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IDA/R2017-0028/2

March 16, 2017

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FROM: Vice President and Corporate Secretary

**Pakistan - Finance for Growth Development Policy Credit**

**Extension of Closing Date**

1. Due to the inclement weather and the closure of WBG Washington, D.C. offices in effect Tuesday, March 14, 2017, the closing date for the proposed Finance for Growth Development Policy Credit to Pakistan (IDA/R2017-0028) was extended to **Wednesday, March 15, 2017**.
2. Questions on these documents should be referred to Mr. Basim (ext. 36586) or Mr. Afram (Islamabad: 5722+221 / 92-51-909-0221 or [gafram@worldbank.org](mailto:gafram@worldbank.org)).

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Secretary, IMF



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IDA/R2017-0028/1

February 21, 2017

**Closing Date: Tuesday, March 14, 2017  
at 6 p.m.**

FROM: Vice President and Corporate Secretary

**Pakistan - Finance for Growth Development Policy Credit**

**Program Document**

Attached is the Program Document regarding a proposed Finance for Growth Development Policy Credit to Pakistan (IDA/R2017-0028), which is being processed on an absence-of-objection basis.

Distribution:

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Report No. 112795-PK

INTERNATIONAL DEVELOPMENT ASSOCIATION  
PROGRAM DOCUMENT FOR A PROPOSED DEVELOPMENT POLICY  
CREDIT  
IN THE AMOUNT OF SDR 222.1 MILLION  
(US\$ 301.6 MILLION EQUIVALENT)  
TO  
THE ISLAMIC REPUBLIC OF PAKISTAN  
FOR THE  
FINANCE FOR GROWTH DEVELOPMENT POLICY CREDIT

February 14, 2017

Finance and Markets Global Practice  
South Asia Region

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**GOVERNMENT OF PAKISTAN FISCAL YEAR**  
*July 1–June 30*  
**CURRENCY EQUIVALENTS**  
*(Exchange Rate Effective as of 31 January 2017)*

*Currency Unit: Pakistani Rupees*

*US\$1.00 = PKRs 104.805*

*US\$ 1.00 = SDR 0.73593*

**ABBREVIATIONS AND ACRONYMS**

AML/CFT	Anti-Money Laundering / Combating Financing of Terrorism	NPLs	Non-performing loans
BOP	Balance of Payments	PKR	Pakistan Rupee
CAS	Country Assistance Strategy	RAS	Reimbursable Advisory Service
CDNS	Central Directorate for National Savings	ICR	Implementation Completion Report
CFAA	Country Financial Accountability Assessment	JSAN	Joint Staff Advisory Note
CGDPF	Competitiveness and Growth Development Policy Financing	KYC	Know-your-customer
CPEC	China Pakistan Economic Corridor	LDP	Letter of Development Policy
DFID	Department for International Development	MDGs	Millennium Development Goals
DTA	Digital Transaction Accounts	MOF	Ministry of Finance
DPC	Development Policy Credit	MTEF	Medium-Term Expenditure Framework
DPO	Development Policy Operation	NFIS	National Financial Inclusion Strategy
ECC	Economic Coordination Committee	NICL	National Insurance Company Limited
EFF	Extended Fund Facility	NRA	National Risk Assessment
EMBI+	Emerging Market Bonds Index Plus	NSS	National Savings Schemes
FATF	The Financial Action Task Force	PDF	Pakistan Development Fund
FBR	Federal Board of Revenue	PEFA	Public Expenditure and Financial Accountability
FDI	Foreign Direct Investment	PER	Public Expenditure Review
FGDPC	Finance for Growth Development Policy Credit	PFM	Public Financial Management
FIIP	Financial Infrastructure and Inclusion Project	PPAF	Pakistan Poverty Alleviation Fund
FRDLA	Fiscal Responsibility and Debt Limitation Act	PRCL	Pakistan Reinsurance Company Limited
FSAP	Financial Sector Assessment Program	REER	Real Effective Exchange Rate
FSIG	Fiscally Sustainable and Inclusive Growth	ROSC	Report on the Observance of Standards and Codes
GCC	Gulf Cooperation Countries	SBP	State Bank of Pakistan
GDP	Gross Domestic Product	SDR	Special Drawing Rights
GNP	Gross National Product	SECP	Securities and Exchange Commission of Pakistan
GOP	Government of Pakistan	SLIC	State Life Insurance Corporation
GRS	Grievance Redress Service	SOE	State Owned Entities
IBRD	International Bank for Reconstruction and Development	UNDP	United Nations Development Program
IDA	International Development Association	S&P	Standard & Poor's
IFC	International Finance Corporation	SMEs	Small and Medium Enterprises
IMF	International Monetary Fund	SROs	Statutory Regulatory Orders
ISR	Implementation Status and Results Report	TA	Technical assistance
IOSCO	International Organization of Securities Commissions	TAGR	Trust Fund for Accelerating Growth and Reforms

MSCI	Morgan Stanley Capital International	USAID	United States Agency for International Development
NEPRA	National Electric Power Regulatory Authority	WB	World Bank
NIFT	National Institutional Facilitation Technologies	WBG	World Bank Group

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**THE ISLAMIC REPUBLIC OF PAKISTAN**  
**FINANCE FOR GROWTH DEVELOPMENT POLICY CREDIT**  
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**SUMMARY OF PROPOSED OPERATION AND PROGRAM  
THE ISLAMIC REPUBLIC OF PAKISTAN  
FINANCE FOR GROWTH DEVELOPMENT POLICY CREDIT (FGDPC)**

Borrower	Islamic Republic of Pakistan
Implementation Agency	Ministry of Finance (MoF)
Financing Data	The IDA Credit of SDR 222.1 million (equivalent to US\$ 301.6 million) is made up of three portions: (i) Portion A of the Credit is on regular IDA blend terms in the amount of SDR178.7 million (equivalent to US\$ 242.7 million) with a maturity of 25 years including a grace period of 5 years, a service charge of 0.75 percent, a commitment charge of not more than 0.5 percent, and an interest rate of 1.25 percent; (ii) Portion B of the Credit is on IDA hard terms in the amount of SDR6.6 million (equivalent to US\$ 8.9 million) with maturity of 25 years including a grace period of 5 years, a service charge of 0.75 percent, a commitment charge of not more than 0.5 percent, and an interest rate of 1.13 percent; and (iii) Portion C of the Credit is on IDA Scale Up Facility (SUF) terms in an amount SDR 36.8 million (equivalent to US\$ 50 million) with a maturity of 24 years including a grace period of 5 years, interest rate of 3.2 percent, a commitment charge of 0.25 percent, and a Front End Fee of 0.25 percent.
Operation Type	Stand-alone Development Policy Financing operation through a single-tranche IDA Credit
Pillars of the Operation and Program Development Objective(s)	The proposed operation will be structured around the development objective (DO) of supporting Government of Pakistan efforts in promoting an inclusive and transparent financial sector that is able to better intermediate resources for long term finance. The DO will be achieved through three pillars: (i) Improving access to finance and enhancing financial inclusion; (ii) Fostering long-term finance; and (iii) Enhancing transparency of the financial sector.
Result Indicators	<p>(i) Ease of access to Finance and enhance financial inclusion</p> <ul style="list-style-type: none"> <li>– Number of transactional accounts at financial institutions by gender</li> <li>– percent of NSS client’s profits distributed through the banking sector</li> <li>– percent increase in number of companies registered</li> <li>– percent increase in deposit base of banking sector</li> </ul> <p>ii) Unlock the constraints to long-term finance</p> <ul style="list-style-type: none"> <li>– Long-term loans as percent of total banking sector loans</li> </ul> <p>(ii) Enhance transparency of the financial sector</p> <ul style="list-style-type: none"> <li>– Adjudicating authority established and operational</li> <li>– Pakistan remains in compliance with FATF Recommendation-1.</li> <li>– Value of registered prize bonds as a share of outstanding prize bonds</li> <li>– The Chairman and the Chief Executive Officer (CEO) of SLIC meet the fit and proper criteria.</li> </ul>
Overall risk rating	Moderate
Climate and disaster risks (required for IDA countries)	<i>(i) Are there short and long term climate and disaster risks relevant to the operation (as identified as part of the SORT environmental and social risk rating)?</i> Yes <input type="checkbox"/> No <input checked="" type="checkbox"/>
Operation ID	P161136
Closing Date	June 30, 2018



