In practice the rates are often very close, otherwise they could be exploited by arbitrageurs instantaneously. A joint venture of the Chicago Mercantile Exchange and Reuters called FXMarketSpace opened in 2007 and aspires to the role of a central market clearing mechanism.

The main trading centers are in London, New York, Tokyo, and Singapore, but banks throughout the world participate. Currency trading happens continuously throughout the day; as the Asian trading session ends, the European session begins, followed by the North American session and then back to the Asian session, excluding weekends.

There is little or no 'inside information' in the foreign exchange markets. Exchange rate fluctuations are usually caused by actual monetary flows as well as by expectations of changes in monetary flows caused by changes in GDP growth, inflation, interest rates, budget and trade deficits or surpluses, large cross-border M&A deals and other macroeconomic conditions. Major news is released publicly, often on scheduled dates; so many people have access to the same news at the same time. However, the large banks have an important advantage; they can see their customers' order flow.

Currencies are traded against one another. Each pair of currencies thus constitutes an individual product and is traditionally noted XXX/YYY, where YYY is the ISO 4217 international three-letter code of the currency into which the price of one unit of XXX is expressed. For instance, EUR/USD is the price of the Euro expressed in US dollars, as in 1 Euro = 1.3045 dollar. Out of convention, the first currency in the pair, the base currency, was the stronger currency at the creation of the pair. The second currency, counter currency, was the weaker currency at the creation of the pair.

The factors affecting XXX will affect both XXX/YYY and XXX/ZZZ. This causes positive currency correlation between XXX/YYY and XXX/ZZZ.

On the spot market, according to the BIS study, the most heavily traded products were:

- EUR/USD: 28 %
- USD/JPY: 18 %
- GBP/USD (*also called sterling or cable*): 14 %

And the US currency was involved in 88.7% of transactions, followed by the Euro (37.2%), the yen (20.3%), and the sterling (16.9%). Note that volume percentages should add up to 200%: 100% for all the sellers and 100% for all the buyers.

Although trading in the Euro has grown considerably since the currency's creation in January 1999, the foreign exchange market is thus far still largely dollar-centered. For instance, trading the Euro versus a non-European currency ZZZ will usually involve two

trades: EUR/USD and USD/ZZZ. The exception to this is EUR/JPY, which is an established traded currency pair in the inter-bank spot market.

Exchange Traded Fund

Exchange-traded funds (or ETFs) are Open Ended investment companies that can be traded at any time throughout the course of the day. Typically, ETFs try to replicate a stock market index such as the S&P 500 (e.g. SPY), but recently they are now replicating investments in the currency markets with the ETF increasing in value when the US Dollar weakness versus a specific Currency, such as the Euro. Certain of these funds track the price movements of world currencies versus the US Dollar, and increase in value directly counter to the US Dollar, allowing for speculation in the US Dollar for US and US Dollar denominated investors and speculators.

Foreign Exchange

Factors affecting currency trading

Although exchange rates are affected by many factors, in the end, currency prices are a result of supply and demand forces. The world's currency markets can be viewed as a huge melting pot: in a large and ever-changing mix of current events, supply and demand factors are constantly shifting, and the price of one currency in relation to another shifts accordingly. No other market encompasses (and distills) as much of what is going on in the world at any given time as foreign exchange.

Supply and demand for any given currency, and thus its value, are not influenced by any single element, but rather by several. These elements generally fall into three categories: economic factors, political conditions, and market psychology.

Economic factors

These include economic policy, disseminated by government agencies and central banks, economic conditions, generally revealed through economic reports, and other economic indicators.

Economic policy comprises government fiscal policy (budget/spending practices) and monetary policy (the means by which a government's central bank influences the supply and "cost" of money, which is reflected by the level of interest rates).

Economic conditions include:

- **Government budget deficits or surpluses:** The market usually reacts negatively to widening government budget deficits, and positively to narrowing budget deficits. The impact is reflected in the value of a country's currency.
- **Balance of trade levels and trends:** The trade flow between countries illustrates the demand for goods and services, which in turn indicates demand for a country's currency to conduct trade. Surpluses and deficits in trade of goods and services reflect the competitiveness of a nation's economy. For example, trade deficits may have a negative impact on a nation's currency.
- **Inflation levels and trends:** Typically, a currency will lose value if there is a high level of inflation in the country or if inflation levels are perceived to be rising. This is because inflation erodes purchasing power, thus demand, for that particular currency.
- **Economic growth and health:** Reports such as gross domestic product (GDP), employment levels, retail sales, capacity utilization and others, detail the levels of a country's economic growth and health. Generally, the more healthy and robust a country's economy, the better its currency will perform, and the more demand for it there will be.

Political conditions

Internal, regional, and international political conditions and events can have a profound effect on currency markets.

For instance, political upheaval and instability can have a negative impact on a nation's economy. The rise of a political faction that is perceived to be fiscally responsible can have the opposite effect. Also, events in one country in a region may spur positive or negative interest in a neighboring country and, in the process, affect its currency.

Market psychology

Market psychology and trader perceptions influence the foreign exchange market in a variety of ways:

- **Flights to quality:** Unsettling international events can lead to a "flight to quality," with investors seeking a "safe haven". There will be a greater demand, thus a higher price, for currencies perceived as stronger over their relatively weaker counterparts.
- **Long-term trends:** Currency markets often move in visible long-term trends. Although currencies do not have an annual growing season like physical commodities, business cycles do make themselves felt. Cycle analysis looks at longer-term price trends that may rise from economic or political trends.
- **"Buy the rumor, sell the fact:"** This market truism can apply to many currency situations. It is the tendency for the price of a currency to reflect the impact of a particular action before it occurs and, when the anticipated event comes to pass, react in exactly the opposite direction. This may also be referred to as a market being "oversold" or "overbought". To buy the rumor or sell the fact can also be an example of the cognitive bias known as anchoring, when investors focus too much on the relevance of outside events to currency prices.
- **Economic numbers:** While economic numbers can certainly reflect economic policy, some reports and numbers take on a talisman-like effect: the number it becomes important to market psychology and may have an immediate impact on short-term market moves. "What to watch" can change over time. In recent years, for example, money supply, employment, trade balance figures and inflation numbers have all taken turns in the spotlight.
- **Technical trading considerations:** As in other markets, the accumulated price movements in a currency pair such as EUR/USD can form apparent patterns that traders may attempt to use. Many traders study price charts in order to identify such patterns

Financial instruments

There are several types of financial instruments commonly used.

❖ Spot

A spot transaction is a two-day delivery transaction, as opposed to the futures contracts, which are usually three months. This trade represents a "direct exchange" between two currencies, has the shortest time frame, involves cash rather than a contract; and interest is not included in the agreed-upon transaction. The data for this study come from the spot market. Spot has the largest share by volume in FX transactions among all instruments.

❖ Forward

One way to deal with the Forex risk is to engage in a forward transaction. In this transaction, money does not actually change hands until some agreed upon future date. A buyer and seller agree on an exchange rate for any date in the future, and the transaction occurs on that date, regardless of what the market rates are then. The duration of the trade can be a few days, months, or years.

❖ Future

Foreign currency futures are forward transactions with standard contract sizes and maturity dates — for example, 500,000 British pounds for next November at an agreed rate. Futures are standardized and are usually traded on an exchange created for this purpose. The average contract length is roughly 3 months. Futures contracts are usually inclusive of any interest amounts.

❖ Swap

The most common type of forward transaction is the currency swap. In a swap, two parties exchange currencies for a certain length of time and agree to reverse the transaction at a later date. These are not standardized contracts and are not traded through an exchange.

❖ Option

A foreign exchange option (commonly shortened to just FX option) is a derivative where the owner has the right but not the obligation to exchange money denominated in one currency into another currency at a pre-agreed exchange rate on a specified date. The FX options market is the deepest, largest and most liquid market for options of any kind in the world.

Speculation

Controversy about currency speculators and their effect on currency devaluations and national economies recurs regularly. Nevertheless, many economists (e.g. Milton Friedman) have argued that speculators perform the important function of providing a market for hedgers and transferring risk from those people who don't wish to bear it, to those who do. Other economists (e.g. Joseph Stiglitz) however, may consider this argument to be based more on politics and a free market philosophy than on economics.

Large hedge funds and other well capitalized "position traders" are the main professional speculators.

Currency speculation is considered a highly suspect activity in many countries. While investment in traditional financial instruments like bonds or stocks often is considered to contribute positively to economic growth by providing capital, currency speculation does not, according to this view; it is simply gambling, that often interferes with economic policy. For example, in 1992, currency speculation forced the Central Bank of Sweden to raise interest rates for a few days to 150% per annum, and later to devalue the krona. Former Malaysian Prime Minister Mahathir Mohamad is one well known proponent of this view. He blamed the devaluation of the Malaysian ringgit in 1997 on George Soros and other speculators.

Gregory Millman reports on an opposing view, comparing speculators to "vigilantes" who simply help "enforce" international agreements and anticipate the effects of basic economic "laws" in order to profit.

In this view, countries may develop unsustainable financial bubbles or otherwise mishandle their national economies, and forex speculators made the inevitable collapse happen sooner. A relatively quick collapse might even be preferable to continued economic mishandling. Mahathir Mohamad and other critics of speculation are viewed as trying to deflect the blame from them for having caused the unsustainable economic conditions.

Lecture # 33**Leasing Companies**

1. A lease or tenancy is a contract that transfers the right to possess specific property. In law, there are two types of property: historically, land is the more important because, under normal circumstances, it holds the highest value in economically developed societies. Ownership of land is an aspect of the system of real property or realty in common law systems.
2. When structured as an operating lease, this is a form of financing that avoids the down payment usually required for the purchase of equipment. Because leased equipment is not owned by the company, it does not appear on the balance sheet. A financing lease does appear on the balance sheet.
3. Don't be intimidated! For most people, leasing is an unfamiliar concept and therefore a little scary, but leasing isn't any more difficult than purchasing a car. Fully understanding how the leasing process works is the first step toward a positive leasing experience.

Leasing a vehicle is similar to renting a car, just for a longer time period. Like renting a car, a person who leases pays a pre-determined rate to drive a vehicle for a pre-determined amount of time. You never own the vehicle and return it when your lease is up. A person who leases enjoys the benefits of driving a car without assuming the up-front costs, and many of the risks of ownership.

Basic Purpose of Leasing**Bargain Purchase Option**

A lease provision allowing the lessee, at its option, to purchase the equipment for a price predetermined at lease inception that is substantially lower than the expected fair market value at the date the option can be exercised.

Broker

A company or person who arranges, for a fee, transactions between lessees and lesser of an asset.

Certificate of Acceptance

A document whereby the lessee acknowledges that the equipment to be leased has been delivered, is acceptable, and has been manufactured or constructed according to specifications.

Economic Life

The period of time during which an asset will have economic value and be usable.

Effective Lease Rate

The effective rate (to the lessee) of cash flows resulting from a lease

Technological Benefits

Technology provides a needed and powerful edge in business; the following points examine those benefits and let you decide how these benefits provide you with the needed edge in business. An equipment leasing arrangement provides you the edge you need without running the expensive costs associated with purchasing state-of-the-art equipment.

Wider Options, Lesser Costs

With equipment leasing arrangement you are free to select your choice of equipment without paying the full price. This advantage also comes with the fact that most business equipment leasing companies will often handle everything from the maintenance to the deployment of their equipment. Your company can save the costs associated with the equipment as the leasing company usually gets price cuts on equipment and related services since they buy in bulk.

Leasing Companies

Leasing has become increasingly important over the last few years. Uncertainty about future tax legislation and strong pressure on costs in bulk business are the controlling factors in the industry. A high level of product and market homogeneity for classical products, at the same time as low customer loyalty, is forcing companies to adopt positive distinguishing signs in the market.

Leasing Act

Leasing acts as a "hedge against inflation." Lease payments are fixed for the full term of the lease and, therefore, not subject to inflationary increases. New equipment obtained today is paid for with tomorrow's Rupees. A fixed lease payment enables you to effectively budget and manage the acquisition of capital equipment. At the end of the lease, you may choose to exercise the agreed upon purchase option or simply return the equipment. Leasing offers you the most manageable and economical way of keeping up with evolving technologies. A lease payment may include installation charges or other related out-of-pocket expenses. Down payments are seldom required. Leasing helps establish additional credit resources for your business. Current working capital is not used, which allows your business to use the cash for other investments or possible expansion. A lease is a simple and economical way to obtain the benefits of the latest technology without assuming the up-front costs, and risks, of ownership.

Simply defined, a lease is a usage agreement between an equipment owner and a user of that equipment. The lessee pays a periodic fee, usually monthly, to the lesser for the use of the equipment. Leases most often take the form of written contracts with specific terms and conditions spelled out: length of term, amount and timing of payments, and any end-of-lease conditions or restrictions. The lesser is usually viewed as the owner of the equipment during the lease term, but depending on the type of lease you select either you or the lesser may be able to claim the benefits of ownership for tax purposes. Regardless of which type of lease you choose, the future expected value of the equipment (the residual value) is considered when pricing most types of leases. The residual value is the lessor's estimate today of the equipment's value when the lease term ends. Or in other words we can say that it is like purchasing a car, a car lease typically lasts for 24, 36, or 48 months; the longer the lease the lower the monthly payment. However, it's usually smarter to get a shorter lease. Your best bet is to get a lease for the same amount of time the car is under warranty. Doing so insures you are covered for most car problems for the entire time you are leasing the vehicle.

Statistics show most cars begin experiencing problems after being driven for 4 years; therefore a lease term longer than 48 months should be carefully considered. Cars begin to lose value immediately after purchase and continue to lose value until they are scrapped. They become less desirable as they accumulate wear and tear or are replaced by newer models. This process is called depreciation. The cost of your lease depends on the expected depreciation of the vehicle you are leasing. All cars have an expected depreciation. In other words, before a car is leased for the first time, a dealer knows the vehicle's value, given normal wear and tear, for each year after it leaves the lot. When leasing, the difference between a car's original value and its value when the lease term is over, determines how much will be paid during the lease. When leasing a car, you should have a clear understanding of the vehicle's depreciation schedule. Some cars lose value faster than others. For example, some local brands are usually bringing better lease rates than many foreign brands because they are known to have low depreciation. Before leasing make sure you understand both the car's original value and its projected value at lease end, called the residual value.

Leasing in Europe and United States of America

The global technology equipment leasing market is worth an estimated US\$25 billion a year and continues to grow rapidly. Currently, the Europe claims the lion's share of the market. The concept is more deeply ingrained in the American culture where renting cars, houses and even furniture is the norm. And, because it is so much part of the mainstream, US businesses have historically been more receptive to the leasing message than their European counterparts. The US is also more homogenous than Europe, in terms of both business culture and financial and regulatory frameworks. However, largely because the business arguments in favor of equipment leasing are so compelling, the market is now beginning to take off in Europe. This article looks at the benefits of leasing and the reasons why IT directors and facilities managers across Europe are increasingly adopting this method of financing the acquisition of new equipment. With US-based equipment leasing companies establishing a stronger presence in the region, more European businesses are being educated on the advantages of this approach to asset finance. One of the most important benefits is that leasing helps companies conserve cash.

Paying cash for equipment, or even making large down payments, can deplete reserves and ultimately even lead to the business failing, if insufficient reserves are available to pay off creditors on demand.

In contrast, leasing enables customers to retain their cash, by eliminating the need for down payments. Many leasing packages provide 100 per cent financing and even cover "soft" costs like shipping, installation and training. In addition, there are no application fees. Instead, businesses are able to make affordable, flexible monthly payments. Today, leasing options exist that let users design a financing plan around the needs of their business, whether their priority is guaranteed ownership; the flexibility to return equipment; specified purchase options or varying monthly payments to match seasonal cash flow. Customers can even convert a recent purchase to a lease. To make certain their move into technology equipment leasing is a success, businesses must also work with providers capable of developing financial products tailored to their precise needs no matter the region in which they are operating. Drawing on expertise gleaned from its long-term presence in 15 European countries, Key Equipment Finance is well positioned to do just this.

Lecture # 34

The Leasing Sector in Pakistan and its Role in Capital Investment

From the Third World perspective where a major source of economic capital is a form of foreign or local debt, Leasing acts as a hybrid form of debt cum investment. In the 80's, when Pakistan floated its first leasing company, the characteristic of 'asset-based' financing made it a more 'Islamic' form of lending. (Asset based lending is a permitted form of debt-financing in Islam). From the perspective of developmental finance, Leasing provided an alternative to interest based debt.

Leasing as investment indicator

Hypothetically, since leasing is directly related to the acquisition of an asset, indicating the Aggregate Investment in Leasing (AIL) of the leasing sector, in a country and at a point in time, would indicate the amount of incremental and fresh capital investment in a year. Hypothetically, we may ignore 'leakages' such as rescheduling and duplicate leasing.

The aggregate figure for 'Investment in Leasing' for the leasing sector in Pakistan has been ranging between PKR18bn to PKR25bn over the past three years. We do not have statistics regarding the exact percentage of new investment in plant and machinery or other income generating assets. I think I can safely estimate about 90% of the AIL is plant and machinery. Of-course, the AIL is only indicative of new capital investment if compared with the same over the previous year. A fairly rough estimate of incremental capital investment would therefore be an average of Rs3billion per year. This does not mean all new investment in a year. That would be much higher since part of the AIL would be paid back, depending on the life of the lease contract.

The cost of leasing for a Pakistani lessee averages around 20-25% per annum. The effective cost for a tax-paying lessee may be 16-20%. Assuming an 18% cost of capital (weighted average) for the lessee, the asset can only generate a net income for the lessee, if the lessee in turn earns at least 19-21% per annum from the asset. This would only be possible in high growth sectors of the economy. In my experience, it is rare to see a gross profit margin of 20%, especially in the manufacturing sectors who are the prime clients for leasing Plant and Machinery. The obvious and glaring fact seems to be that the biggest market of leasing cannot afford the product. The question then remains, "who is able to buy?"

The other target markets of leasing are commercial-trade/service enterprises and small pockets of manufacturers. Commercial-trade/service enterprises for obvious reasons do not invest in capital machinery. Small pockets of manufacturers boil down to the ubiquitous multinational or the established Pakistani Group who invests in a new project or modernizes existing operations. The reason why this market may find leasing cost effective is because their overall cost of capital is effectively low enough to absorb the cost of leasing; in effect they use an already cash rich company/division to finance a new venture. The other possibility is that the new project has foreign equity interest, which acts as a source of comfort for the Pakistani lessor and provides support for import costs. A third reason for choosing leasing is as hedge against investing equity. In a macro-economic scenario where debt is the lynchpin of most investment, an investor would like to reduce the risk of investing equity.

Leasing as working capital

Due to the reasons stated above, the product is being used as a source of working capital and quite often as a competing product with short term loans from commercial banks. A sale and lease back transaction is an instant source of funds, payable over the long-term. However, these days an SLB transaction is being used as a vehicle for a direct lease quite often. Because of the enhanced rate of tax at source on direct leases levied from July 98 as against a nil rate for sale and lease-back transactions, lessees prefer to show the lease as a Sale and Leaseback transaction. At the time of processing and obtaining approval, the asset may not have been purchased; but once the lessee is assured of the financing, the asset is purchased and necessary documents processed.

Lessors as financial intermediaries

With the demise of the development financial institution of Pakistan, a source of cheaper funds for long-term capital investment has dried-up. The private financial sector has grown tremendously in the last decade after the IMF's directives of liberalization and de-regulation were affected. Greater economic efficiency, in terms of resource mobilization and allocation, was expected after the deregulation of the economy.

However, the expected economic efficiency is still a long-way away. The private sector has not been able to satisfy the long-term capital needs of the economy. Lessor is suffering from chronic mismatch of funds and lack of availability of long-term funds. Foreign investors are a moody resource at the best of times and relying on foreign funds is a risky strategy. Contrary to the idea that the South Asian nuclear tests were responsible for driving away investors and the low popularity of Pakistan's investment market, the absence of investors, be they foreign or local, is a symptom of deteriorating economic conditions over the past 3-4 years.

The true cost of leasing or the 'economic' cost of leasing

Based on the principles of a 'free market', the true cost of leasing (from an economic perspective) is its return to the economy as a whole. If there is a marked and substantial difference between the rate of return of the lessor and the cost of the lessee (like in Pakistan), there may be inefficiency in the sector—a big gap in demand and supply or some other dis-equilibrium. Of-course, this is not true for manufacturing sectors and other services and products where the value added to a product is perceived to be high. In the financial services, value added cannot be high due to the nature of the product. In Pakistan, the net profit margin of the lessor ranges between 3% and 5%. The cost of lease to the lessee is 18-20%. Where is the bulk in between the two going? Who/what is earning this difference and who is being burdened with the cost of the difference? Poor credit policy, corruption, high uncertainty, and poor quality of information available are a few of the symptoms and reasons for the disparity in returns. The 'real' reason may well be the outflow of capital from developing countries to the developed countries like the USA, because of the 'dollarization' of their economies ... and consequent rapid devaluation of their own currency.

Role of Insurance Companies

Insurance, in law and economics, is a form of risk management primarily used to hedge against the risk of a contingent loss. Insurance is defined as the equitable transfer of the risk of a loss, from one entity to another, in exchange for a premium. **Insurer**, in economics, is the company that sells the insurance. **Insurance rate** is a factor used to determine the amount, called the **premium**, to be charged for a certain amount of insurance coverage. Risk management, the practice of appraising and controlling risk, has evolved as a discrete field of study and practice.

Principles of insurance

Commercially insurable risks typically share seven common characteristics.

1. **A large number of homogeneous exposure units.** The vast majority of insurance policies are provided for individual members of very large classes. Automobile insurance, for example, covered about 175 million automobiles in the United States in 2004.[2] The existence of a large number of homogeneous exposure units allows insurers to benefit from the so-called “law of large numbers,” which in effect states that as the number of exposure units increases, the actual results are increasingly likely to become close to expected results. There are exceptions to this criterion. Lloyd's of London is famous for insuring the life or health of actors, actresses and sports figures. Satellite Launch insurance covers events that are infrequent. Large commercial property policies may insure exceptional properties for which there are no ‘homogeneous’ exposure units. Despite failing on this criterion, many exposures like these are generally considered to be insurable.
2. **Definite Loss.** The event that gives rise to the loss that is subject to insurance should, at least in principle, take place at a known time, in a known place, and from a known cause. The classic example is death of an insured on a life insurance policy. Fire, automobile accidents, and worker injuries may all easily meet this criterion. Other types of losses may only be definite in theory. Occupational disease, for instance, may involve prolonged exposure to injurious conditions where no specific time, place or cause is identifiable. Ideally, the time, place and cause of a loss should be clear enough that a reasonable person, with sufficient information, could objectively verify all three elements.
3. **Accidental Loss.** The event that constitutes the trigger of a claim should be fortuitous, or at least outside the control of the beneficiary of the insurance. The loss should be ‘pure,’ in the sense that it results from an event for which there is only the opportunity for cost. Events that contain speculative elements, such as ordinary business risks, are generally not considered insurable.
4. **Large Loss.** The size of the loss must be meaningful from the perspective of the insured. Insurance premiums need to cover both the expected cost of losses, plus the cost of issuing and administering the policy, adjusting losses, and supplying the capital needed to reasonably assure that the insurer will be able to pay claims. For small losses these latter costs may be several times the size of the expected cost of losses. There is little point in paying such costs unless the protection offered has real value to a buyer.

5. **Affordable Premium.** If the likelihood of an insured event is so high, or the cost of the event so large, that the resulting premium is large relative to the amount of protection offered, it is not likely that anyone will buy insurance, even if on offer. Further, as the accounting profession formally recognizes in financial accounting standards (See FAS 113 for example), the premium cannot be so large that there is not a reasonable chance of a significant loss to the insurer. If there is no such chance of loss, the transaction may have the form of insurance, but not the substance.
6. **Calculable Loss.** There are two elements that must be at least estimable, if not formally calculable: the probability of loss, and the attendant cost. Probability of loss is generally an empirical exercise, while cost has more to do with the ability of a reasonable person in possession of a copy of the insurance policy and a proof of loss associated with a claim presented under that policy to make a reasonably definite and objective evaluation of the amount of the loss recoverable as a result of the claim.
7. **Limited risk of catastrophically large losses.** The essential risk is often aggregation. If the same event can cause losses to numerous policyholders of the same insurer, the ability of that insurer to issue policies becomes constrained, not by factors surrounding the individual characteristics of a given policyholder, but by the factors surrounding the sum of all policyholders so exposed. Typically, insurers prefer to limit their exposure to a loss from a single event to some small portion of their capital base, on the order of 5 percent. Where the loss can be aggregated, or an individual policy could produce exceptionally large claims, the capital constraint will restrict an insurer's appetite for additional policyholders. The classic example is earthquake insurance, where the ability of an underwriter to issue a new policy depends on the number and size of the policies that it has already underwritten. Wind insurance in hurricane zones, particularly along coast lines, is another example of this phenomenon. In extreme cases, the aggregation can affect the entire industry, since the combined capital of insurers and reinsurers can be small compared to the needs of potential policyholders in areas exposed to aggregation risk. In commercial fire insurance it is possible to find single properties whose total exposed value is well in excess of any individual insurer's capital constraint. Such properties are generally shared among several insurers, or are insured by a single insurer who syndicates the risk into the reinsurance market.

Indemnification

The technical definition of "indemnity" means to make whole again. There are two types of insurance contracts; 1) an "indemnity" policy and 2) a "pay on behalf" or "on behalf of"[3] policy. The difference is significant on paper, but rarely material in practice.

An "indemnity" policy will not pay claims until the insured has paid out of pocket to some third party; i.e. a visitor to your home slips on a floor that you left wet and sues you for \$10,000 and wins. Under an "indemnity" policy the homeowner would have to come up with the \$10,000 to pay for the visitor's fall and then would be "indemnified" by the insurance carrier for the out of pocket costs (the \$10,000).

Under the same situation, a "pay on behalf" policy, the insurance carrier would pay the claim and the insured (the homeowner) would not be out of pocket anything. Most modern liability insurance is written on the basis of "pay on behalf" language.

An entity seeking to transfer risk (an individual, corporation, or association of any type, etc.) becomes the 'insured' party once risk is assumed by an 'insurer', the insuring party, by means of a contract, called an insurance 'policy'. Generally, an insurance contract includes, at a minimum, the following elements: the parties (the insurer, the insured, the beneficiaries), the premium, the period of coverage, the particular loss event covered, the amount of coverage (i.e., the amount to be paid to the insured or beneficiary in the event of a loss), and exclusions (events not covered). An insured is thus said to be "indemnified" against the loss events covered in the policy.

When insured parties experience a loss for a specified peril, the coverage entitles the policyholder to make a 'claim' against the insurer for the covered amount of loss as specified by the policy. The fee paid by the insured to the insurer for assuming the risk is called the 'premium'. Insurance premiums from many insured are used to fund accounts reserved for later payment of claims—in theory for a relatively few claimants—and for overhead costs. So long as an insurer maintains adequate funds set aside for anticipated losses (i.e., reserves), the remaining margin is an insurer's profit.

When is a policy really insurance?

An operational definition of insurance is that it is

- the benefit provided by a particular kind of indemnity contract, called an insurance policy;
- that is issued by one of several kinds of legal entities (stock insurance company, mutual insurance company, reciprocal, or Lloyd's syndicate, for example), any of which may be called an insurer;
- in which the insurer promises to pay on behalf of or to indemnify another party, called a policyholder or insured;
- That protects the insured against loss caused by those perils subject to the indemnity in exchange for consideration known as an insurance premium.

In recent years this kind of operational definition proved inadequate as a result of contracts that had the form but not the substance of insurance. The essence of insurance is the transfer of risk from the insured to one or more insurers. How much risk a contract actually transfers proved to be at the heart of the controversy.

This issue arose most clearly in reinsurance, where the use of Financial Reinsurance to reengineer insurer balance sheets under US GAAP became fashionable during the 1980s. The accounting profession raised serious concerns about the use of reinsurance in which little if any actual risk was transferred, and went on to address the issue in FAS 113, cited above. While on its face, FAS 113 is limited to accounting for reinsurance transactions, the guidance it contains is generally conceded to be equally applicable to US GAAP accounting for insurance transactions executed by commercial enterprises.

Does the contract contain adequate risk transfer?

FAS 113 contains two tests, called the '9a and 9b tests,' that collectively require that a contract create a reasonable chance of a significant loss to the underwriter for it to be considered insurance.

9. Indemnification of the ceding enterprise against loss or liability relating to insurance risk in reinsurance of short-duration contracts requires both of the following, unless the condition in paragraph 11 is met:

- a. The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance contracts.
- b. It is reasonably possible that the reinsurer may realize a significant loss from the transaction.

Paragraph 10 of FAS 113 makes clear that the 9a and 9b tests are based on comparing the present value of all costs to the PV of all income streams. FAS give no guidance on the choice of a discount rate on which to base such a calculation, other than to say that all outcomes tested should use the same rate.

Statement of Statutory Accounting Principles ("SSAP") 62, issued by the National Association of Insurance Commissioners, applies to so-called 'statutory accounting' - the accounting for insurance enterprises to conform to regulation. Paragraph 12 of SSAP 62 is nearly identical to the FAS 113 test, while paragraph 14, which is otherwise very similar to paragraph 10 of FAS 113, additionally contains a justification for the use of a single fixed rate for discounting purposes. The choice of an "reasonable and appropriate" discount rate is left as a matter of judgment.

Is there a bright line test?

Neither FAS 113 nor SAP 62 defines the terms reasonable or significant. Ideally, one would like to be able to substitute values for both terms. It would be much simpler if one could apply a test of an X percent chance of a loss of Y percent or greater. Such tests have been proposed, including one famously attributed to an SEC official who is said to have opined in an after lunch talk that a 10 percent chance of a 10 percent loss was sufficient to establish both reasonableness and significance. Indeed, many insurers and reinsurers still apply this 10/10" test as a benchmark for risk transfer testing.

It should be obvious that an attempt to use any numerical rule such as the 10/10 test will quickly run into problems. Implicit in the test is keeping the 10/10 that either are upper bounds for the comment made by the SEC official therefore, the rest of this paragraph doesn't apply. Suppose a contract has a 1 percent chance of a 10,000 percent loss? It should be reasonably self-evident that such a contract is insurance, but it fails one half of the 10/10 test.