# IDA PROGRAM DOCUMENT FOR A PROPOSED CREDIT TO PAKISTAN

## 1. INTRODUCTION AND COUNTRY CONTEXT

1. **This program document proposes a Finance for Growth Development Policy Credit operation to support the Government's reform efforts in the financial sector.** The proposed operation combines a single-tranche stand-alone IDA and IDA SUF Development Policy Credit (DPC) of SDR 222.1 million (US\$ 301.6 million equivalent). The development objective (DO) of the proposed operation is to support Government of Pakistan (GoP) efforts in promoting an inclusive and transparent financial sector that is able to better intermediate resources including for long term finance. Only 13 percent of Pakistani adults currently have a formal account, compared to 46 percent in South Asia and 43 percent of low middle-income countries. The DO will be achieved through the following three pillars: (i) Improving access to finance and enhancing financial inclusion; (ii) Fostering long-term finance; and (iii) Enhancing transparency of the financial sector. The operation contributes to the Government's strategy for accelerating economic growth through better access to credit and longer-term finance, improving the investment climate through a more robust Companies Bill, promoting financial inclusion and increasing financial sector transparency. A stand-alone operation is being proposed to support a selected number of discrete reforms that GoP intends to implement in the immediate term, while also building on and complementing other parallel efforts to build a financial sector that is better able to respond to the needs of a growing economy.

2. **The GoP has made significant progress in the implementation of its economic reform program in its first three years in office.** Upon taking office, GoP's first priority was to re-establish macroeconomic stability and strengthen macroeconomic fundamentals, addressing significant internal and external imbalances. In doing so, it also initiated a number of crucial structural reforms. The Fiscally Sustainable and Inclusive Growth (FSIG) DPC series (approved in June 2014 and June 2015) supported these reforms, thereby also contributing to restoring macroeconomic stability. The reform momentum has been maintained and supported through the Competitiveness and Growth Development Policy Financing (CGDPF), approved in June 2016. The Bank also provided a series of Power Sector DPCs during this time to support complementary reforms in the energy sector. In addition, a large TA program underpinned the Bank engagement on the economic and structural reforms, providing analytical and technical assistance required for the implementation of key reform areas in energy, debt management, revenue mobilization and private sector development.

3. **The CGDPF aimed to accelerating growth and fostering an inclusive growth pattern beyond stabilization.** It built on the success of the previous FSIG series and the International Monetary Fund (IMF) program through focusing on improving the business environment, and enhancing fiscal management by improving revenue management and making public spending more pro-poor. Crucial reforms were continued, such as the phasing out of the Statutory Regulatory Orders (SROs) and redirecting expenditures to priority areas. Several reform areas were deepened including broadening the tax base, Doing Business reforms, State Owned Enterprises (SOE) reforms and reforms to enhance access to overhaul parts of the legislative and institutional framework of the financial sector, while new reform areas were introduced such as debt management and poverty measurement.

4. **Despite the substantial progress in the three operations and recent developments in the financial sector, there remains an important unfinished structural reforms agenda; and financial access and inclusion remain particularly low.** The main areas of reform are: credit markets and the financial sector's role in financing private and public investments, business environment reforms, trade competitiveness, fiscal management, and inclusion (poverty, gender). Even though the private sector has started to recover, the

credit to Gross Domestic Product (GDP) ratio is very low (15 percent), lower than the South Asian median (42 percent) and peers such as Indonesia (33 percent) and Malaysia (120 percent)<sup>1</sup>. This implies that intermediation in the financial markets is well below the levels required to foster growth of firms and households' financial intermediation that Pakistan needs to sustain and enhance growth. According to the World Bank Global Financial Inclusion Database (Findex), only 13 percent of adults had access to a formal account in 2014<sup>2</sup>. Use of formal financial services is also limited. Individuals often make payments or borrow informally (about 43 percent of unbanked adults made or received payments informally and half of the Pakistani population reported borrowing through informal methods). Additionally, women are largely excluded, with only 4.8 percent women having accounts at a formal institution.

**5. The low level of financial inclusion and slow recovery of credit to the private sector can be attributed in part to factors which go beyond the scope of financial sector policy and are linked more closely to the economic cycle, fiscal policy and Pakistan's business climate.** Credit, including to underserved segments such as SMEs and housing, had been growing rapidly prior to the economic downturn in 2008 which was followed by the lowest average five-year period of GDP growth (2.8 percent) in the past 60 years. The challenging economic and business climate, including severe energy shortages and security concerns, has been highly disruptive for businesses, particularly Micro and Small and Medium Enterprises (MSMEs), negatively impacting their creditworthiness. There was a sharp deterioration in asset quality post-2008, particularly in the SME and housing sectors, where NPLs now stand at 26.5 percent and 29 percent, respectively. The economic downturn resulted in a decline in demand for credit. Banks sought less risky assets and invested heavily in government debt (see annex 7 for a detailed discussion). Large government borrowing crowded out private sector investment during the period FY08/09 to FY12/13 where Government financing needs increased from PKR680 billion (US\$6.53 billion) to PKR 1.8 trillion (US\$17.3 billion). Efforts to increase revenues and a more prudent fiscal policy have contributed to a marked decline in the fiscal deficit and the government's financing needs to PKR 7.5 trillion in FY15/16. The declining financing needs as well as increased access to foreign financing has resulted in reduced reliance on domestic financing and an increase in private sector credit more recently. The WBG's complementary support to the government on fiscal and debt management reforms under other operations are helping to address some of these challenges.

**6. Enhancing the financial sector's role in effectively intermediating resources for public and private investment including for Pakistan's poor and financially underserved population, including women, and to support private sector development is critical for accelerating growth.** The proposed operation is supporting reforms that would represent a significant overhaul of the legislative and institutional framework of the financial sector which contribute to building an inclusive and transparent financial sector that intermediates resources to meet the needs of the economy better.