It does not appear that any bright line test of reasonableness nor significance can be constructed.

Excess of loss contracts, like those commonly used for umbrella and general liability insurance, or to insure against property losses, will typically have a low ratio of premium paid to maximum loss recoverable. This ratio (expressed as a percentage), commonly called the rate on line for historical reasons related to underwriting practices at Lloyd's of London, will typically be low for contracts that contain reasonably self-evident risk transfer. As the ratio increases to approximate the present value of the limit of coverage, self-evidence decreases and disappears.

Contracts with low rates on line may survive modest features that limit the amount of risk transferred. As rates on line increase, such risk limiting features become increasingly important.

"Safe harbor" exemptions

The analysis of reasonableness and significance is an estimate of the probability of different gain or loss outcomes under different loss scenarios. It takes time and resources to perform the analysis, which constitutes a burden without value where risk transfer is reasonably self-evident.

Guidance exists for insurers and reinsurers, whose CEO's and CFO's attest annually as to the reinsurance agreements their firms undertake. The American Academy of Actuaries, for instance, identifies three categories of contract as outside the requirement of attestation:

- Inactive contracts. If there are neither premiums due nor losses payable, and the insurer is not taking any credit for the reinsurance, determining risk transfer is irrelevant.
- Pre-1994 contracts. The attestation requirement only applies to contracts that were entered into, renewed or amended on or after 1 January 1994. Prior contracts need not be analyzed.
- Where risk transfer is "reasonably self-evident."

"Risk transfer is reasonably self-evident in most traditional per-risk or per-occurrence excess of loss reinsurance contracts. For these contracts, a predetermined amount of premium is paid and the reinsurer assumes nearly all or all of the potential variability in the underlying losses, and it is evident from reading the basic terms of the contract that the reinsurer can incur a significant loss. In many cases, there is no aggregate limit on the reinsurer's loss. The existence of certain experience-based contract terms, such as experience accounts, profit commissions, and additional premiums, generally reduce the amount of risk transfer and make it less likely that risk transfer is reasonably self-evident."

- "Reinsurance Attestation Supplement 20-1: Risk Transfer Testing Practice Note," American Academy of Actuaries, November 2005. ...

Risk limiting features

An insurance policy should not contain provisions that allow one side or the other to unilaterally void the contract in exchange for benefit. Provisions that void the contract for failure to perform or for fraud or material misrepresentation are ordinary and acceptable.

The policy should have a term of not more than about three years. This is not a hard and fast rule. Contracts of over five years duration are classified as 'long-term,' which can impact the accounting treatment, and can obviously introduce the possibility that over the entire term of the contract, no actual risk will transfer. The coverage provided by the contract need not cease at the end of the term (e.g., the contract can cover occurrences as opposed to claims made or claims paid).

The contract should be considered to include any other agreements, written or oral, that confer rights, create obligations, or create benefits on the part of either or both parties. Ideally, the contract should contain an 'Entire Agreement' clause that assures there are no undisclosed written or oral side agreements that confer rights, create obligations, or create benefits on the part of either or both parties. If such rights, obligations or benefits exist, they must be factored into the tests of reasonableness and significance.

The contract should not contain arbitrary limitations on timing of payments. Provisions that assure both parties of time to properly present and consider claims are acceptable provided they are commercially reasonable and customary.

Provisions that expressly create actual or notional accounts that accrue actual or notional interest suggest that the contract contains, in fact, a deposit.

Provisions for additional or return premium do not, in and of themselves, render a contract something other than insurance. However, it should be unlikely that either a return or additional premium provision be triggered, and neither party should have discretion regarding the timing of such triggering.

All of the events that would give rise to claims under the contract cannot have materialized prior to the inception of the contract. If this "all events" test is not met, then the contract is considered to be a retroactive contract, for which the accounting treatment becomes complex.

Insurer's business model

Profit = earned premium + investment income - incurred loss - underwriting expenses.

Insurers make money in two ways: (1) through underwriting, the process by which insurers selects the risks to insure and decide how much in premiums to charge for accepting those risks and (2) by investing the premiums they collect from insureds.

The most difficult aspect of the insurance business is the underwriting of policies. Using a wide assortment of data, insurers predict the likelihood that a claim will be made against their policies and price products accordingly. To this end, insurers use actuarial science to quantify the risks they are willing to assume and the premium they will charge to assume them. Data is analyzed to fairly accurately project the rate of future claims based on a given risk. Actuarial science uses statistics and probability to analyze the risks associated with the range of perils covered, and these scientific principles are used to determine an insurer's overall exposure. Upon termination of a given policy, the amount of premium collected and the investment gains thereon minus the amount paid out in claims is the insurer's underwriting profit on that policy. Of course, from the insurer's perspective, some policies are winners (i.e., the insurer pays out less in claims and expenses than it receives in premiums and investment income) and some are losers (i.e., the insurer pays out more in claims and expenses than it receives in premiums and investment income).

An insurer's underwriting performance is measured in its combined ratio. The loss ratio (incurred losses and loss-adjustment expenses divided by net earned premium) is added to the expense ratio (underwriting expenses divided by net premium written) to determine the company's combined ratio. The combined ratio is a reflection of the company's overall underwriting profitability. A combined ratio of less than 100 percent indicates profitability, while anything over 100 indicates a loss.

Insurance companies also earn investment profits on "float". "Float" or available reserve is the amount of money, at hand at any given moment that an insurer has collected in insurance premiums but has not been paid out in claims. Insurers start investing insurance premiums as soon as they are collected and continue to earn interest on them until claims are paid out.

In the United States, the underwriting loss of property and casualty insurance companies was \$142.3 billion in the five years ending 2003. But overall profit for the same period was \$68.4 billion, as the result of float. Some insurance industry insiders, most notably Hank Greenberg, do not believe that it is forever possible to sustain a profit from float without an underwriting profit as well, but this opinion is not universally held. Naturally, the “float” method is difficult to carry out in an economically depressed period. Bear markets do cause insurers to shift away from investments and to toughen up their underwriting standards. So a poor economy generally means high insurance premiums. This tendency to swing between profitable and unprofitable periods over time is commonly known as the “underwriting” or insurance cycle.

Property and casualty insurers currently make the most money from their auto insurance line of business. Generally better statistics are available on auto losses and underwriting on this line of business has benefited greatly from advances in computing. Additionally, property losses in the US, due to natural catastrophes, have exacerbated this trend.

Finally, claims and loss handling is the materialized utility of insurance. In managing the claims-handling function, insurers seek to balance the elements of customer satisfaction, administrative handling expenses, and claims overpayment leakages. As part of this balancing act, fraudulent insurance practices are a major business risk that must be managed and overcome.

Gambling analogy

Both gambling and insurance transfer risk and reward.

Gambling transactions offer the possibility of either a loss or a gain. Gambling creates losers and winners. Insurance transactions do not present the possibility of gain. Insurance offers financial support sufficient to replace loss, not to create pure gain.

Gamblers can continue spending, buying more risk than they can afford to pay for. Insurance buyers can only spend up to the limit of what carriers would accept to insure; their loss is limited to the amount of the premium.

Gamblers, by creating new risk transfer, are risk seekers. Insurance buyers are risk avoiders, creating risk transfer in terms of their need to reduce exposure to large losses.

Gambling or gaming is designed at the start so that the odds are not affected by the players' conduct or behavior and not required to conduct risk mitigation practices. But players can prepare and increase their odds of winning in certain games such as poker or blackjack. In contrast to gambling or gaming, to obtain certain types of insurance, such as fire insurance, policyholders can be required to conduct risk mitigation practices, such as installing sprinklers and using fireproof building materials to reduce the odds of loss to fire. In addition, after a proven loss, insurers specialize in providing rehabilitation to minimize the total loss.

Insurance, the avoiding, mitigating and transferring of risk, creates greater predictability for individuals and organizations.

Lecture # 36

Role of Insurance Companies

Types of insurance

Any risk that can be quantified can potentially be insured. Specific kinds of risk that may give rise to claims are known as "perils". An insurance policy will set out in detail which perils are covered by the policy and which is not.

- Below is a (non-exhaustive) list of the many different types of insurance that exist. A single policy may cover risks in one or more of the categories set forth below. For example, auto insurance would typically cover both property risk (covering the risk of theft or damage to the car) and liability risk (covering legal claims from causing an accident). A homeowner's insurance policy in the U.S. typically includes property insurance covering damage to the home and the owner's belongings, liability insurance covering certain legal claims against the owner, and even a small amount of health insurance for medical expenses of guests who are injured on the owner's property.
- Automobile insurance, known in the UK as *motor insurance*, is probably the most common form of insurance and may cover both legal liability claims against the driver and loss of or damage to the insured's vehicle itself. Throughout most of the United States an auto insurance policy is required to legally operate a motor vehicle on public roads. In some jurisdictions, bodily injury compensation for automobile accident victims has been changed to a no-fault system, which reduces or eliminates the ability to sue for compensation but provides automatic eligibility for benefits. Credit card companies insure against damage on rented cars.
- Aviation insurance insures against hull, spares, deductible, hull war and liability risks.
- Boiler insurance (also known as boiler and machinery insurance or equipment breakdown insurance) insures against accidental physical damage to equipment or machinery.
- Builder's risk insurance insures against the risk of physical loss or damage to property during construction. Builder's risk insurance is typically written on an "all risk" basis covering damage due to any cause (including the negligence of the insured) not otherwise expressly excluded.
- Business insurance can be any kind of insurance that protects businesses against risks. Some principal subtypes of business insurance are (a) the various kinds of **professional liability insurance**, also called **professional indemnity insurance**, which are discussed below under that name; and (b) the business owners policy (BOP), which bundles into one policy many of the kinds of coverage that a business owner needs, in a way analogous to how homeowners insurance bundles the coverage that a homeowner needs.
- Casualty insurance insures against accidents, not necessarily tied to any specific property.
- Credit insurance repays some or all of a loan back when certain things happen to the borrower such as unemployment, disability, or death. Mortgage insurance (which see below) is a form of credit insurance, although the name *credit insurance* more often is used to refer to policies that cover other kinds of debt.

- Crime insurance insures the policyholder against losses arising from the criminal acts of third parties. For example, a company can obtain crime insurance to cover losses arising from theft or embezzlement.
- Crop insurance "Farmers use crop insurance to reduce or manage various risks associated with growing crops. Such risks include crop loss or damage caused by weather, hail, drought, frost damage, insects, or disease, for instance." [8]
- Defense Base Act Workers' compensation or DBA Insurance insurance provides coverage for civilian workers hired by the government to perform contracts outside the US and Canada. DBA is required for all US citizens, US residents, US Green Card holders, and all employees or subcontractors hired on overseas government contracts. Depending on the country, Foreign Nationals must also be covered under DBA. This coverage typically includes expenses related to medical treatment and loss of wages, as well as disability and death benefits.
- Directors and officers liability insurance protects an organization (usually a corporation) from costs associated with litigation resulting from mistakes incurred by directors and officers for which they are liable. In the industry, it is usually called "D&O" for short.
- Disability insurance policies provide financial support in the event the policyholder is unable to work because of disabling illness or injury. It provides monthly support to help pay such obligations as mortgages and credit cards.
 - Total permanent disability insurance provides benefits when a person is permanently disabled and can no longer work in their profession, often taken as an adjunct to life insurance.
- Errors and omissions insurance: See "Professional liability insurance" under "Liability insurance".
- Expatriate insurance provides individuals and organizations operating outside of their home country with protection for automobiles, property, health, liability and business pursuits.
- Financial loss insurance protects individuals and companies against various financial risks. For example, a business might purchase cover to protect it from loss of sales if a fire in a factory prevented it from carrying out its business for a time. Insurance might also cover the failure of a creditor to pay money it owes to the insured. This type of insurance is frequently referred to as "business interruption insurance." Fidelity bonds and surety bonds are included in this category, although these products provide a benefit to a third party (the "obligee") in the event the insured party (usually referred to as the "obligor") fails to perform its obligations under a contract with the obligee.
- Health insurance policies will often cover the cost of private medical treatments if the National Health Service in the UK (NHS) or other publicly-funded health programs do not pay for them. It will often result in quicker health care where better facilities are available.
- Kidnap and ransom insurance
- Home insurance or homeowners insurance:
- Liability insurance is a very broad superset that covers legal claims against the insured. Many types of insurance include an aspect of liability coverage. For example, a homeowner's insurance policy will normally include liability coverage which protects the insured in the event of a claim brought by someone who slips and

falls on the property; automobile insurance also includes an aspect of liability insurance that indemnifies against the harm that a crashing car can cause to others' lives, health, or property. The protection offered by a liability insurance policy is twofold: a legal defense in the event of a lawsuit commenced against the policyholder and indemnification (payment on behalf of the insured) with respect to a settlement or court verdict. Liability policies typically cover only the negligence of the insured, and will not apply to results of willful or intentional acts by the insured.

- Environmental liability insurance protects the insured from bodily injury, property damage and cleanup costs as a result of the dispersal, release or escape of pollutants.
 - Professional liability insurance, also called professional indemnity insurance, protects professional practitioners such as architects, lawyers, doctors, and accountants against potential negligence claims made by their patients/clients. Professional liability insurance may take on different names depending on the profession. For example, professional liability insurance in reference to the medical profession may be called malpractice insurance. Notaries public may take out errors and omissions insurance (E&O). Other potential E&O policyholders include, for example, real estate brokers, home inspectors, appraisers, and website developers.
- Life insurance provides a monetary benefit to a decedent's family or other designated beneficiary, and may specifically provide for income to an insured person's family, burial, funeral and other final expenses. Life insurance policies often allow the option of having the proceeds paid to the beneficiary either in a lump sum cash payment or an annuity.
 - Annuities provide a stream of payments and are generally classified as insurance because they are issued by insurance companies and regulated as insurance and require the same kinds of actuarial and investment management expertise that life insurance requires. Annuities and pensions that pay a benefit for life are sometimes regarded as insurance against the possibility that a retiree will outlive his or her financial resources. In that sense, they are the complement of life insurance and, from an underwriting perspective, are the mirror image of life insurance.
- Locked funds insurance is a little-known hybrid insurance policy jointly issued by governments and banks. It is used to protect public funds from tamper by unauthorized parties. In special cases, a government may authorize its use in protecting semi-private funds which are liable to tamper. The terms of this type of insurance are usually very strict. Therefore it is used only in extreme cases where maximum security of funds is required.
- Marine insurance and marine cargo insurance cover the loss or damage of ships at sea or on inland waterways, and of the cargo that may be on them. When the owner of the cargo and the carrier are separate corporations, marine cargo insurance typically compensates the owner of cargo for losses sustained from fire, shipwreck, etc., but excludes losses that can be recovered from the carrier or the carrier's insurance. Many marine insurance underwriters will include "time element" coverage in such policies, which extends the indemnity to cover loss of profit and other business expenses attributable to the delay caused by a covered loss.
- Mortgage insurance insures the lender against default by the borrower.
- National Insurance is the UK's version of social insurance (which see below).

- No-fault insurance is a type of insurance policy (typically automobile insurance) where insureds are indemnified by their own insurer regardless of fault in the incident.
- Nuclear incident insurance covers damages resulting from an incident involving radioactive materials and is generally arranged at the national level. (For the United States, see the Price-Anderson Nuclear Industries Indemnity Act.)
- Pet insurance insures pets against accidents and illnesses - some companies cover routine/wellness care and burial, as well.
- Political risk insurance can be taken out by businesses with operations in countries in which there is a risk that revolution or other political conditions will result in a loss.
- Pollution Insurance. First-party coverage for contamination of insured property either by external or on-site sources. Coverage for liability to third parties arising from contamination of air, water, or land due to the sudden and accidental release of hazardous materials from the insured site. The policy usually covers the costs of cleanup and may include coverage for releases from underground storage tanks. Intentional acts are specifically excluded
- Property insurance provides protection against risks to property, such as fire, theft or weather damage. This includes specialized forms of insurance such as fire insurance, flood insurance, earthquake insurance, home insurance, inland marine insurance or boiler insurance.
- Protected Self-Insurance is an alternative risk financing mechanism in which an organization retains the mathematically calculated cost of risk within the organization and transfers the catastrophic risk with specific and aggregate limits to an Insurer so the maximum total cost of the program is known. A properly designed and underwritten Protected Self-Insurance Program reduces and stabilizes the cost of insurance and provides valuable risk management information.
- Purchase insurance is aimed at providing protection on the products people purchase. Purchase insurance can cover individual purchase protection, warranties, guarantees, care plans and even mobile phone insurance. Such insurance is normally very limited in the scope of problems that are covered by the policy.
- Retrospectively Rated Insurance is a method of establishing a premium on large commercial accounts. The final premium is based on the insured's actual loss experience during the policy term, sometimes subject to a minimum and maximum premium, with the final premium determined by a formula. Under this plan, the current year's premium is based partially (or wholly) on the current year's losses, although the premium adjustments may take months or years beyond the current year's expiration date. The rating formula is guaranteed in the insurance contract. Formula: retrospective premium = converted loss + basic premium × tax multiplier. Numerous variations of this formula have been developed and are in use.
- Self Insurance is protection against loss by setting aside one's own money. This can be done on a mathematical basis by establishing a separate fund into which funds are deposited on a periodic basis. Through self insurance it is possible to protect against high-frequency low-severity losses. To do this through an insurance company would mean having to pay a premium that includes loadings for the company's general expenses, cost of putting the policy on the books, acquisition expenses, premium taxes, and contingencies.

- Social insurance can be many things to many people in many countries. But a summary of its essence is that it is a collection of insurance coverages (including components of life insurance, disability income insurance, unemployment insurance, health insurance, and others), plus retirement savings, that mandates participation by all citizens. By forcing everyone in society to be a policyholder and pay premiums, it ensures that everyone can become a claimant when or if he/she needs to. Along the way this inevitably becomes related to other concepts such as the justice system and the welfare state. This is a large, complicated topic that engenders tremendous debate, which can be further studied in the following articles (and others):
 - o Social welfare provision
 - o Social security
 - o Social safety net
 - o National Insurance
 - o Social Security (United States)
 - o Social Security debate (United States)
- Stop-loss insurance provides protection against catastrophic or unpredictable losses. It is purchased by organizations who do not want to assume 100% of the liability for losses arising from the plans. Under a stop-loss policy, the insurance company becomes liable for losses that exceed certain limits called deductibles.
- Surety Bond insurance is a three party insurance guaranteeing the performance of the principal.
- Terrorism insurance provides protection against any loss or damage caused by terrorist activities.
- Title insurance provides a guarantee that title to real property is vested in the purchaser and/or mortgagee, free and clear of liens or encumbrances. It is usually issued in conjunction with a search of the public records performed at the time of a real estate transaction.
- Travel insurance is an insurance cover taken by those who travel abroad, which covers certain losses such as medical expenses, lost of personal belongings, travel delay, personal liabilities, etc.
- Volcano insurance is an insurance that covers volcano damage in Hawaii.
- Workers' compensation insurance replaces all or part of a worker's wages lost and accompanying medical expense incurred because of a job-related injury.

Types of insurance companies

Insurance companies may be classified as

- Life insurance companies, which sell life insurance, annuities and pensions products.
- Non-life or general insurance companies, which sell other types of insurance.

General insurance companies can be further divided into these sub categories.

- Standard Lines
- Excess Lines

In most countries, life and non-life insurers are subject to different regulatory regimes and different tax and accounting rules. The main reason for the distinction between the two

types of company is that life, annuity, and pension business is very long-term in nature — coverage for

Life assurance or a pension can cover risks over many decades. By contrast, non-life insurance cover usually covers a shorter period, such as one year.

In the United States, standard line insurance companies are your "main stream" insurers. These are the companies that typically insure your auto, home or business. They use pattern or "cookie-cutter" policies without variation from one person to the next. They usually have lower premiums than excess lines and can sell directly to individuals. They are regulated by state laws that can restrict the amount they can charge for insurance policies.

Excess line insurance companies (aka Excess and Surplus) typically insure risks not covered by the standard lines market. They are broadly referred as being all insurance placed with non-admitted insurers. Non-admitted insurers are not licensed in the states where the risks are located. These companies have more flexibility and can react faster than standard insurance companies because they don't have the same regulations as standard insurance companies. State laws generally require insurance placed with surplus line agents and brokers to not be available through standard licensed insurers.

Insurance companies are generally classified as either mutual or stock companies. This is more of a traditional distinction as true mutual companies are becoming rare. Mutual companies are owned by the policyholders, while stockholders (who may or may not own policies) own stock insurance companies. Other possible forms for an insurance company include reciprocals, in which policyholders 'reciprocate' in sharing risks, and Lloyds organizations.

Insurance companies are rated by various agencies such as A. M. Best. The ratings include the company's financial strength, which measures its ability to pay claims. It also rates financial instruments issued by the insurance company, such as bonds, notes, and securitization products.

Reinsurance companies are insurance companies that sell policies to other insurance companies, allowing them to reduce their risks and protect themselves from very large losses. The reinsurance market is dominated by a few very large companies, with huge reserves. A reinsurer may also be a direct writer of insurance risks as well.

Captive insurance companies may be defined as limited-purpose insurance companies established with the specific objective of financing risks emanating from their parent group or groups. This definition can sometimes be extended to include some of the risks of the parent company's customers. In short, it is an in-house self-insurance vehicle. Captives may take the form of a "pure" entity (which is a 100 percent subsidiary of the self-insured parent company); of a "mutual" captive (which insures the collective risks of members of an industry); and of an "association" captive (which self-insures individual risks of the members of a professional, commercial or industrial association). Captives represent commercial, economic and tax advantages to their sponsors because of the reductions in costs they help create and for the ease of insurance risk management and the flexibility for cash flows they generate. Additionally, they may provide coverage of risks which is neither available nor offered in the traditional insurance market at reasonable prices.

The types of risk that a captive can underwrite for their parents include property damage, public and products liability, professional indemnity, employee benefits, employers liability, motor and medical aid expenses. The captive's exposure to such risks may be limited by the use of reinsurance.

Captives are becoming an increasingly important component of the risk management and risk financing strategy of their parent. This can be understood against the following background:

- heavy and increasing premium costs in almost every line of coverage;
- difficulties in insuring certain types of fortuitous risk;
- differential coverage standards in various parts of the world;
- rating structures which reflect market trends rather than individual loss experience;
- Insufficient credit for deductibles and/or loss control efforts.

There are also companies known as 'insurance consultants'. Like a mortgage broker, these companies are paid a fee by the customer to shop around for the best insurance policy amongst many companies.

Similar to an insurance consultant, an 'insurance broker' also shops around for the best insurance policy amongst many companies. However, with insurance brokers, the fee is usually paid in the form of commission from the insurer that is selected rather than directly from the client.

Neither insurance consultants nor insurance brokers are insurance companies and no risks are transferred to them in insurance transactions.

Third party administrators are companies that perform underwriting and sometimes claim handling services for insurance companies. These companies often have special expertise that the insurance companies do not have.

Life insurance and saving

Certain life insurance contracts accumulate cash values, which may be taken by the insured if the policy is surrendered or which may be borrowed against. Some policies, such as annuities and endowment policies, are financial instruments to accumulate or liquidate wealth when it is needed. See life insurance.

In many countries, such as the U.S. and the UK, the tax law provides that the interest on this cash value is not taxable under certain circumstances. This leads to widespread use of life insurance as a tax-efficient method of saving as well as protection in the event of early death.

In U.S., the tax on interest income on life insurance policies and annuities is generally deferred. However, in some cases the benefit derived from tax deferral may be offset by a low return. This depends upon the insuring company, the type of policy and other variables (mortality, market return, etc.). Moreover, other income tax saving vehicles (e.g., IRAs, 401(k) plans, Roth IRAs) may be better alternatives for value accumulation. A combination of low-cost term life insurance and a higher-return tax-efficient retirement account may achieve better investment return.

Role of financial Institutions in Agriculture Sector

Which banks are authorized for providing agricultural credit to farmers/growers?

All banks can provide agricultural credit to Farmers / growers. SBP does not restrain any bank from providing agricultural credit. However, under the Agricultural Credit Scheme indicative targets are given to 21 banks on annual basis. These include; two specialized banks (ZTBL & PPCBL), five major commercial banks (ABL, HBL, MCB, NBP & UBL) and 14 domestic private commercial banks; 1) Askari Com. Bank, 2) Bank Al-Habib, 3) Bank Al-Falah , 4) My Bank, 5) Faysal Bank, 6) Habib Metropolitan Bank, 7) PICIC Com. Bank, 8) KASB Bank, 9) Prime Com. Bank , 10) Saudi Pak Com. Bank, 11) Soneri Bank, 12) Bank of Khyber, 13) Bank of Punjab and 14) Standard Chartered Bank (Pakistan).

Who is eligible for agricultural credit from the banks?

Any individual (farmers/livestock farmers, fishermen, fish farmers), corporate firms, cooperative societies/self help groups under-taking livestock related activities, fish catching/processing /packing companies and fish exporters having sufficient knowledge and relevant experience are eligible to draw agricultural credit from banks.

Are the traders and intermediaries engaged in trading/processing of agricultural commodities eligible for agricultural credit?

Loans to entities exclusively engaged in processing, packaging and marketing of agricultural produce shall not fall under agricultural financing and would be covered under commercial or SME financing. However, agricultural financing can be extended to entities (including corporate farms, partnerships and individuals) engaged in farming activity as well as processing, packaging and marketing of mainly their own agricultural produce, provided 75% of the agriculture produce being processed, packaged and marketed is being produced by the abovementioned entities themselves.

How can a person get agricultural loan from banks?

Applicant must be a genuine farmer/tenant. For this purpose a farmer's name must appear in revenue record and a tenant should establish this fact through a government acknowledgement or the applicant must be handling Non-Farm activities like livestock, poultry, dairy farming, fishery, forestry or firms/ cooperative societies/self help groups undertaking agriculture related activities.

The borrower should be holder of computerized N.I.C in cases of individuals.

The borrower should not be a defaulter of any Bank/Financial Institution. This condition may be relaxed in cases where the bank is satisfied with the creditworthiness of the borrower and that the earlier default was circumstantial and not willful.

Applicant must produce proper securities / sureties / passbook or other collaterals acceptable to the banks.

If one brother was declared defaulter, do the banks provide loan to other brothers?

Every individual could be separately considered for grant of loans if he had credit worthiness and separate landed property.

For what purposes the banks provide Agricultural Credit?

Agricultural credit is provided by banks for complete value chain of activities such as production/crop loans i.e. in-puts (seed, fertilizer, & pesticides etc.), development loans (tractors & tube wells, agricultural machinery / equipments / implements etc.), corporate farming, marketing, cold storage (godowns) on farm & off farm, silos, processing of crops (other than major crops), fruits & vegetables, grading, polishing, packing, transportation and exports of agricultural goods etc.

Agricultural credit is also available for non-farm sector such as poultry, livestock, dairy farming, forestry and fisheries, apiculture, sericulture, floriculture, horticulture, etc.

There is no provision of financing for procurement of fruits/crops under the list of eligible items for agricultural credit such lending would be covered under commercial or SME financing.

What types of loans are provided to farmers/growers by banks?

Banks are providing three types of loans; short-term (upto 18 months), medium-term (1.5 years to 5 years) and long-term (5 – 7 years). While short-term loans are provided for working capital, medium and long-term loans are given for developmental requirements such as improvement and development of land, purchase of tractors and other agricultural machinery / equipments / implements related to farm and non-farm sector, etc.

Why the mark-up rate of Agricultural Credit is higher than the mark-up rate of Commercial/Industrial Credit?

In the post financial sector reforms era, banks' markup rates are not fixed for different sectors but are based on their cost structure and risk profile of the borrowers and the sector. Banks are required to use KIBOR as a bench mark for determining pricing of their loans.

Our farming community is generally unaware of different agricultural loan schemes/products. What efforts have been made by SBP for awareness of the farming community?

For awareness building of the farmers, SBP has published pamphlets, brochures/book-lets containing information about different agricultural credit schemes/products in Urdu and English as well as in all regional languages and these publications have been distributed to the stakeholders including farming community.

Besides, SBP has been arranging special outreach training programs since 2003 in different cities of Pakistan for the banks, Agriculturists, Nazims, Chambers of Agriculture and representatives of Farmers' Associations. SBP officials along with banks' representatives

also undertake field visits across the country especially to make the farmers aware of loaning facilities available and various schemes & new products of banks.

Banks are vigorously going for car leasing business. Can't such facility be extended to farming / rural community by providing agricultural machines/equipments / implements including tractor on leasing, hiring, rental basis?

SBP has already allowed banks to extend leasing facilities to the farmers under the scheme for tube wells, tractors, harvesters etc. These machines/equipments / implements are also available to the farmers on hiring, leasing and rental basis through Leasing Companies.

Whether lease holders of orchards are eligible for agriculture loans from banks?

Yes, lease holders of Orchards are also eligible to avail loan under Agricultural Credit Scheme

Is there any limit for agriculture financing?

No, there is no limit on agricultural loans; however, the loan limit amount is assessed by the ACO/branch manager on the basis of financing appraisal or feasibility report, etc.

Do the bank branches functioning in remote areas have sufficient information about the schemes for agricultural financing?

Guidelines on different financing schemes and other instructions issued to banks are communicated to banks with the instructions to send the same to all concerned branches. In addition to this, SBP has published brochures about different loan schemes which were translated into Urdu and regional languages and distributed among stakeholders including ACOs/MCOs of rural branches of banks. Moreover, special outreach and training programs organized in collaboration with commercial banks create awareness among the farming/rural community of agri-financing facilities they can access and also to enhance the capacity of commercial banks in agricultural & rural finance by providing training to local agricultural credit officers of the banks.

What areas are covered under the Agricultural Loans scheme?

The Agricultural Loans Scheme has been designed to cover the entire Pakistan including AJK with no restriction of territorial jurisdiction. Any farmer / grower can avail bank credit from any designated branch of banks throughout Pakistan as per his choice. Likewise banks are also free to provide credit to any farmer through out Pakistan subject to completion of required formalities.