**7. The World Bank (WB) has a long-lasting and ongoing engagement working on the development of Pakistan's financial sector.** The engagement is a combination of financial, advisory, knowledge, and convening services and is complemented by investments and private sector engagement by the International Finance Corporation (IFC). The WB supported the development of the National Financial Inclusion Strategy (NFIS), and is now providing a comprehensive package of support to enable Pakistan to achieve its targets. This includes: a) the current DPC to support institutional and legislative reforms; b) data and analysis to underpin more effective reforms e.g. FSAPs; c) technical assistance to build implementation and supervisory capacity; and d) support for critical improvements to the enabling environment. The WBs engagements in the financial sector are focused on increasing financial inclusion, developing long-term finance (Housing and

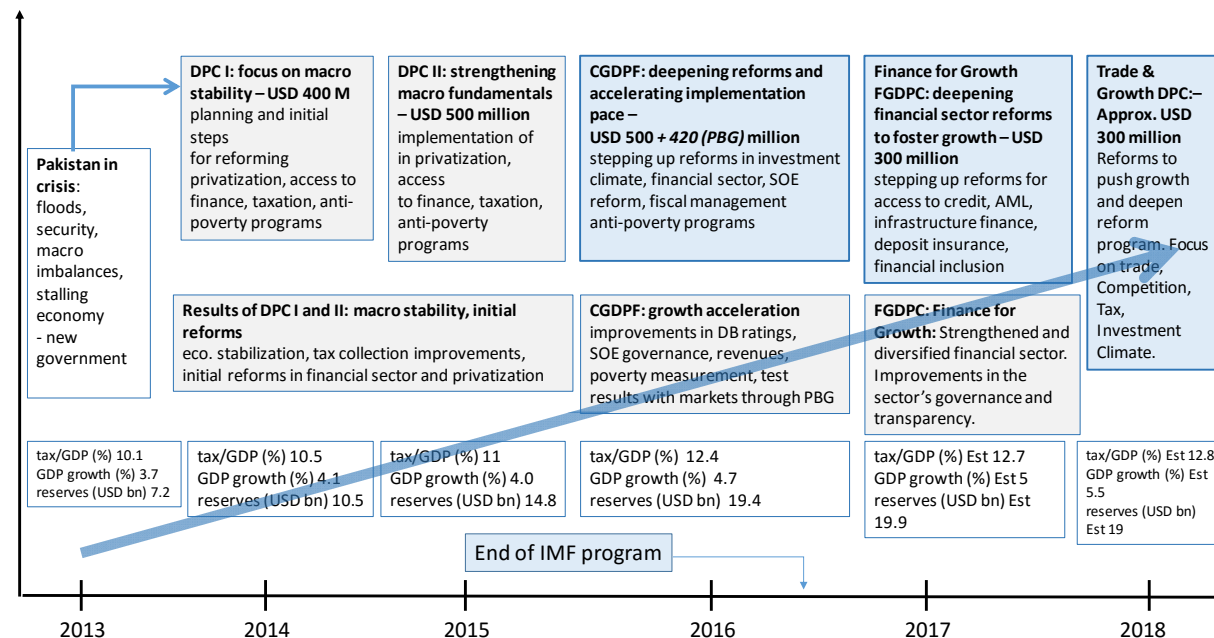
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<sup>1</sup> E. Feyen, K. Kibuuka and D. Sourrouille (2015). "FinStats 2016: A ready-to-use tool to benchmark financial sectors across countries and time", World Bank.

<sup>2</sup> Pakistan is far behind Sri Lanka at 83 percent, India at 53 percent and Bangladesh at 31 percent

Infrastructure) and supporting overall financial sector stability. **The structural reform agenda is expected to continue and will be supported through another Growth DPC which is expected to go to the Board in FY18 (see figure 1) and will support and complement the proposed financial sector investment operations.**

**Figure 1: Aspirational trajectory of Pakistan DPO-supported reforms**



Poverty and Shared Prosperity

8. **Growth, though low in some periods, has been quite pro-poor in Pakistan over the past decade and a half.** The headcount poverty rate has fallen consistently over this period, from 64 percent in 2001/02 to 29.5 percent in 2013/2014. Using incidence curves that plot the growth rate in consumption at each percentile of the distribution, it is evident that growth has been pro-poor in Pakistan through much of this period. When growth first starts to rise, the incomes of those at the top of the distribution grow faster than the incomes at the bottom. However, this quickly reverses, with those at the bottom growing faster than the top of the distribution. Between 2001 and 2004, for example, median income grew at 4.8 percent while income at the bottom grew close to 3 percent. In the next period (2004-2008), the bottom grew at more than 5 percent while the median grew at only half that rate. After 2008, despite the global food price shock and the collapse of GDP growth, incomes at the bottom continued to grow faster than incomes at the top until 2010-11. In the period after that, as GDP growth began to rise once again, incomes at the top were growing faster than incomes at the bottom. Looking at the bottom 40 percent of the population—a measure of shared prosperity—there is a similar pattern. The proposed operation supports sustained poverty reduction through greater access to financial services and increased transparency of the financial sector. Greater financial inclusion is expected to bring more poor and vulnerable people – including in particular women – into the financial mainstream, with positive effects on financial stability, economic growth, equity and social cohesion. Greater transparency is expected to contribute to a more responsible financial sector, and increased trust and confidence in the financial sector. Additionally, the prior actions related to financial inclusion have inherent awareness and communication campaign elements to ensure that the potential impacts are widely understood and realized by people across all segments of the population.

9. **Understanding the process driving inclusive growth is, however, an important and unfinished agenda.** The Government's adoption of a revised methodology to measure poverty and the release of the new poverty line last year, was an important move in the right direction. This has helped restore confidence in official government statistics and made it possible to design more effective anti-poverty programs. There is now a need to better understand the drivers behind successful poverty reduction over the last 15 years. Addressing the quality of national accounts data, will need to be a key aspect of this.

## 2. MACROECONOMIC POLICY FRAMEWORK

### 2.1. Recent Economic Developments

10. **Economic conditions have improved over the past years.** The risk of a balance of payments crisis was averted with a significant increase in international reserves to US\$18.3 billion by end-December 2016 (more than 4 months of imports coverage), supported by strong remittances and foreign capital and financial inflows. With prudent monetary and fiscal management, the current account deficit remains moderate and the foreign exchange market has been stable. Headline inflation remains low and the fiscal deficit has declined. The end of the IMF's Extended Fund Facility (EFF) program in September 2016 marked significant progress in achieving macroeconomic stability over the last three years. This has helped in improving the market's perception of country risk.

11. **GDP growth continues to increase and was at 4.7 percent in FY15/16.** The growth for FY15/16 increased to 4.7 percent from 4.0 percent in the previous year, driven by large-scale manufacturing growth of 4.6 percent and services growth of over 5.7 percent. The agriculture sector, after suffering a poor cotton harvest contracted by 0.2 percent during FY15/16, compared with 2.5 percent growth in FY14/15. The near-term growth outlook will be driven by public and private consumption, aided by a moderate increase in investment. A further growth revival will remain contingent on the government making further progress in addressing structural challenges like electricity availability, narrow fiscal space and access to credit.

12. **Pakistan's improved balance of payment position strengthened the macroeconomic stability.** A lower current account deficit and relatively healthy financial inflows contributed to the sustained build-up of foreign exchange reserves during the past few years. However, this performance masks the structural weaknesses that continue to make the external sector vulnerable. Exports have been declining since FY14/15 and registered a contraction of 8.8 percent in FY15/16. This trend continues in FY16/17, but the decline has decelerated to 1.4 percent in July-November FY16/17. Imports also declined in FY15/16 by 2.3 percent but this trend has reversed in the first 5 months of FY16/17 with a growth of 5.6 percent. This pickup in imports reflects increased economic activity related to China Pakistan Economic Corridor (CPEC). Higher inflows in the capital and financial account during this period were supported by the issuance of US\$ 0.5 billion Eurobond and US\$ 1.0 billion Sukuk (Sharia compliant bond).

13. **While overall remittances have grown over the years, recently there has been a slight dip.** The growth in remittances continued in FY15/16, albeit at a much slower pace than before, with 6.4 percent growth in FY15/16. Remittances financed 49 percent of the country's import bill and 108 percent of the overall trade deficit in FY15/16. The Gulf Cooperation Council (GCC) countries remained the largest source of remittances with a share of 65 percent of the total. However, remittances declined by 2.4 percent during Jul-Dec FY17 due to weak growth and declining public investment in GCC economies.

14. **The Rupee (PKR) has appreciated in real terms in the last year.** The Rupee remained largely stable against the US dollar in Jul-Dec FY16/17 as a result of the market's positive reaction to the build-up of reserves, with a small appreciation of 0.03 percent. The successful completion of the IMF's EFF program has

also improved sentiment in the foreign exchange market. With a relatively stable nominal exchange rate against the US dollar and inflation that is stable in comparison to peer countries, Pakistan's real effective exchange rate (REER) has appreciated in recent times. This appreciation<sup>3</sup> could be affecting Pakistan's export competitiveness<sup>4</sup>, adding to structural constraints such as the poor investment climate, energy shortages and security concerns.

15. **After reducing the fiscal deficit from 8.2 percent in FY12/13 to 4.6 percent in FY15/16, it increased in the first quarter of FY16/17 to 1.3 percent from 1.1 percent in the first quarter of FY 15/16.** The consolidated fiscal deficit (excluding grants) has declined from 5.3 percent of GDP in FY14/15 to 4.6 percent in FY15/16—the lowest in nine years. This improvement was primarily supported by strong tax collection at the federal level, which grew by 20 percent. Progress in reducing tax expenditures by removing concessions granted through SROs have contributed to this strong performance. However, Pakistan's fiscal deficit during Q1-FY16/17 rose to 1.3 percent, 0.2 percentage points higher than the deficit in same period last year. The total expenditure experienced a modest increase during Q1-FY16/17. However total revenues declined by PKR74.8 billion (US\$719 million) during this quarter compared to the corresponding period last year- with non-tax revenues declining by PKR90 billion (US\$865 million) due to drying up of coalition support flows and lower State Bank of Pakistan (SBP) profit.

16. **Efforts continue to curb subsidy payments to the power sector.** The Government was able to reduce electricity subsidies from 2.3 percent of GDP in FY11/12 to 0.6 percent in FY15/16 by introducing significant increases for all tariff classes following the introduction of the National Power Tariff and Subsidy Policy Guidelines 2014<sup>5</sup>. Under this mechanism, the Ministry for Water and Power informs the regulator of the amount of subsidies provided, which ensures the subsidies are taken into account in its determination of consumer tariffs for the fiscal year. In June 2015, the Government notified the FY14/15 tariffs, as determined by the National Electric Power Regulatory Authority (NEPRA), and implemented surcharges in line with its commitment to reduce subsidies. The Government has also implemented a mechanism to maintain national uniform tariffs in distribution companies (Discos) while ensuring cost recovery. The Government began addressing both the flow and stock of payables in the power sector including by allocating budgetary resources, levying surcharges, and gradual improvement in company performance and recoveries. The Government is also revisiting its plan to reduce circular debt in light of delays in the privatization of Discos. The Government remains committed to gradually phasing out untargeted subsidies while continuing to protect the most vulnerable consumers.

17. **Public debt stayed above the legislative threshold over a period of five years up to FY15/16.** Gross debt to GDP ratio has increased to 67.5<sup>6</sup> percent in FY15/16 compared to 64.1 percent in FY14/15 (net public debt to GDP ratio has increased to 60.2 percent in FY15/16 compared to 58.1 percent in FY 14/15). The amended Fiscal Responsibility and Debt Limitation Act (FRDLA) of 2016 stipulates that the 60 percent debt to GDP limit should be adhered to by June 2018. Domestic debt dominates at 69 percent of total debt. The increase witnessed in FY15/16 after declining consecutively for two years is due to sizeable revaluation losses, record high disbursements under external debt and additional debt creation on the domestic front

<sup>3</sup> The latest IMF estimates point towards an overvaluation of Pakistani rupee between 5 and 20 percent (Source: IMF Country Report No. 16/2 Pakistan Selected Issues Paper, January 2016).

<sup>4</sup> Cross-country empirical relationships estimated by Fund economists suggest that a 10 percent real appreciation has a negative effect on exports of about 7 percent and a positive effect on imports (i.e., displacing domestic production) of about 9 percent, which would accrue over time. (Source: IMF Country Report No. 16/2 Pakistan Selected Issues Paper, January 2016).

<sup>5</sup> <http://www.mowp.gov.pk/gop/index.php?q=aHR0cDovLzE5Mi4xNjguNzAuMTMwOjkwODAvbW93cC91c2VyzmlsZXMxL2ZpbGUvZmluYWwIMjAlMjBwb2xpY3kIMjBGaW5hbCUyMDIwMTQwNDxLnBkZg%3D%3D>

<sup>6</sup> Debt-to-GDP ratio is estimated by the World Bank as per the Government Financial Statistics Manual 2014. This results in the inclusion of external debt of public enterprises worth 1 percent of GDP not included in the debt stock as defined by the Government of Pakistan. The Government of Pakistan official statistics show debt-to-GDP ratio of 66.5 percent as of June 30, 2016.

that led to a strong build-up of government deposits.<sup>7</sup> Nonetheless, the government has succeeded in efforts to lengthen debt maturity<sup>8</sup> and diversify financing sources through increased access to international financial markets.

18. **Prices have stabilized, supported by low oil prices.** For a fourth year in a row, headline CPI inflation is in single digits. Falling oil prices have not only contributed directly through reductions in petroleum product prices and electricity tariffs but also indirectly through reduced cost of manufactured goods and services. CPI inflation (y-o-y) has started to rise since October 2015 and currently stands at 3.7 percent in December 2016.