What types of sureties / securities/collaterals are acceptable to the banks for providing agricultural credit to farmers/growers?

Agricultural land under the pass book system, urban/rural property, commercial property, Defense Saving Certificates, Special Saving Certificates, Gold & Silver Ornaments, personal surety, hypothecation of livestock and other assets e.g. motor boats / fishing trawlers, etc. are generally accepted by banks as collateral.

Is mark-up rate fixed by SBP on agricultural loans?

SBP does not fix any maximum/minimum mark-up rate to be charged on agricultural loans. Banks' mark-up is based on their cost structure and risk profile of the borrowers and the sector. However, for benchmarking, Karachi inter-bank Offered Rate (KIBOR) is used by banks for the purpose.

What is "Revolving Credit Scheme"?

Revolving Credit Scheme was introduced in 2003 in consultation with banks. Under the scheme, banks can provide finance for agricultural purposes on the basis of revolving limits for a period of three years with one-time documentation. The borrowers are required to clear the entire loan amount (including mark-up) once in a year at the date of their own choice.

Multiple withdrawals are allowed and the borrowers are also allowed to make partial repayments. Only the amount utilized by the borrower will attract mark-up. This facility can be availed by the farmers just like "running finance". The limits under this scheme are automatically renewed on annual basis without any request or fresh application.

Is the credit facility under "Revolving Credit Scheme" available only on seasonal basis i.e. one crop only?

The credit limits under Revolving Credit Scheme are available to the farmers for full one year i.e. covering both the crops in a year. To save the farmers from stress sale of their crops, they are required to clear their account only once in a year at a date indicated by the borrower and mutually agreed with lending bank.

Is there any system/procedure under which farmers can get agricultural loans at their doorsteps?

Mobile Credit Officers (MCOs) and Agricultural Credit Officers of banks are visiting the farmers regularly to ascertain the credit needs of the farmers and ensure its availability at their doorsteps and also provide technical help for different crops.

Whether landless farmers/tenants can avail agricultural credit under Revolving Credit Scheme?

Yes, agricultural credit under Revolving Credit Scheme can be availed against personal surety, guarantee or any other collateral acceptable to banks.

Are farmers who had availed any concession or remission under Government relief package announced from time to time, eligible for fresh loans?

Yes, borrowers who have availed concession under any scheme notified by the government or concerned bank/DFI in the light of guidelines issued by SBP may be eligible for fresh financing.

Lecture # 38

Agriculture Sector and Financial Institutions of Pakistan**What types of securities/collaterals are acceptable to the banks for providing agricultural credit to farmers/growers?**

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What are SMEs?

As defined by State Bank of Pakistan - **SME (Small and Medium Enterprise)** means an entity, ideally not a public limited company, which does not employ more than 250 persons (if it is manufacturing concern) and 50 persons (if it is trading / service concern) and also fulfills the following criteria of either 'a' and 'c' or 'b' and 'c' as relevant:

- a. A trading / service concern with total assets at cost excluding land and buildings up to Rs 50 million.
- b. A manufacturing concern with total assets at cost excluding land and building up to Rs 100 million
- c. Any concern (trading, service or manufacturing) with net sales not exceeding Rs 300 million as per latest financial statements.

SME Financing and Hand-Holding

Research reveals that despite the lack of collateral, SMEs are a better credit risk, as the default rate of this sector is much below that of large enterprises (LEs). Throughout the world, SMEs have provided tremendous opportunities to financial institutions to design various tools for the sector's development (e.g. Program Lending Schemes, Credit Scoring, Venture Capital Financing, etc.). Then there are clusters, technology parks and industrial estates, all being fuelled by the dynamism and vibrancy of small and medium enterprises. Banking institutions, running on Islamic principles, are also experimenting with interest free financial instruments (e.g. Mudarabah, Murabaha, Ijarah etc.) for this sector.

Small and medium enterprises or SMEs, also called **small and medium-sized enterprises** and **small and medium-sized businesses** or **small and medium businesses** or **SMBs** are companies whose headcount or turnover falls below certain limits.

The abbreviation SME occurs commonly in the European Union and in international organizations, such as the World Bank, the United Nations and the WTO . The term small and medium-sized businesses or SMBs has become more standard in a few other countries.

EU Member States traditionally had their own definition of what constitutes an SME, for example the traditional definition in Germany had a limit of 500 employees , while, for example, in Belgium it could have been 100. But now the EU has started to standardize the

concept. Its current definition categorizes companies with fewer than 50 employees as "small", and those with fewer than 250 as "medium". By contrast, in the United States, when small business is defined by the number of employees, it often refers to those with less than 100 employees, while medium-sized business often refers to those with less than 500 employees. However, the most widely used American definition of micro-business by the number of employees is the same of that of European Union less than 10 employees. As of 2005, Germany will use the definition of the European Commission. Business enterprises of fewer than 10 employees often class as SOHO

In most economies, smaller enterprises are much greater in number. In the EU, SMEs comprise approximately 99% of all firms and employ between them about 65 million people. In many sectors, SMEs are also responsible for driving innovation and competition. Providing SME finance and support is thus an important area of economic policy.

Significance of SMEs

SMEs are considered the engine of economic growth in both developed and developing countries, as they: Provide low cost employment since the unit cost of persons employed is lower for SMEs than for large-size units.

- Assist in regional and local development since SMEs accelerate rural industrialization by linking it with the more organized urban sector.
- Help achieve fair and equitable distribution of wealth by regional dispersion of economic activities.
- Contribute significantly to export revenues because of the low-cost labour intensive nature of its products.
- Have a positive effect on the trade balance since SMEs generally use indigenous raw materials.
- Assist in fostering a self-help and entrepreneurial culture by bringing together skills and capital through various lending and skill enhancement schemes.
- Impart the resilience to withstand economic upheavals and maintain a reasonable growth rate since being indigenous is the key to sustainability and self-sufficiency.

Problems Faced by Pakistan's SME Sector?

Pakistan's economy has amazing potential for development but sadly, we haven't been able to derive optimal benefits despite a series of efforts launched by various policy makers at different times. The impetus of all these endeavors was on the large scale industries and manufacturing concerns. High rate of failures, owing to economic slumps, institutional malpractices, political motives and damaging activities of labour unions in that sector, left the formal lending institutions with huge infected portfolios, in addition to adverse effects on the entire economy e.g. insufficient and low quality production to meet the demands of local and international markets, deficit in balance of payments and ever rising unemployment, etc.

Pakistan's SMEs are still unable to achieve their maximum potential and are in dire need of 'hand-holding' and business support services.

A major challenge to economic policy in Pakistan at this time is to energize the private

SME sector of the economy. This follows in part from the fact that other sectors are unlikely, under present circumstances, to provide the needed growth either of output or of reasonably remunerative employment; in fact, there will be a major employment challenge over the coming years as labour supply continues to expand rapidly and as neither the large-scale private sector nor the public sector are poised to create significant numbers of jobs, and though agriculture and the non-agricultural micro enterprise sector can and probably will do so the levels of productivity and hence of remuneration are likely to be unattractively low. By contrast, the SME sector does have substantial untapped potential to contribute to those objectives; both economic logic and the experiences of other developing countries point to that potential, as well as providing evidence on how it may be achieved. A dynamic SME sector is an important complement to a more open economy; in most of the countries which appear to have reaped major benefits from export orientation the SME sector has been importantly involved in that process. Achieving the maximum contribution from SME, however, will require significant improvements in the support system. If achieved it will not only constitute an important source of dynamism in and of itself, but will also complement efficient large enterprise, strengthen the demand for agricultural products, and make it easier for micro enterprise to graduate into the SME size range.

Promotion of Small and Medium Enterprises (SMEs) entails enhancement of the competitiveness of the economy and generation of additional employment. A thriving Small and Medium Enterprise (SME) sector has long been recognized as one of the key characteristics of any prosperous and growing economy.

Pakistan is an economy comprising mainly of SMEs. The significance of their role is clearly indicated by various statistics. According to more recent estimates there are approximately 3.2 million business enterprises in Pakistan. Enterprises employing up to 99 persons constitute over 95% of all private enterprises in the industrial sector and employ nearly 78% of the non-agriculture labour force. They contribute over 30% to the GDP, Rs.140 billion to exports, and account 25% of exports of manufactured goods besides sharing 35% in manufacturing value added.

However, there has been concern that in Pakistan the SME sector has not been able to realize its full potential. The SMEs continue to suffer from a number of weaknesses, which hamper their ability to take full advantage of the opening of economy and the increasingly accessible world markets. The areas of constraints are normally identified as labour, taxation, trade capacity, and finance and credit availability.

It is understood that despite previous efforts the SME sector has not received due priority on account of segregated efforts and non-consolidation of programs to achieve well targeted results. In order to move forward, we need to develop a common vision for SMEs to be the real engine of growth. Our vision also needs to be achievable so we may find motivation in implementing phase.

Implementing change requires the formulation of a Policy for SME development and assigning specific responsibilities for its implementation and continuous improvement. The Government of Pakistan has thus constituted the SME Task Force, by Notification No.1 (68)/2003-Inv-III of 29 January 2004 of the Ministry of Industries and Production, which is to define the basic elements of our SME policy.

As there are many cross-cutting issues to be addressed, the SME Task Force is composed of diverse sectors and levels of Government and includes major stakeholders of the private sector, and SME in particular. Where the SME Task Force deems it necessary or useful, it may invite specific organizations or individuals to assist its work. It may also co-opt further members.

Lecture # 39

Can Government of Pakistan Lay a Pivotal Role in this Sector?

In the recent past SMEDA stands out as a significant step towards Govt of Pakistan commitment to SME development. Created as an autonomous institution with private sector led governance structure, SMEDA promises to become an important institution spearheading Government's SME development efforts. However, in absence of a coherent SME development policy framework it is unrealistic to expect a single organization such as SMEDA, to be able to implement aggressive SME development initiatives because:

1. Issues to be addressed for SME development fall within the purview of a large number of Ministries and Departments at the Federal, Provincial and Local government levels. SMEDA has no institutional jurisdiction or linkage with such institutions; and
2. SMEDA has limited budget and manpower, posing restrictions on its capacity to launch capital intensive initiatives and extend its outreach. Thus to provide a coherent policy mechanism, there is a need to develop a comprehensive SME Policy for Pakistan that defines the role of concerned public sector institutions. Such a Policy framework will provide the required direction and focus for achieving SME led economic growth resulting in job creation and reduction in poverty. Private sector growth in SME sector (as opposed to the large scale manufacturing) will result in lesser investments per job created, wider geographic and social spread of investments and better income distribution.

SME Policy & Their Objectives

The objective of SME Policy is to provide a short and a medium to long- term policy framework with an implementation mechanism for achieving higher economic growth based on SME led private sector development.

The SME Policy suggests concurrent and specific policy measures in all possible areas of SME development:

1. Business environment
2. Access to finance
3. Human resource development
4. Support for technology up gradation and marketing

A single SME definition is recommended to be applicable to all institutions countrywide to allow uniformity in designing support systems and incentives and also to monitor progress.

The SME Policy also contains an implementation and adjustment mechanism that identifies the following:

- ◆ Implementation and monitoring mechanism
- ◆ Capacity building requirements of the public institutions
- ◆ Resource allocation and potential sources of funding

- ◆ Linkages with other initiatives and public sector reform processes (Social Sector Reforms)
- ◆ Self contained framework for ongoing feedback and adjustment
- ◆ Role of various public and private sector players at Federal, Provincial and Local levels
- ◆ The Policy finds it appropriate to highlight the key principles on which it is being based. They are:
- ◆ The recommendations proposed in the SME Policy may be implemented / supported through an SME Act 2006
- ◆ The SME Policy covers measures for promotion of 'Entrepreneurship Culture' and support for growth of existing enterprises
- ◆ The SME Policy realizes the different approaches required for supporting
- ◆ Small Enterprises as opposed to Medium Enterprises. Thus, wherever required, separate policy measures are proposed for small and for medium enterprise growth
- ◆ Women and other marginalized groups are proposed to receive special focus within the SME Policy.
- ◆ Rural based and agro processing enterprises are proposed to receive special attention while devising specific support mechanisms
- ◆ SME development offers most viable option for private sector led growth that reduces poverty and creates a large number of jobs all across Pakistan.
- ◆ SME development must be at the center stage of all economic growth policies of Pakistan
- ◆ SME development in Pakistan will require decisive and concurrent measures in a number of policy areas such as business regulations, fiscal, trade rules, labor, incentives and support (Human Resource Development, Technology, Marketing, etc.) leading to an 'SME Space' in these domains.
- ◆ Sues face inherent disadvantages (because of their size) vis-à-vis large firms, which need to be offset by government support mechanisms and incentives
- ◆ Effective implementation of the Policy framework will require ownership, commitment and monitoring at highest level of the Government
- ◆ SME development requires provision of level playing field for smaller firms' vis-à-vis large enterprises.
- ◆ Private sector will be encouraged to play a key role in implementation of the SME Policy including mobilization of capital and operational responsibility for implementing policy measures suggested in this document.
- ◆ Financial support to enterprises will be, wherever possible, at a collective level, and will essentially require resource commitment on behalf of the beneficiaries.
- ◆ Pakistan does not have a single definition of Small and Medium Enterprises. Various Government agencies, e.g., State Bank of Pakistan (SBP), Federal Bureau of Statistics (FBS), Provincial Labor Depts., etc. use their own definition. Absence of a single SME definition makes it difficult to identify target firms, align development programs, collect data and monitor progress.

Business Environment

The fiscal, labor and enterprise regulations of the Federal and Provincial Governments in Pakistan do not provide for a focus on SMEs that is in line with their specific needs. Generally the fiscal regulations divide enterprises by income levels and labor related regulations realize only two forms of enterprises, small and large, thus, not providing laws and implementation mechanisms that are sensitive to SME needs. Largely, the support and grievance redressal regime of the Government does not differentiate between enterprises on the basis of their size thus making it difficult for SMEs to access public support programs and attention of public authorities when competing for it with the large firms. This dilutes the ability of SMEs to effectively compete with large firms.

Access to Finance & Related Services

Now banks provide for only 7-8% of the total funding requirement of SMEs. Also, as per a study by researchers on '*Barriers to SME Growth in Pakistan: an Analysis of Constraints*', access to finance, was identified by SMEs, as the single most important impediment to growth. This problem increases in magnitude with reduction in size and experience of the firm. With the promulgation of the Prudential Regulations for SME Financing by SBP, the basic regulatory framework for promoting SMEs' access to formal financing has been provided. However, increased SME access to financing will require interventions in all three areas of SME financing, i.e., demand side (SMEs), supply side (Banks) and intermediaries and regulators (SBP, SMEDA, etc)

Supporting Human Resource Development Technology Up- gradation & Marketing

- ◆ Need Assessment Survey to identify major SME needs in HRD, technology up gradation and marketing.
- ◆ Establishment of Institutes of Small and Medium Enterprise &
- ◆ Entrepreneurship Development in select business schools.
- ◆ Capacity building and up-gradation (curriculum redesign, provision of equipment, teachers training, SME liaison, etc.) of selected sector specific technical training institutes serving in major SME clusters and establishment of such institutes where none exist.
- ◆ Encouraging use of the technical training infrastructure by the private sector BDSPs serving SME sector and incentives for investment in setting up SME training facilities Induction of genuine SME representatives in private sector boards of the technical training institutes.