19. **The financial sector is healthy and private sector credit is recovering.** To foster private sector credit, the SBP cut its key policy rate by a cumulative 75 basis points (bps) in FY15/16, owing to favorable trends in oil prices and falling inflation. The banking sector has maintained improved performance and solvency in recent years. Non-performing loans (NPLs), although still at a high level, declined from 15.3 percent of the overall loan portfolio in June 2011 to 11.1 percent in June 2016 and by virtue of adequate provisioning, net NPLs fell from 5.5 percent in June 2011 to 2.2 percent in June 2016. The improvement in credit quality is broad based, as NPLs in corporate, small and medium enterprises, and consumer segments decreased from 15.9 percent, 31.8 percent, and 18.3 percent respectively in June 2011 to 11.8 percent, 26.5 percent, and 9.8 percent respectively in June 2016. As a result of lower interest rates and improving asset quality, private sector credit is recovering and has grown by 12.8 percent in FY15/16 (y-o-y). Much of this increase stems from the manufacturing, construction and transport and communication sectors (see Annex 6 for detailed financial sector overview and performance). Overall credit intermediation however, remains very modest and to further enhance the domestic private sector's access to credit, the recent FSAP Report recommends that the Government should diversify its sources of borrowing, in particular by tapping external markets and extending debt maturities.

20. **The market's perception of country risk is improving.** Pakistan's Emerging Market Bonds Index Plus (EMBI+) risk spread has declined from its peak in March 2013 of 1,011 bps to 359 bps on January 04, 2017. Moody's changed the outlook for its Caa1 sovereign credit rating from stable to positive in March 2015. Later, in June 2015, Moody's upgraded Pakistan's foreign currency bond rating to B3 and assigned a stable outlook. Standard and Poor's (S&P) rating agency raised Pakistan's credit rating outlook from stable to positive in May 2015 but affirmed its B- rating, which was further raised to B in October 2016. Pakistan was also upgraded to 'emerging market' status in the Morgan Stanley Capital International (MSCI) Index recently. Market confidence allowed Pakistan to raise US\$1 billion at 5.5 percent by five-year international Sukuk in October 2016.

## 2.2. Macroeconomic Outlook

21. **The outlook up until FY19/20 is for moderately higher growth.** This is predicated on continued macroeconomic stability, as well as steady progress in implementing the main pillars of the Government's medium-term reform program, which tackle key constraints to growth. The outlook assumes that oil prices will increase moderately but remain low, and that political and security risks are managed.

22. **The near-term growth outlook will be driven by public and private consumption, aided by a moderate increase in investment.** Pakistan's growth is expected to continue to accelerate, reaching 6.0

<sup>7</sup> Government deposits underwent a large increase during FY15/16, closing the year at PKR459 billion (US\$4.41 billion) (or 1.6 percent of GDP) compared to PKR25 billion (US\$24 million) in FY14/15.

<sup>8</sup> Average Time to Maturity (ATM) of domestic debt – a key indicator of refinancing risk inherent in a country's debt portfolio – has improved from 1.8 years in FY13 to 2.1 years in FY16 (as per modalities of MTDS). Source: *Public Debt Management Risk Report, End-June 2016 and Medium-Term Debt Management Strategy (2015/16 – 2018/19)*, Debt Policy Coordination Office, Ministry of Finance, Government of Pakistan

percent in FY19/20<sup>9</sup>. On the demand side GDP growth is primarily driven by public and private consumption, however some rebalancing in growth components is expected due to a rise in investment. Gross fixed investment is expected to rise from 14.0 percent of GDP in FY16 to 15.5 percent of GDP in FY20<sup>10</sup>. This increase is predicated on Foreign Direct Investment (FDI) picking up, due in part to the CPEC<sup>11</sup> and higher public investment. Supply-side effects facilitated by higher power generation capacity and better infrastructure will be beneficial for the economy in the medium- to long-term. More generally, supply in the medium-term will expand as a result of productivity gains in the services, large-scale manufacturing and construction sectors, which should benefit from decreased power load-shedding and improvements in the business climate. The medium-term outlook assumes an increasing oil price trajectory and, given Pakistan is a net oil importer, this assumption has a sizeable impact on the trade bill (particularly imports) as well as direct and indirect effects on headline inflation. The cost to the government budget from increased energy subsidies is expected to be offset by higher oil-related revenue receipts.

23. **Fiscal slippages may impact private sector investment.** Increased public spending during the upcoming election cycle is expected to increase the Government's borrowing needs, leading to the crowding out of private sector investment. However, it will increase domestic public investment. The baseline macro projections are explained below:

- *Growth and inflation:* GDP growth is expected to pick up to around 6.0 percent in FY19/20. Services are projected to expand, especially finance and insurance, transport and communication sectors. Manufacturing is expected to benefit from improved energy supply, better security, implementation of CPEC-related investments and better private sector credit conditions. Investment is expected to benefit from better business conditions (CPEC), strengthening FDI flows and increased public investment. Inflation is expected to steadily rise, as the base effect diminishes, domestic energy prices increase, and aggregate demand grows.
- *Fiscal accounts:* The consolidated fiscal deficit (excluding grants) is projected to expand from 4.6 percent of GDP in FY15/16 to 5.2 percent by FY17/18 and then decline to 4.6 percent of GDP by FY19/20 as shown in Table 2<sup>12</sup>. Expenditure, both current and development, is expected to increase as the country nears the next electoral cycle, to decline again after the elections. Increasing tax revenues will help offset some of the additional expenditures. The tax revenue is projected to increase from 12.4 percent of GDP in FY15/16 to 13.5 percent in FY19/20.

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<sup>9</sup> GoP projects GDP growth to be 7 percent in FY19/20.

<sup>10</sup> GoP projects fixed investment to increase to 20 percent of GDP by FY19/20.

<sup>11</sup> The economic impact of CPEC will be limited in the short-run as increased investment will likely be offset by a significant increase in imports.

<sup>12</sup> GoP projects consolidated fiscal deficit at 3.8 percent in FY16/17, 3.7 percent in FY17/18, and 3.5 percent in FY18/19.

**Table 1: Key Macroeconomic Indicators Pakistan FY12/13 to FY19/20<sup>13</sup>**

	FY12/13	FY13/14	FY14/15	FY15/16	FY16/17	FY17/18	FY18/19	FY19/20
	Actual				Projections			
<b>Real economy</b>	(Percentage change; unless otherwise indicated)							
Nominal GDP at market prices (in bn. of rupees)	22,386	25,169	27,493	29,598	32,729	36,959	41,706	47,448
Real GDP growth (at factor cost)	3.7	4.1	4.0	4.7	5.0	5.5	5.8	6.0
Contributions:								
<i>Agriculture</i>	0.6	0.5	0.5	0.0				
<i>Industry</i>	0.2	0.9	1.0	1.4				
<i>Services</i>	2.9	2.6	2.5	3.3				
Per Capita GDP (current US\$) 5/	1087.1	1114.2	1142.8	..				
Unemployment rate 1/	6.2	6.0	5.9	..				
Consumer prices (period average)	7.4	8.6	4.5	2.9	5.0	6.0	7.0	7.0
Consumer prices (cop)	5.9	8.2	3.2	3.2				
<b>Fiscal sector</b>	(In percent of GDP; unless otherwise indicated)							
Expenditures	21.5	20.0	19.6	19.6	20.4	20.7	20.8	20.6
Revenue	13.3	14.5	14.3	15.0	15.4	15.5	15.7	16.0
Overall balance (excl. grants)	-8.2	-5.5	-5.3	-4.6	-4.9	-5.2	-5.0	-4.6
Total public debt	64.7	64.4	64.1	67.5	66.1	64.6	62.6	59.7
Foreign currency public debt 2/	22.1	21.1	19.8	21.4	20.6	19.8	18.7	17.3
Domestic currency public debt	42.5	43.3	44.3	46.0	45.6	44.8	43.8	42.4
<b>Monetary Sector</b>	(Percentage change; unless otherwise indicated)							
Broad Money	15.9	12.5	13.2	13.7				
Credit to non-government	-0.6	11.1	7.3	12.8				
Interest (key policy interest rate)	9.00	10.00	6.50	5.75				
<b>Balance of payments</b>	(In percent of GDP; unless otherwise indicated)							
Current account balance (incl. transfers)	-1.1	-1.3	-1.0	-1.2	-1.9	-2.2	-2.2	-2.1
Exports of goods & services	13.6	12.4	11.1	9.6	8.8	8.5	8.1	8.0
Imports of goods & services	21.0	20.2	18.5	17.1	16.3	15.7	14.8	14.0
Capital and financial account	0.4	3.0	2.0	2.1	2.0	2.0	2.0	2.0
Foreign direct investment, net	0.5	0.6	0.3	0.7	0.5	1.0	1.1	1.1
Gross official reserves (in US\$ million, cop)	7,198	10,509	14,836	19,446	19,875	18,975	18,082	17,909
Gross official reserves (in months of imports of G&S) 3/	1.7	2.5	3.7	4.6	4.4	3.9	3.6	3.4
Total external debt 4/	26.4	26.7	24.0	25.8	24.5	22.9	21.2	19.6
Rupees per U.S. dollar (period average)	96.8	102.5	101.4	104.4				
<b>Memo:</b>								
Crude oil, average (\$/bbl) 6/	104.1	96.2	50.8	43.3	55.2	59.9	62.7	65.6
Nominal GDP at market prices (in US\$ billion)	231.2	245.5	271.1	283.6	311.7	345.8	390.2	435.0
GDP, PPP (current international In US\$ billion) 5/	839.5	894.4	946.7	..				
Workers' remittances (in US\$ billion)	13.9	15.8	18.7	19.9	19.5	19.7	19.9	20.1

Sources: Pakistan authorities, IMF, World Bank Staff estimates

1/ National estimates.

2/ This includes medium and long term PPG debt as well as short-term external debt. This also includes IMF debt (both budget support and balance of payments support), Foreign currency bonds (NHA/NC) as well as PSEs non-guaranteed debt.

3/ In months of next year's imports of goods and services.

4/ Total external debt is inclusive of medium and long term PPG debt as well as short-term external debt, IMF and private debt.

5/ Source: WDI (as of January 06, 2017)

6/ Source: Commodity Markets Outlook, DECPG

- Revenue mobilization:** Tax revenues are expected to increase from 12.4 percent in FY15/16 to 13.5 percent by FY19/20. The increased revenue mobilization will be supported by higher growth and imports as well as successful implementation of the ongoing reforms in tax policy and administration. In FY15/16, revenues collected by Federal Board of Revenue (FBR) posted an impressive 20.2 percent increase, on the back of increase in direct and indirect tax collection. The total estimated additional revenue gained from phasing out SROs over the past three years is about one percent of GDP. Non-tax revenues are assumed to be between 2.6 and 2.8 percent of GDP for the projection period.

<sup>13</sup> This macroeconomic framework has been developed by the World Bank. The Government's framework differs

**Table 2: Key Fiscal Indicators Pakistan FY12/13 to FY19/20<sup>14</sup>**

(In percent of GDP; unless otherwise indicated)

	FY12/13	FY13/14	FY14/15	FY15/16	FY16/17	FY17/18	FY18/19	FY19/20
	Actual				Projections			
<b>Revenue and grants</b>	<b>13.5</b>	<b>15.2</b>	<b>14.4</b>	<b>15.1</b>	<b>15.6</b>	<b>15.7</b>	<b>15.9</b>	<b>16.1</b>
Total Revenue	13.3	14.5	14.3	15.0	15.4	15.5	15.7	16.0
Tax revenue	10.1	10.5	11.0	12.4	12.7	12.8	13.1	13.5
Taxes on goods and services	4.3	4.5	4.6	5.1				
Direct Taxes	3.3	3.5	3.7	4.0				
Taxes on international trade	1.1	1.0	1.1	1.4				
Other taxes	1.5	1.5	1.6	1.9				
Nontax revenue	3.2	4.0	3.3	2.7	2.8	2.8	2.7	2.6
Grants	0.1	0.8	0.1	0.1	0.2	0.1	0.1	0.1
<b>Expenditure</b>	<b>21.5</b>	<b>20.0</b>	<b>19.6</b>	<b>19.6</b>	<b>20.4</b>	<b>20.7</b>	<b>20.8</b>	<b>20.6</b>
Current expenditure	16.4	15.9	16.1	15.9	16.0	16.3	16.1	16.0
Interest payments	4.4	4.6	4.7	4.3	4.2	4.2	4.2	4.2
Superannuation allowances & pension	0.8	0.7	0.7	0.8	0.8	0.8	0.8	0.8
Transfers (other than provinces)	1.0	1.1	1.0	1.2	1.2	1.2	1.2	1.2
Others	5.2	4.8	4.6	4.4	4.7	4.9	4.8	4.9
Provincial	4.9	4.7	5.0	5.2	5.2	5.2	5.0	4.8
Development expenditure & net lending	5.1	4.9	4.1	4.4	4.5	4.5	4.7	4.6
Statistical discrepancy	0.1	-0.9	-0.6	-0.7	-0.1	0.0	0.0	0.0
<b>Overall balance (excluding grants)</b>	<b>-8.2</b>	<b>-5.5</b>	<b>-5.3</b>	<b>-4.6</b>	<b>-4.9</b>	<b>-5.2</b>	<b>-5.0</b>	<b>-4.6</b>
<b>Overall balance (including grants)</b>	<b>-8.1</b>	<b>-4.7</b>	<b>-5.2</b>	<b>-4.5</b>	<b>-4.8</b>	<b>-5.1</b>	<b>-4.9</b>	<b>-4.5</b>
<b>Financing</b>	<b>8.2</b>	<b>5.5</b>	<b>5.2</b>	<b>4.6</b>	<b>4.9</b>	<b>5.2</b>	<b>5.0</b>	<b>4.6</b>
External	0.0	2.0	0.7	1.3	1.0	0.7	0.9	0.7
Of which : privatization receipts	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Domestic	8.2	3.5	4.6	3.3	3.9	4.5	4.1	3.9
<b>Memo:</b>								
Primary balance (excluding grants)	-3.8	-1.0	-0.6	-0.3	-0.8	-1.0	-0.8	-0.3
Primary balance (including grants)	-3.6	-0.2	-0.5	-0.2	-0.6	-0.9	-0.7	-0.2

Source: World Bank Staff calculations and estimates

- Fiscal Financing Gap.** Gross financing requirements for the GoP are projected to be PKR 9.3 trillion (US\$88.5 billion) in FY16/17 and is expected to increase to PKR 12 trillion (US\$107 billion) by FY19/20 (Table 3). Amortization of medium- and long-term public sector debt will increase significantly in FY16/17, particularly to domestic creditors<sup>15</sup>. Multilateral official financing and domestic creditor financing will remain the main long-term financing sources. For instance, the Government is expected to generate a net issuance of PKR 1.0 trillion (US\$9 billion) on average during the projection horizon through medium- to long-term (MLT) domestic debt instruments while short-term debt creation is projected to be around PKR 625 billion (US\$6 billion) during the same period. The Government will seek to continue accessing international financial markets<sup>16</sup>, which will facilitate the Eurobond bullet repayments due from FY16/17. Increased financing from abroad will diversify the government's funding and reduce its reliance on the domestic banking sector, creating much-needed space for private sector credit. Table 3 shows the Government's gross fiscal financing requirements and sources that will finance that gap.