Entrepreneurship Development

Pakistan is a society of 'employees'. The education and social system does not encourage entrepreneurship as a preferred career option amongst the youth. Entrepreneurship is usually undertaken by those belonging to the existing business families. As a result the economy witnesses a small number of new enterprises being created and that too in traditional areas of business overcrowding the supply/product base and their markets. On the other hand, there are no limitations in the entrepreneurial capabilities in the populace. If, this entrepreneurial potential can be unleashed, by providing level playing field, information, awareness and support in

establishing enterprises, Pakistan can witness fast paced growth in establishment of new enterprises creating new employment opportunities, improving distribution of wealth and exploiting the opportunities offered by international markets in the liberalized WTO regime. The past Government programs to encourage entrepreneurship were limited and not too comprehensively designed and thus achieved little in promoting entrepreneurship amongst the educated Pakistani youth. There is a need for Govt. to actively promote entrepreneurship through changes in education curricula, by creating awareness amongst youth and by providing effective support to those who wish to establish new enterprises.

SME Policy Ownership and Implementation

A large number of Government Ministries and organizations (in addition to the private sector) will have to play their role in removing impediments and providing support for SME growth. Therefore, it is imperative that the SME Policy is approved by the Prime Minister and endorsed by all Provincial Governments. Such support coupled with clear definition of responsibilities of various Government institutions will provide the required policy vehicle for promoting SME led economic growth in Pakistan.

SME Policy Investment & Expected Impact

The SME Policy also presents the estimates of public and private sector investments for implementation of the policy recommendations and envisages benefits in terms of enterprise growth, job creation and poverty reduction.

Financial Crimes

What is Money Laundering?

Defined in non-technical terms, money laundering is the conversion of 'dirty' money into - seemingly - 'clean' money. Dirty money is money that meets the following conditions: (1) it has been derived by illegal means and (2) for an outside observer it is possible to identify that condition (1) applies. **Money laundering** is the practice of engaging in financial transactions in order to conceal the identity, source, and/or destination of money, and is a main operation of the underground economy. In the past, the term "money laundering" was applied only to financial transactions related to organized crime. Today its definition is often expanded by government regulators to encompass any financial transaction which generates an asset or a value as the result of an illegal act, which may involve actions such as tax evasion or false accounting. As a result, the illegal activity of money laundering is now recognized as potentially practiced by individuals, small and large businesses, corrupt officials, members of organized crime (such as drug dealers or the Mafia) or of cults, and even corrupt states, through a complex network of shell companies and trusts based in offshore tax havens. The increasing complexity of financial crime, the increasing recognized value of so-called "financial intelligence" in combating transnational crime and terrorism, and the speculated impact of capital extracted from the legitimate economy has led to an increased prominence of money laundering in political, economic, and legal debate.

Process of Money Laundering

Money laundering is often described as occurring in three stages: placement, layering, and integration.

- ◆ **Placement:** refers to the initial point of entry for funds derived from criminal activities.
- ◆ **Layering:** refers to the creation of complex networks of transactions which attempt to obscure the link between the initial entry point, and the end of the laundering cycle.
- ◆ **Integration:** refers to the return of funds to the legitimate economy for later extraction.

The Anti Money Laundering Network Recommends the Terms

1. **Hide:** to reflect the fact that cash is often introduced to the economy via commercial concerns which may knowingly or not knowingly be part of the laundering scheme, and it is these which ultimately prove to be the interface between the criminal and the financial sector.
2. **Move:** clearly explains that the money launderer uses transfers, sales and purchase of assets, and changes the shape and size of the lump of money so as to obfuscate the trail between money and crime or money and criminal.
3. **Invest:** the criminal spends the money: he/she may invest it in assets, or in his/her lifestyle.

Can Legal Considerations Stop Money Laundering?

Many jurisdictions adopt a list of specific predicate crimes for money laundering prosecutions as a "self launderer". In addition, laws typically have other offences such as "tipping off," "willful blindness," not reporting suspicious activity, and conscious facilitation of a money launderer/terrorist financier to move his/her monies.

Financial Institutions & Fight against Money Laundering

The prime method of anti-money laundering is the requirement on financial intermediaries to know their customers - usually termed KYC (know your customer) requirements. With good knowledge of their customers, financial intermediaries will often be able to identify unusual or suspicious behavior, including false identities, unusual transactions, changing behavior, or other indicators that laundering may be occurring. But for institutions with millions of customers and thousands of customer-contact employees, traditional ways of knowing their customers must be supplemented by technology.

Why Launder Dirty Money at All?

Basically there are two motives for laundering money: avoiding suspicion and avoiding detection. Avoiding suspicion refers to the need to remove all traces that may indicate a crime has been committed - such as dirty money. Avoiding detection refers to the need to shield the money from attempts to confiscate it. If you are not entitled to own or dispose of money or assets someone may take it away!

What do to against money laundering?

Usually one distinguishes between *preventive* and *repressive* measures which are complementary rather than mutually exclusive. Preventive measures aim at denying criminals the access to the financial system and tend to rely heavily on the private sector's cooperation. The international standard model envisages that financial institutions identify their customers and keep records, maintain internal compliance programs and actively cooperate with the designated authorities by reporting suspicions of money laundering. The idea of course is that vital information is thereby transmitted from the private sector players that are being 'misused' for money-laundering purposes to the law enforcement agencies. Repressive measures on the other hand are instituted to facilitate prosecution or to have more effective sanctions at hand. Thus, among the repressive measures we find attempts to facilitate international legal cooperation and asset forfeiture or money laundering provisions in the penal code.

Terrorist Financing

Terrorist financing is a topic that shot into the limelight after the events of September 11, 2001. The US passed the USA PATRIOT Act, among other reasons, to ensure that both combating the financing of terrorism and anti-money laundering was given adequate focus by US financial institutions.

The act also had extra-territorial impact and non-US banks having correspondent banking accounts or doing business with US banks had to upgrade their Anti-Money Laundering processes. Although efforts have brought about a huge change to global regulations and have ushered in a new era of information sharing. According to US Government, Islamic charities, which were prime sponsors of terrorist groups around the world, are now under much tighter controls albeit there is still a lot to do in the Middle East and specially Pakistan. Terrorist groups are on the run albeit they are also innovating – in making/moving

monies and in hiring of their key operatives - the new terrorist is a western educated middle class technology savvy person and the source for getting information on a do-it-yourself bomb is the internet.

The future of terrorist financing in Pakistan

Looking into the near future, if terrorist groups are replaced by smaller, decentralized groups, the premise that terrorists need a financial support network may become outdated. Moreover, some terrorist operations do not rely on outside sources of money and may now be self-funding, either through legitimate employment or low-level criminal activity, for example, the 7/7 London 9/11 US terrorists .

How we can trapped Terrorist Finances

1. Bilateral and multilateral diplomacy;
2. Law enforcement and intelligence cooperation;
3. Public designations of terrorists and their supporters for asset-freeze actions;
4. Technical assistance; and
5. Concerted international action through multilateral organizations and groups, notably the anti-money Laundering departments and the United Nations.

US assistance to control Money Laundering in Pakistan

South Asia, and especially Pakistan, is a priority region for counterterrorist financing, due to the presence of terrorist groups, porous borders, and cash-based economies that often operate through informal mechanisms. All countries in the region need to improve their terrorist financing regimes to meet international standards, including the establishment of functioning Financial Intelligence Units. And both political will and technical assistance are needed to make this region a more effective partner of established countries. Pakistan, specifically, US welcome the concrete actions it has taken to implement its obligations under UN Security Council Resolutions, including the freezing of over \$10 assets. Pakistan has also apprehended terrorists, including big names of operational leaders. US, European Union are encouraged by Pakistan's concern about the money laundering & infiltration of terrorist groups into charitable organizations, and would welcome the opportunity to provide technical assistance to help Pakistan meet international standards on preventing abuse of its non-profit sector. US has provided Pakistan assistance on drafting an anti-money laundering/ counterterrorist financing (AML) law that meets international standards, but this legislation is still awaiting parliamentary consideration. In the absence of an anti-money laundering and counterterrorism financing law, the State Bank of Pakistan has introduced FATF-compliant regulations in know-your- customer policy, record retention, due diligence of correspondent banks, and reporting suspicious transactions. Also in compliance with FATF recommendations, the Securities and Exchange Commission of Pakistan has applied know-your-customer regulations to stock exchanges, trusts, and other non-bank financial institutions. All settlements exceeding Rs 50,000 (\$840) must be performed by check or bank draft, as opposed to cash. Speaking generally, South Asian countries lack sophisticated tools to combat the money laundering. Anti-money laundering programs also tend to be absent or not up to international standards. Nonetheless, there is a degree of interest in all countries of the region, and we have seen some progress.

Know Your Customer (KYC) Guidelines – Anti Money Laundering Standards

The objective of KYC guidelines is to prevent banks from being used, intentionally or unintentionally, by criminal elements for money laundering activities. KYC procedures also enable banks to know/understand their customers and their financial dealings better which in turn help them manage their risks prudently.

Lecture # 41

DFIs & Risk Management

Risks are usually defined by the adverse impact on profitability of several distinct sources of uncertainty. While the types and degree of risks an organization may be exposed to depend upon a number of factors such as its size, complexity business activities, volume etc, it is believed that generally the banks face Credit, Market, Liquidity, Operational, Compliance / legal / regulatory and reputation risks. Before overarching these risk categories, given below are some basics about risk Management and some guiding principles to manage risks in banking organization.

Risk Management

Risk management is the human activity which integrates recognition of risk, risk assessment, developing strategies to manage it, and mitigation of risk using managerial resources. The strategies include transferring the risk to another party, avoiding the risk, reducing the negative effect of the risk, and accepting some or all of the consequences of a particular risk. Some traditional risk managements are focused on risks stemming from physical or legal causes (e.g. natural disasters or fires, accidents, death and lawsuits). Financial risk management, on the other hand, focuses on risks that can be managed using traded financial instruments. Objective of *risk management* is to reduce different risks related to a pre-selected domain to the level accepted by society. It may refer to numerous types of threats caused by environment, technology, humans, organizations and politics. On the other hand it involves all means available for humans, or in particular, for a risk management entity (person, staff, and organization). In every financial institution of Pakistan, risk management activities broadly take place simultaneously at following different hierarchy levels.

- ◆ **Strategic level:** It encompasses risk management functions performed by senior management. For instance definition of risks, ascertaining institutions risk appetite, formulating strategy and policies for managing risks and establish adequate systems and controls to ensure that overall risk remain within acceptable level and the reward compensate for the risk taken.
- ◆ **Macro Level:** It encompasses risk management within a business area or across business lines. Generally the risk management activities performed by middle management or units devoted to risk reviews fall into this category.
- ◆ **Micro Level:** It involves 'On-the-line' risk management where risks are actually created. This is the risk management activities performed by individuals who take risk on organization's behalf such as front office and loan origination functions. The risk management in those areas is confined to following operational procedures and guidelines set by management.

Managing Credit Risk

Credit Risk is the risk of loss due to a debtor's non-payment of a loan or other line of credit (either the principal or interest (coupon) or both). Credit risk arises from the potential that an obligor is either unwilling to perform on an obligation or its ability to perform such obligation is impaired resulting in economic loss to the bank. In a bank's portfolio, losses stem from outright default due to inability or unwillingness of a customer or counter party to meet commitments in relation to lending, trading, settlement and other financial transactions. Alternatively losses may result from reduction in portfolio value due to actual or perceived deterioration in credit quality. Credit risk emanates from a bank's dealing with individuals, corporate, financial institutions or a sovereign. For most banks, loans are the largest and most obvious source of credit risk; however, credit risk could stem from activities both on and off balance sheet. In addition to direct accounting loss, credit risk

should be viewed in the context of economic exposures. This encompasses opportunity costs, transaction costs and expenses associated with a non-performing asset over and above the accounting loss.

Managing Market Risk

It is the risk that the value of on and off-balance sheet positions of a financial institution will be adversely affected by movements in market rates or prices such as interest rates, foreign exchange rates, equity prices, credit spreads and/or commodity prices resulting in a loss to earnings and capital. Financial institutions may be exposed to Market Risk in variety of ways. Market risk exposure may be explicit in portfolios of securities / equities and instruments that are actively traded. Conversely it may be implicit such as interest rate risk due to mismatch of loans and deposits. Besides, market risk may also arise from activities categorized as off-balance sheet item. Therefore market risk is potential for loss resulting from adverse movement in market risk factors such as interest rates, forex rates, equity and commodity prices.

Managing Liquidity Risk

Liquidity risk is the potential for loss to an institution arising from either its inability to meet its obligations or to fund increases in assets as they fall due without incurring unacceptable cost or losses. Liquidity risk is considered a major risk for banks. It arises when the cushion provided by the liquid assets are not sufficient enough to meet its obligation. In such a situation banks often meet their liquidity requirements from market.

However conditions of funding through market depend upon liquidity in the market and borrowing institution's liquidity. Accordingly an institution short of liquidity may have to undertake transaction at heavy cost resulting in a loss of earning or in worst case scenario the liquidity risk could result in bankruptcy of the institution if it is unable to undertake transaction even at current market-prices. Banks with large off-balance sheet exposures or the banks, which rely heavily on large corporate deposit, have relatively high level of liquidity risk. Further the banks experiencing a rapid growth in assets should have major concern for liquidity.

Managing Operational Risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and system or from external events. Operational risk is associated with human error, system failures and inadequate procedures and controls. It is the risk of loss arising from the potential that inadequate information system; technology failures, breaches in internal controls, fraud, unforeseen catastrophes, or other operational problems may result in unexpected losses or reputation problems. Operational risk exists in all products and business activities. Operational risk event types that have the potential to result in substantial losses includes Internal fraud, External fraud, employment practices and workplace safety, clients, products and business practices, business disruption and system failures, damage to physical assets, and finally execution, delivery and process management. The objective of operational risk management is the same as for credit, market and liquidity risks that is to find out the extent of the financial institution's operational risk exposure; to understand what drives it, to allocate capital against it and identify trends internally and externally that would help predicting it. The management of specific operational risks is not a new practice; it has always been important for banks to try to prevent fraud, maintain the integrity of internal controls, and reduce errors in transactions processing, and so on. However, what is relatively new is the view of operational risk management as a comprehensive practice comparable to the management of credit and market risks in principles. Failure to understand and manage operational risk, which is present in virtually all banking transactions and activities, may greatly increase the likelihood that some risks will go unrecognized and uncontrolled.

Currency Risk

- **Currency Risk** is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.
- **Transaction Risk** is the risk that exchange rates will change un-favorably over time. It can be hedged against using forward currency contracts;
- **Translation Risk** is an accounting risk, proportional to the amount of assets held in foreign currencies. Changes in the exchange rate over time will render a report inaccurate, and so assets are usually balanced by borrowings in that currency. The exchange risk associated with a foreign denominated instrument is a key element in foreign investment. This risk flows from differential monetary policy and growth in real productivity, which results in differential inflation rates.
- **Interest Rate Risk** is the risk that the relative value of an interest-bearing asset, such as a loan or a bond, will worsen due to an interest rate increase. In general, as rates rise, the price of a fixed rate bond will fall, and vice versa. Interest rate risk is commonly measured by the bond's duration, the oldest of the many techniques now used to manage interest rate risk. Asset liability management is a common name for the complete set of techniques used to manage risk within a general enterprise risk management framework.