<sup>14</sup> These figures are sourced from World Bank estimates. The Government of Pakistan's estimates differ slightly.

<sup>15</sup> This is due to maturity of around PKR 1.2 trillion (US\$11.53 billion) for 3-year PIBs falling due on July 18, 2016 during FY16/17.

<sup>16</sup> Continued volatility in global markets may constrain Pakistan's ability to access international financial markets at reasonable costs.

**Table 3: Pakistan Fiscal Financing Requirements and Sources FY15/16 to FY19/20**

(in billions of PKR; unless otherwise specified)

	Actual		Projections		
	FY15/16	FY16/17	FY17/18	FY18/19	FY19/20
<b>Financing requirements</b>	<b>7,459</b>	<b>9,297</b>	<b>9,778</b>	<b>10,717</b>	<b>11,951</b>
Fiscal deficit (incl. grants)	1,321	1,569	1,870	2,032	2,114
Maturing short-term public sector debt (previous year stock)	4,713	5,179	5,718	6,288	7,013
Amortization of medium- and long-term public sector debt	1,425	2,549	2,190	2,397	2,824
To domestic creditors	1,166	2,203	1,917	1,985	2,401
To other official creditors (incl. IMF)	207	268	273	303	311
To Eurobonds	52	79	-	110	112
<b>Financing sources</b>	<b>7,458</b>	<b>9,297</b>	<b>9,778</b>	<b>10,718</b>	<b>11,951</b>
Privatization receipts	-	-	-	-	-
Short term debt disbursements	5,257	5,724	6,290	7,013	7,670
Long term debt disbursements	2,654	3,630	3,542	3,726	4,255
From other official creditors	388	509	528	544	579
From domestic creditors	2,213	3,016	2,960	3,072	3,564
From Eurobonds	52	105	54	110	112
Change in assets (decrease = +)	(453)	(57)	(54)	(21)	26

Source: World Bank Staff calculations and estimates

**Note:** Typically, the short-term debt stock (3, 6 and 12 months T-bills) gets rolled-over in the course of a year and the (projected) increase may have some impact on financing costs. ST debt share has reduced from 33 percent of total public debt (including domestic and external) in FY12 to 25 percent in FY16.

- **External Sector.** As a result of the forecasted moderate increase in oil prices, the current account deficit is expected to increase to 2.1 percent of GDP in FY19/20—from 1.2 percent in FY15/16. Faster economic growth will require higher imports of raw materials, machinery and fuels on top of sizeable oil imports. Exports are expected to grow at an average of 7.1 percent for the next four years. Remittances will continue to partly finance the current account deficit in the medium term, although budget cuts and slower growth in GCC countries (arising from the absence of a full recovery in oil prices) will affect migrants' employment options and remittances. Significantly higher foreign investment inflows under the CPEC and investments attracted by a gradually lower country risk will support the financial account, despite declining multilateral financial net inflows. Official foreign exchange reserves are projected to decline to 3.4 months of imports by FY19/20 as the trade deficit widens and repayments begin on the IMF EFF in FY17/18.
- **External Financing Gap.** Gross financing requirements from the balance of payments are expected to be US\$14.1 billion by end-FY18/19. The current account deficit is projected to increase in absolute terms and reach US\$8.8 billion by FY18/19. Multilateral, bilateral and private debt-creating flows are expected to be the main financing sources. To meet external financing needs, the Government will continue to access international markets. The Policy-Based Guarantee by the WB approved in June 2016 could contribute to maintain access to international markets. Balance of payments (BOP) financing requirements are shown below.

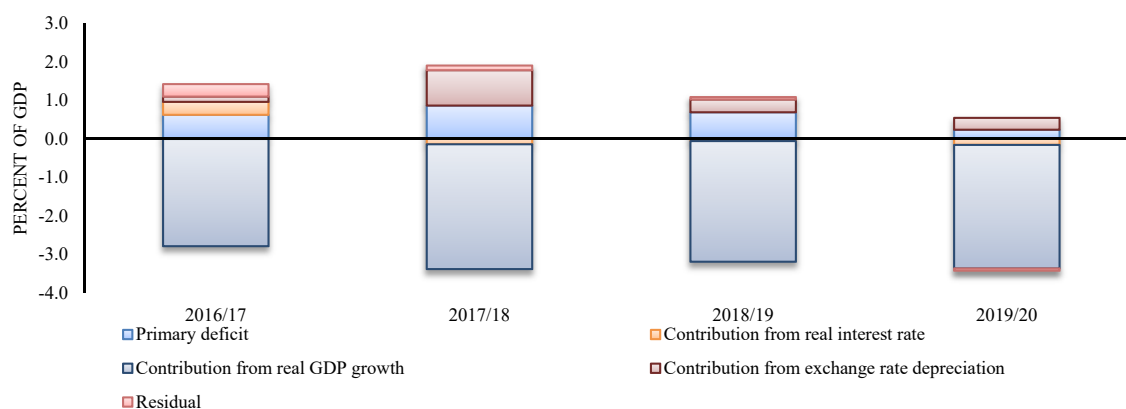
**Table 4: Pakistan BOP Financing Requirements and Sources FY15/16 to FY19/20**

(in millions of US dollars; unless otherwise specified)

	Actual	Projections			
	FY15/16	FY16/17	FY17/18	FY18/19	FY19/20
<b>Financing requirements</b>	<b>6,476</b>	<b>10,848</b>	<b>12,442</b>	<b>14,108</b>	<b>14,825</b>
Current account deficit	3,262	5,797	7,611	8,775	9,039
Amortization	3,214	5,051	4,831	5,333	5,786
To IMF	53	-	-	-	-
To other official creditors	1,927	2,550	2,444	2,372	2,025
To private creditors	734	1,751	2,387	1,961	2,761
To Eurobonds	500	750	-	1,000	1,000
<b>Financing sources</b>	<b>9,607</b>	<b>11,153</b>	<b>12,624</b>	<b>13,363</b>	<b>14,818</b>
FDI and portfolio investments (net)	1,449	2,612	4,155	3,918	5,190
Of Which: Eurobonds/Sukuk					
Capital grants	349	362	348	372	398
Short term debt disbursements	3,722	4,847	4,889	4,941	5,173
Long term debt disbursements	2,449	2,387	1,961	2,761	2,561
Other financial flows	1,638	945	1,272	1,371	1,496