Lecture # 42

Banking Fraud & Misleading Activities

Bank fraud is a federal crime in many countries, defined as planning to obtain property or money from any federally insured financial institution. It is sometimes considered a white-collar crime.

- **Rogue Traders**

A rogue trader is a highly placed insider nominally authorized to invest sizeable funds on behalf of the bank; this trader secretly makes progressively more aggressive and risky investments using the bank's money, when one investment goes bad, the rogue trader engages in further market speculation in the hope of a quick profit which would hide or cover the loss. Unfortunately, when one investment loss is piled onto another, the costs to the bank can reach into the hundreds of millions of dollars; there have even been cases in which a bank goes out of business due to market investment losses.

- **Fraudulent Loans**

One way to remove money from a bank is to take out a loan, a practice bankers would be more than willing to encourage if they know that the money will be repaid in full with interest. A fraudulent loan, however, is one in which the borrower is a business entity controlled by a dishonest bank officer or an accomplice; the "borrower" then declares bankruptcy or vanishes and the money is gone. The borrower may even be a non-existent entity and the loan merely an artifice to conceal a theft of a large sum of money from the bank.

- **Wire Fraud**

Wire transfer networks such as the international SWIFT inter-bank fund transfer system are tempting as targets as a transfer, once made, is difficult or impossible to reverse. As these networks are used by banks to settle accounts with each other, rapid or overnight wire transfer of large amounts of money is commonplace; while banks have put checks and balances in place, there is the risk that insiders may attempt to use fraudulent or forged documents which claim to request a bank depositor's money be wired to another bank, often an offshore account in some distant foreign country.

- **Forged or Fraudulent Documents**

Forged documents are often used to conceal other thefts; banks tend to count their money meticulously so every penny must be accounted for. A document claiming that a sum of money has been borrowed as a loan, withdrawn by an individual depositor or transferred or invested can therefore be valuable to a thief who wishes to conceal the minor detail that the bank's money has in fact been stolen and is now gone.

- **Uninsured Deposits**

There are a number of cases each year where the bank itself turns out to be uninsured or not licensed to operate at all. The objective is usually to solicit for deposits to this uninsured "bank", although some may also sell stock representing ownership of the "bank". Sometimes the names appear very official or very similar to those of legitimate banks. For instance, the "Chase Trust Bank" of Washington DC appeared in 2002 with no license and no affiliation to its seemingly apparent namesake; the real Chase Manhattan Bank is based in New York. There is a very high risk of fraud when dealing with unknown or uninsured institutions.

The risk is greatest when dealing with offshore or Internet banks (as this allows selection of countries with lax banking regulations), but not by any means limited to these institutions.

- **Theft of Identity**

Dishonest bank personnel have been known to disclose depositors' personal information for use in theft of identity frauds. The perpetrators then use the information to obtain identity cards and credit cards using the victim's name and personal information.

- **Demand Draft Fraud**

Demand draft fraud is usually done by one or more dishonest bank employees. They remove few DD leaves or DD books from stock and write them like a regular DD. Since they are insiders, they know the coding, punching of a demand draft. These Demand drafts will be issued payable at distant town/city without debiting an account.

Then it will be cashed at the payable branch. For the paying branch it is just another DD. This kind of fraud will be discovered only when the head office does the branch-wise reconciliation, which normally will take 6 months. By that time the money is unrecoverable.

- **Stolen Cheques**

Some fraudsters obtain access to facilities handling large amounts of cheques, such as a mailroom or post office or the offices of a tax authority (receiving many cheques) or a corporate payroll or a social or veterans' benefit office (issuing many cheques).

A few cheques go missing; accounts are then opened under assumed names and the cheques (often tampered or altered in some way) deposited so that the money can then be withdrawn by thieves. Stolen blank cheque-books are also of value to forgers who then sign as if they were the depositor.

- **Accounting Fraud**

In order to hide serious financial problems, some businesses have been known to use fraudulent bookkeeping to overstate sales and income, inflate the worth of the company's assets, or state a profit when the company is operating at a loss. These tampered records are then used to seek investment in the company's bond or security issues or to make fraudulent loan applications in a final attempt to obtain more money to delay the inevitable collapse of an unprofitable or mismanaged firm.

- **Stolen Credit or Debit Cards**

Often, the first indication that a victim's wallet has been stolen is a 'phone call from a credit card issuer asking if the person has gone on a spending spree; the simplest form of this theft involves stealing the card itself and charging a number of high-ticket items to it in the first few minutes or hours before it is reported as stolen. A variant of this is to copy just the credit card numbers (instead of drawing attention by stealing the card itself) in order to use the numbers in online frauds.

- **Fraudulent Loan Applications**

These take a number of forms varying from individuals using false information to hide a credit history filled with financial problems and unpaid loans to corporations using accounting fraud to overstate profits in order to make a risky loan appear to be a sound investment for the bank.

Can We Avoid Cheque Fraud?

1. **Reconcile your account;** Reconcile your cheque account promptly and regularly. If you hold business accounts, consider opening a separate account specifically for higher value cheques, so they can be easily monitored.
2. **Signing of Cheques;** Never sign blank cheques, only sign cheques after all details have been completed.
3. **Preparation;** Cheques must be completed in a way that deters fraudulent alternation. Ensure that a strong bold and consistent font is used and that no gaps are left in completion of the payee name, amount in words and in figures. Use permanent ballpoint or ink (preferably black) when filling out a cheque.
4. **Ordering and maintaining cheques;** If cheques are lost or stolen contact your bank immediately and ask them to load a 'Stop Payment'. Notify bank, if you have not received an ordered cheque book.

Protect your credit / debit card

Save your personal identification number (PIN). Don't use the same PIN for different cards or equipment, and don't choose your birth date or any other easily identifiable number that might be on something else in your wallet. Check statements and call your credit card issuer immediately if you see anything suspicious on your bill. You could help the company uncover fraud—and save yourself from paying un-authorized charges. Keep track of when new and reissued cards should arrive, and call the credit card issuer if they don't come on time. Make sure your mailbox is secure, and that only you and the postal carrier have access to it. When you use your credit card online, make sure you are using a secure website. Look for a small key or lock symbol at the bottom right of your browser's window. Never give your card number to strangers or telemarketers who call you on the phone. Don't give your card number unless you initiated the call.

Lecture # 43

The Collapse of ENRON

Only months before Enron Corporation's bankruptcy filing in December 2001, the firm was widely regarded as one of the most innovative, fastest growing, and best managed businesses in the United States. With the swift collapse, shareholders, including thousands of Enron workers who held company stock in their 401(k) retirement accounts, lost tens of billions of dollars. Investigations of wrongdoing may take years to conclude, but Enron's failure already raises financial oversight issues with wider applications. This lecture briefly examines the accounting system that failed to provide a clear picture of the firm's true condition, the independent auditors and board members who were unwilling to challenge Enron's management, the Wall Street stock analysts and bond raters who missed the trouble ahead, the rules governing employer stock in company pension plans, and the unregulated energy derivatives trading that was the core of Enron's business. Formed in 1985 from a merger of Houston Natural Gas and Inter-north, Enron Corporation was the first nationwide natural gas pipeline network. Over time, the firm's business focus shifted from the regulated transportation of natural gas to unregulated energy trading markets. The guiding principle seems to have been that there was more money to be made in buying and selling financial contracts linked to the value of energy assets (and to other economic variables) than in actual ownership of physical assets. Until late 2001, nearly all observers – including professional Wall Street analysts – regarded this transformation as an outstanding success. Enron's reported annual revenues grew from under \$10 billion in the early 1990s to \$101 billion in 2000, ranking it seventh on the Fortune 500. Several committees in the House and Senate have held or plan to hold hearings related to Enron's fall. The Justice Department is conducting a criminal investigation. The challenge for financial oversight, however, does not depend on findings of wrongdoing. Even if no one at Enron did anything improper, the swift and unanticipated collapse of such a large corporation suggests basic problems with the U.S. system of securities regulation, which is based on the full and accurate disclosure of all financial information that market participants need to make informed investment decisions.

- **Auditing Issues**

Federal securities law requires that the accounting statements of publicly traded corporations be certified by an independent auditor. Enron's outside audits have received much attention. While external audits do not prevent corporations from making financial mistakes, let alone bankruptcy, problems with recent Enron audits may have contributed to both the rapid rise and the sharp fall in its stock price. Outside investors, including financial institutions may have been misled about the corporation's net income (which was subsequently restated) and contingent liabilities (which were far larger than generally known). The auditor, Arthur Andersen, has admitted some mistakes. Andersen fired the partner in charge of Enron audits on January 15, 2002, and Enron dismissed Andersen on January 17. One issue is whether Andersen's extensive consulting work for Enron may have compromised its judgment in determining the nature, timing, and extent of audit procedures and in asking that revisions be made to financial statements, which are the responsibility of Enron's management. Questions have also been asked about Andersen destroying documents and e-mails related to its audits. Oversight of auditors has primarily rested with the American Institute of Certified Public Accountants (a nongovernmental trade group) and state boards of accountancy. On January 17, 2002, the Chairman of the Securities and Exchange Commission (SEC) proposed a new oversight board that would be responsible for disciplinary actions.

- **Accounting Issues**

The Enron controversy involves several accounting issues. One concerns the rules governing whether the financial statements of special purpose entities (SPEs) established by a corporation should be consolidated with the corporation's financial statements; for certain SPE partnerships at issue, consolidation is not required if among other things an independent third party invests as little as 3% of the capital, a threshold some consider too low. A second issue concerns the latitude allowed in valuing derivatives, particularly non-exchange traded energy contracts. Third, there are calls for improved disclosure, either in notes to financial statements or a management discussion and analysis, especially for financial arrangements involving contingent liabilities. Accounting standards for corporations are set by the Financial Accounting Standards Board, a nongovernmental entity, though there are also SEC requirements. (The SEC has statutory authority to set accounting standards for firms that sell securities to the public.)

- **Pension Issues**

Like many companies, Enron sponsors a retirement plan – a “401(k)” – for its employees to which they can contribute a portion of their pay on a tax-deferred basis. As of December 31, 2000, 62% of the assets held in the corporation's 401(k) retirement plan consisted of Enron stock. Many individual Enron employees held even larger percentages of Enron stock in their 401(k) accounts. Shares of Enron, which in January 2001 traded for more than \$80/share, were worth less than 70 cents in January 2002. Consequently, the company's bankruptcy has substantially reduced the value of its employees' retirement accounts. The losses suffered by participants in the Enron Corporation's 401(k) plan have prompted questions about the laws and regulations that govern these plans.

- **Corporate Governance Issues**

The role of a company's board of directors is to oversee corporate management to protect the interests of shareholders. However, in 1999 Enron's board waived conflict of interest rules to allow chief financial officer Andrew Fastow to create private partnerships to do business with the firm. These partnerships appear to have concealed debts and liabilities that would have had a significant impact on Enron's reported profits. Enron's collapse raises the issue of how to reinforce directors' capability and will to challenge questionable dealings by corporate managers. Specific questions involve independent or “outside” directors. (Stock exchange rules require that a certain percentage of board members be unaffiliated with the firm and its management.)

- **Securities Analyst Issues**

Securities analysts employed by investment banks provide research and make “buy,” “sell,” or “hold” recommendations for the use of their sales staffs and their investor clients. These recommendations are widely circulated and are relied upon by many investors throughout the markets. Analyst support was crucial to Enron because it required constant infusions of funding from the financial markets. On November 29, 2001, after Enron's stock had fallen 99% from its high, and after rating agencies had downgraded its debt to “junk bond” status, only two of 11 major firm analysts rated its stock a “sell.” This performance added to concerns that were raised in 2000 in the wake of the “dot com” stock crash.

Derivatives Issues

The core of Enron's business appears to have been dealing in derivative contracts based on the prices of oil, gas, electricity and other variables. For example, Enron sold long-term contracts to sell energy at fixed prices. These contracts allow the buyers to avoid, or hedge, the risks that increases (or drops) in energy prices posed to their businesses. Since the markets in which Enron traded are largely unregulated, with no reporting requirements,

little information is available about the extent or profitability of Enron's derivatives activities. Did Enron earn money from dealer commissions and spreads, or was it actively speculating on future price trends? Speculative losses in derivatives, perhaps masked by "creative" accounting, could have contributed to the firm's downfall. On the other hand, the trading operations may have been profitable and trouble free, and Enron's financial difficulties the result of other unrelated operations. Enron's collapse raises the issue of supervision of unregulated derivatives markets.

Corrective Actions

The collapse of Enron proved to be a valuable wake-up call to a number of affected groups. The following actions have already been taken by private organizations: The Business Roundtable, composed of the chief executives of about 150 large firms, urged corporations to adopt a number of voluntary changes in corporate governance rules, including that a "substantial majority" of corporate boards be independent "both in fact and appearance." The New York Stock Exchange and the National Association of Securities Dealers approved major additions and changes in the rules for accounting, auditing, and corporate governance as necessary conditions for listing of a corporation's stock for trade on the exchange. The major continuing uncertainty is how the exchanges will monitor and enforce these rules. The International Corporate Governance Network, institutional investors that control about \$10 trillion in assets, has approved a set of international standards for corporate governance that its members would use their voting power to promote. Standard and Poor's, one of the three major credit-rating agencies, has developed a new concept of "core earnings" as a measure of earnings from a company's primary lines of business. Compared with earnings as defined by the generally accepted accounting principles (GAAP), for example, the S&P measure will exclude gains and losses from a variety of financial transactions. S&P plans to report this measure of earnings for all publicly held U.S. companies.

Classic Financial Scandals

"Bankers who hire money hungry geniuses should not always express surprise and amazement when some of them turn around with brilliant, creative, and illegal means of making money." "The quotation is from a speech by the financial thriller writer on the Psychology of Risk, Speculation and Fraud, at a conference on EMU in Amsterdam.

Barings Bank collapsed when one of the Singapore based employees of London's Barings Bank, Nick Leeson, lost £827 million (US\$1.4 billion) - primarily on futures contract speculation. Leeson's actions led the oldest merchant bank to default on its debts. The bank's collapse is considered a pivotal turning point in the history of banking and has become a textbook example of accounting fraud.

- **Internal auditing**

The way that Barings Bank's activities in Singapore were organized between 1992 and 1995 enabled Leeson to operate effectively without supervision from Barings Bank's head office in London. Leeson acted both as head of settlement operations (charged with ensuring accurate accounting) and as floor manager for Barings' trading on Singapore International Monetary Exchange (SIMEX). Normally the positions would have been held by two employees. This concentration of functions placed Leeson in the position of reporting to an office inside the bank which he himself held. Several observers, including Leeson, placed much of the blame on the bank's own deficient internal auditing and risk management practices.

- **Corruption**

Because of the absence of oversight, Leeson was able to make seemingly small gambles in the futures market at Barings Futures Singapore (BFS) and cover for his shortfalls by reporting losses as gains to Barings in London. Specifically, Leeson altered the branch's error account, subsequently known by its account number 88888 as the "five-eight account," to prevent the London office from receiving the standard daily reports on trading, price, and status. Leeson claims the losses started when one of his colleagues bought contracts when she should have sold them. By December 1994 Leeson had cost Barings £200 million but he reported to British tax authorities a £102 million profit. If the company had uncovered his true financial dealings then, collapse might have been avoided as Barings had capital of £350 million

- **Kobe earthquake**

Using the hidden "five-eight account," Leeson began to aggressively trade in futures and options on SIMEX. His decisions routinely lost substantial sums, but he used money entrusted to the bank by subsidiaries for use in their own accounts. He falsified trading records in the bank's computer systems, and used money intended for margin payments on other trading. Barings Bank management in London at first congratulated and rewarded Leeson for what seemed to be his outstanding trading profits. However, his luck ran out when the Kobe earthquake sent the Asian financial markets into a tailspin. Leeson bet on a rapid recovery by the Nikkei Stock Average which failed to materialize.

- **Discovery**

Appointed administrators began managing the finances of Barings Group and its subsidiaries on 26 February 1995. On 26 February, the Board of Banking Supervision launched an investigation led by Britain's Chancellor of the Exchequer. The Chancellor

released his report on 18 July. By 27 February, Leeson had cost the bank £827 million. The collapse itself cost the bank another £100 million.

Barings Bank auditors finally discovered the fraud, around the same time that Chairman Peter Barings received a confession note from Leeson, but it was too late. Leeson's activities had generated losses totaling £827 million (US\$1.4 billion), twice the bank's available trading capital. The Bank of England attempted a weekend bailout but it was unsuccessful. Barings was declared insolvent 26 February 1995. The collapse was dramatic and employees around the world were denied their bonuses

- **Aftermath**

ING, a Dutch bank, purchased Barings Bank for the nominal sum of £1 and assumed all of Barings liabilities. Barings Bank therefore no longer has a separate corporate existence, although the Barings name still lived on as Baring Asset Management. BAM was split and sold by ING to Mass Mutual and Northern Trust in March 2005. Nick Leeson fled Singapore but was arrested in Germany and extradited back to Singapore, where he was convicted of fraud and imprisoned for six years. Upon release, he wrote an autobiography, *Rogue Trader*, covering the events leading up to the collapse. A film maker later dramatized the book in the film *Rogue Trader*.

Black Wednesday

In British politics and economics, **Black Wednesday** refers to 16 September 1992 when the Conservative government was forced to withdraw the Pound from the European Exchange Rate Mechanism (ERM) due to pressure by currency speculators—most notably George Soros who made over US\$1 billion from this speculation. In 1997 the UK Treasury estimated the cost of Black Wednesday at £3.4 billion.

The trading losses in August and September were estimated at £800m, but the main loss to taxpayers arose because the devaluation could have made them a profit. The papers show that if the government had maintained \$24bn foreign currency reserves and the pound had fallen by the same amount, the UK would have made a £2.4bn profit on sterling's devaluation (Financial Times 10 February 2005). The papers also show that the Treasury spent £27bn of reserves in propping up the pound; the Treasury calculates the ultimate loss was only £3.4bn.

The currency speculators' attack

The fundamental sterling problem in September 1992 was that the dollar was rapidly depreciating against the deutschmark. Tied as it was to the ERM, the pound was hence appreciating to unsustainable levels against the US currency. With a large proportion of British exports priced in dollars, a pound/dollar correction was well overdue. ERM membership was preventing this from happening. In anticipation of the inevitable dam-bursting, speculators hastened the process by borrowing pounds (and also lire) and selling them for DM, in the expectation of being able to repay the loan in devalued currency and to pocket the difference.

On September 16 the British government announced a rise in the base interest rate from an already high 10% to 12% in order to tempt speculators to buy pounds. Despite this and a promise later the same day to raise base rates again to 15%, dealers kept selling pounds, convinced that the government would not stick with its promise. By 19:00 that evening, Norman Lamont, then Chancellor, announced Britain would leave the ERM and rates would remain at the new level of 12%.

EU economists' analysis of this event concluded that stable exchange rates are the result, not the cause, of a common approach to economic management, resulting in the Stability and Growth Pact that underpins ERM II and subsequently the Euro single currency.

Treasury bond Scandal

“Saloman Brothers”

Salomon Brothers was a Wall Street investment bank. Founded in 1910, it remained a partnership until the early 1980s, when it was acquired by the commodity trading firm then known as **Phibro Corporation**. This proved a "wag the dog" type merger as the parent company became first **Phibro-Salomon** and then **Salomon Inc.** and the commodity operations were sold. Eventually Salomon was acquired by Travelers Group (now Citigroup) in 1998.

It eventually became the largest issuer and trader of bonds in the United States, its PR man defining a liquid bond as any bond traded by Salomon Brothers.

During its time of greatest prominence in the 1980s, Salomon became noted for its innovation in the bond market, creating the first mortgage-backed security. Later, it moved away from traditional investment banking (helping companies raise funds in the capital market and negotiating mergers and acquisitions) to almost exclusively **proprietary trading** (the buying and selling of stocks, bonds, options, etc. for the profit of the company).

Salomon had an expertise in fixed income trading, betting large amounts of money on certain swings in the bond market on a daily basis. The top bond traders called themselves "Big Swinging Dicks", and were the inspiration for the books ***The Bonfire of the Vanities*** and ***Liar's Poker***.

During this period however the performance of the firm was not to the satisfaction of its upper management. The amount of money being made relative to the amount being invested in all the markets Salomon was in was small, and the company's traders were paid in a flawed way which was disconnected from their true profitability (fully accounting for both the amount of money they used and the risk they took). There were debates as to which direction the firm should head in, whether it should prune down its activities to focus on certain areas. For example, the commercial paper business (providing short term day to day financing for large companies), was apparently unprofitable, although some in the firm argued that it was a good activity because it kept the company in constant contact with other businesses' key financial personnel. It was decided that the firm should try to imitate Drexel Burnham Lambert, using its Investment Bankers and its own money to urge companies to restructure or engage in leveraged buyouts which would result in financing business for Salomon Brothers. The first moves in this direction were for the firm to compete on the leveraged buyout of RJR Nabisco, followed by the leveraged buyout of Revco stores (which ended in failure).

RECAP**1) FINANCIAL ENVIRONMENT & FINANCIAL INSTITUTIONS**

- Role Of Financial Institutions
- Long Run Performance Of Financial Institutions For Economic Growth
- Capital market
- Commodity markets
- Money markets
- Derivatives markets
- Futures markets
- Borrowers of financial markets
- Lenders of financial market
- Stock markets
- Bond markets

2) FINANCIAL INSTITUTIONS

- Types of Financial Institutions
- Central Bank
- Commercial Banks
- Investment Bank
- Saving Bank
- Micro Finance Bank
- Islamic Bank
- Agriculture Bank
- SME Banks
- Non-Banking Financial Institutions
- Investment Companies
- Brokerage Houses
- Leasing Companies
- Insurance Companies
- Mutual Fund
- Financial Institution & Their Functions

3) CENTRAL BANK

- Activities & Responsibilities
- Monetary Policy
- Central or National “Bankers Bank”
- Interest Rate Intervention
- Limits of Enforcement Power

4) Central Bank

- Policy Instruments
- Interest rate Intervention
- Limits of Enforcement Power
- Interest Rates
- Open Market Operations
- Repo Market known as repurchase operations
- Direct Operations

- Buying or selling securities ("Direct Operations")
- Foreign exchange operations such as forex swaps.
- Capital Requirements
- Reserve requirements
- Exchange Requirements

5) Balance of Trade

- Balance of Trade
- Balance of Payments
- Factors that can affect BOT
 - Exchange rates
 - Trade agreements or barriers
 - Other tax, tariff and trade measures
 - Business cycle at home or abroad.
- Current Account Surplus & Deficit
- Capital or Financial Account Surplus & Deficit
- Balance of Payments Equilibrium
- Challenges of a Central Bank
 - Economic Growth
 - Poverty Reduction
 - Inflation
 - Stability in Forex Rate
- Independence of Central Banks

6 to 11) State Bank of Pakistan

- History
- Functions
- Primary Function
- Secondary Function
- Non-Promotional Function
- Regulation of Liquidity
- Banking Assets & Liabilities

Various Departments of SBP

- Agricultural Credit
- Audit
- Banking Inspection
- Banking Policy
- Banking Supervision
- Corporate Services
- Economic Policy
- Exchange and Debt Management
- Exchange Policy
- Human Resource
- Information System
- Islamic Banking
- Legal Services
- Payment System
- Research
- Statistics

- Real Time Gross Settlement System (RTGS System)
- Small and Medium Enterprises

11 & 12) Macro Economic Performance of a Country

- National Income
- Concepts of National Income
- Difference b/w GDP & GNP
- Regulating risk and the importance of risk management
- Basel 2 Type Rules for Insurers
- Global Financial System
- International Financial Institutions
- International Monetary Fund
- The World Bank
- World Trade Organization
- Role of WTO in Pakistan Trade Environment
- Asian Development Bank
- ADB Projects in Pakistan
- Paris Club

13) Pakistan Economic Aid & Debt

- The major causes of poverty in Pakistan
- Key challenges facing the Government of Pakistan
- Future Prospects for Pakistan's Economy
- Macroeconomic Stability
- Strengthening Institutions

14) Increasing Foreign Direct Investment

- Foreign Interest in Local Financial Markets
- Enhancing and Sustaining a Growing GDP
- How can Pakistan improve and sustain its growth rate?
 1. Industrial Sector
 2. Inter-provincial harmony in Pakistan
 3. Achieving a Favorable Balance of Trade
 4. Managing the Debt
 5. Economic Resilience

15 to 19) Role of Commercial Banks

- Purpose of a bank
- Commercial Lending
- Banking Services
- A Bank's Profit
- Services Typically Offered by Banks
- Types of banks
- Banks in the Economy
- Role in the money supply
- Size of Global Banking Industry
- Bank Crisis
- Challenges within the Banking Industry

1. Economic Environment
 2. Growth Strategies
 3. The Management of the Banks
- Public perceptions of banks
 - Profitability
 - SWIFT Society for Worldwide Interbank Financial Transactions
 - Commercial Banking In Pakistan
 - CAMEL
 - These are:
 - 1) Capital Adequacy,
 - 2) Asset Quality,
 - 3) Management Soundness,
 - 4) Earnings and Profitability,
 - 5) Liquidity and Sensitivity to Market Risk.
 - Deposit Mobilization
 - Credit extension
 - Banking spreads
 - Asset composition
 - Problem bank management

BANKING SECTOR REFORMS in Pakistan

1. Privatization of Nationalized Commercial Banks
 2. Corporate governance.
 3. Capital Strengthening.
 4. Improving Asset quality.
 5. Liberalization of foreign exchange regime
 6. Consumer Financing
 7. Mortgage Financing
 8. Legal Reforms
 9. Prudential Regulations
 10. Micro financing
 11. SME Financing
 12. Taxation
 13. Agriculture Credit
 14. E-Banking
 15. Human Resources
 16. Credit Rating
 17. Supervision and Regulatory Capacity
 18. Payment Systems
- Commercial Banking in a Free Society
 - Private Deposit Insurance

20) Branch Banking in Pakistan

- Remittances
- Demand Draft
- Telegraphic Transfer
- Mail Transfer
- Online Fund Transfer
- Types of Account
 1. Individual
 2. Joint Account

3. Sole Proprietorship
4. Club & Societies
5. Joint Stock Companies
6. Agents
- Operations & Status of Accounts Nature of Accounts
 1. Current Account
 2. Profit & Loss Sharing
 3. Current foreign currency
 4. Saving Foreign Currency
 5. Term Deposits
 6. BBA “Basic Banking Account”
- Commercial Banks Loan Facilities:
 1. Types of Loan
 2. Personal finance
 3. Mortgage Finance
 4. Business Finance

21) Role of Commercial Banks in Micro Finance Sector

22 to 26) Mutual Funds

- History
- Usage
- Net asset value
- Turnovers
- Expenses and TER'S
 1. Management Fees
 2. Non-management Expenses
 3. Service Fees
 4. Fees and Expenses Borne by the Investor (not the Fund)
 5. Brokerage Commissions
- Types of mutual funds
 1. Open-end fund
 2. Exchange-traded funds
 3. Equity funds
 - i. Capitalization
 - ii. Growth vs. value
 - iii. Index funds versus active management
 4. Bond funds
 5. Money market funds
 6. Funds of funds
 7. Hedge funds
- Mutual funds vs. other investments
 1. Share classes
 2. Load and expenses
- Criticism of managed mutual funds

28) Investment Banking

- Organizational structure of an investment bank
- The main activities and units of Investment Banks

- Size of industry
- Recent evolution of the business
- New products
- Possible conflicts of interest
- Types of Investment banks

29 & 30) Letter of Credit & International Trade

- Terminology
- How it works
- Legal principles governing documentary credits
- The price of LCs
- Legal Basis for Letters of Credit
- Risks in International Trade

31 & 32) Foreign Exchange & Role of Financial Institutions

- Market size and liquidity
- Market participants
 1. Banks
 2. Commercial companies
 3. Central banks
 4. Investment management firms
 5. Hedge funds
 6. Retail forex brokers
- Trading characteristics
- Factors affecting currency trading
 7. Economic factors
 8. Political conditions
 9. Market psychology
- Algorithmic trading in forex
- Financial instruments
 10. Spot
 11. Forward
 12. Future
 13. Swap
 14. Option
 15. Exchange Traded Fund
- Speculation

33 & 34) Leasing Companies

- Conceptual background
 - Leasing of real property
 - Leasing of tangible personal property
- Real leases
 - Private property rental
 - Commercial leasehold
 1. Advantages of commercial leasing
 2. Disadvantages of commercial leasing

- The Leasing Sector in Pakistan and its Role in Capital Investment

35 & 36) Insurance Companies

- Principles of insurance
- Indemnification
- When is a policy really insurance?
 1. Does the contract contain adequate risk transfer?
 2. Is there a bright line test?
 3. "Safe harbor" exemptions
 4. Risk limiting features
- Insurer's business model
- Gambling analogy
- History of insurance
- Types of insurance
- Types of insurance companies
- Life insurance and saving
- Size of global insurance industry
- Financial viability of insurance companies
- Controversies
 1. Insurance insulates too much
 2. Closed community self-insurance
 3. Complexity of insurance policy contracts
 4. Redlining
 5. Health insurance
 6. Dental insurance
 7. Insurance patents
 8. The insurance industry and rent seeking
 9. Criticism of insurance companies

37) Role of Financial Institutions in Agriculture Sector

39) SME sector & Financial Institutions

- SME Policy in Pakistan
- Government of Pakistan & its Role

40) Financial Crimes

- Money Laundering
- Modern development
- Process
- Irregular funding
- Captive business
- Legal considerations
- Fighting money laundering
- Using information technology
- September 11, 2001 and the international response to the underground economy

41) Financial Institutions & Risk Management

42) Banking Crimes

43) Collapse of Enron

44) Misleading in Baring Bank, Black Wednesday, Soloman Brothers and Treasury Fraud.

45) Recap