Source: World Bank Staff calculations and estimates

- Public Debt.** Real GDP growth, combined with declining primary deficit, towards end of the projection period, is expected to lead to a gradual decline in Pakistan's public debt to GDP ratio, which is expected to fall below the legislative threshold of 60 percent by FY19/20 (see Figure in Annex 4 for the projected debt path and Figure 3 for a decomposition of debt dynamics). This declining trajectory assumes fiscal tightening post 2018 elections and any deviation from the expected path of fiscal consolidation may lead to an upward trend in the public debt ratio. Moreover, the debt sustainability analysis shows that the debt path is particularly sensitive to the materialization of contingent liabilities, from power sector arrears or SOE losses, and to exchange rate depreciation. In both of these shock scenarios, the public debt stock rises to 68.8 percent of GDP by FY19/20, almost 9.1 percentage points of GDP above the baseline. And as the total interest payments will continue to absorb a large share of fiscal revenues, public debt dynamics will remain a source of fiscal vulnerability in the medium-term. The debt sustainability analysis is discussed further in Annex 4.

**Figure 3: Composition of the Projected Change in Public Debt Levels**

Source: Pakistan Public DSA 2016/17 - 2019/20

24. **There are significant downside risks to the projected outlook.** Pakistan remains vulnerable to domestic and external shocks. *Domestically*, the country is exposed to natural disasters, political events and terrorism. Challenging domestic political conditions like those suffered during the first half of FY14/15 may disrupt economic activity. Security risks may also disrupt economic activity, discourage investment and undermine fiscal consolidation. Slippages in the privatization program may affect private sector investment, lead to fiscal outlays and further increase Pakistan's contingent liabilities. In the case of Discos, further delays in privatization may slow the Government's efforts to reduce circular debt in the energy sector. A persistent dollar appreciation with limited exchange rate flexibility may erode export competitiveness. The upcoming national election in 2018 may affect reform momentum. Delays in much-needed structural reforms would weaken growth prospects and discourage private investment. *Externally*, protracted global economic weakness, especially in the Euro area, China and Japan, could negatively affect exports. Pakistan benefits from significant remittance flows, particularly from oil-rich countries (around two thirds of all remittances). Low oil prices represent a downside risk for remittances, as GCC countries may reduce public spending, leading to reduced demand for Pakistani migrant workers. But low oil prices also improve the current account deficit and create an environment conducive for reductions in energy subsidies. On balance, low oil prices have been positive for Pakistan, being a net oil importer. Conversely, a sharp increase in oil prices will worsen the trade deficit and could increase energy subsidies.

25. **Mitigation of these risks is best achieved by building domestic and external buffers to absorb shocks.** GoP has been rebuilding buffers by increasing reserves, tightening fiscal policy to reduce borrowing needs and conducting an appropriate monetary policy that has maintained relatively low inflation.

26. **The macroeconomic framework is adequate for the proposed operation.** Prudent fiscal and monetary policies have resulted in improved macroeconomic outcomes. Efforts to increase revenues and reign in expenditure has resulted in a significant decline in fiscal deficits over the past 3 years. Revisions to the Fiscal Responsibility and Debt Limitation Act have anchored fiscal policy on a more sustainable path. The monetary policy framework is being strengthened, including amendments to the SBP law, introduction of administrative measures to increase SBP autonomy and an independent monetary policy committee. Debt management is being improved, with a strengthening of the Debt Policy Coordination Office and the approval and monitoring of the medium-term debt management strategy. The WB is providing technical assistance in a number of these areas (tax policy and administration, fiscal management, debt management) to continue strengthening institutional capacity for improved macroeconomic management.

### 2.3. IMF Relations

27. **The onset of FY2017 saw government conclude the 12th and final review of a three-year EFF program with the IMF.** During these three years, the economy has achieved macroeconomic stability primarily on the back of fiscal discipline shown by the government and a reduction in the current account deficit due to falling global commodity prices and buoyant remittances. This stability has set the stage for the government to further implement structural reforms to help unlock sustained and inclusive growth in the medium term. With the EFF program concluding, the IMF will continue its extensive engagement in Pakistan through bi-yearly post-program monitoring missions.

## 3. THE GOVERNMENT'S PROGRAM

28. **Upon taking office, the Government started pursuing a comprehensive economic reform program, supported by development partners.** Under this program, the government committed to adopt stabilization measures to eliminate macroeconomic imbalances and promote a more efficient economy. In its first three years, the government developed ambitious reform agendas in a number of areas: Energy Policy, privatization,

tax reform, phasing out SROs-based tax exemptions, improving the investment climate, financial inclusion, tariff rationalization and the Doing Business Indicators Reform.

29. **The GoP has sought to change the trajectory of growth with greater private sector development, which in turn will require stronger financial intermediation.** Raising private investment is crucial for the government's ambitions to accelerate growth. At present, investment stands at 15 percent of GDP in Pakistan; one of the lowest levels in South Asia and also amongst other peer group countries. GoP is focusing on policy reforms at federal and provincial levels to enhance the business and financial environment, including improving the legal framework and addressing constraints on the private sector. Efforts to improve competitiveness at the provincial level are also being supported by the WB through a number of projects, including the recent Punjab Growth and Competitiveness PforR, and the WB is also preparing the Financial Infrastructure and Inclusion Project (FIIP) to support Pakistan's recently adopted Financial Inclusion Strategy. In addition, Government is committed to supporting policy actions supported by this proposed operation, and investments in financial infrastructure and market development.

30. **Pakistan's low access to finance particularly to households and SMEs represents a serious impediment to inclusive growth and job creation.** After years of steady growth, credit to the private sector declined markedly from 2008 to 2015 (showing slow recovery recently), falling from 22 percent of GDP in 2009 to just 15 percent in 2015, a level only above Afghanistan's in the region and significantly below other peer group countries. The decline in credit to SMEs was particularly pronounced, declining from 16 percent of bank lending in 2008 to just 7 percent in 2015. Against a backdrop of increasing non-performing loans in the past (on account of weak credit models of banks and investment climate deterioration), slow demand from the private sector, and rising government borrowing, banks invested heavily in government securities, which now exceed private sector credit in banks' portfolios. As of June 30, 2016, government securities represented 47 percent of total bank assets (which equates to 140 percent of banks' outstanding private sector credit), while private sector credit accounted for just 37 percent of total assets. The recent decline in interest rates on government securities has made this option less attractive to banks, and, this, coupled with stronger growth, has resulted in a modest increase in private sector credit in the past year. Nonetheless, there is considerable scope to increase access to finance and foster long-term financing opportunities for the private sector to make investments, create jobs, and contribute to inclusive and sustainable economic growth.

31. **The Government has shown strong commitment to pursuing a reform agenda which strengthens both the soundness and development of the financial sector.** Analytical work by the WB and the IMF has confirmed that weaknesses in financial sector infrastructure and in the legal and judicial framework have discouraged lending to the private sector. The supply of credit has been depressed by the absence of an appropriate insolvency framework, deficiencies in credit information, the lack of a secured transactions framework and electronic collateral registry for moveable collateral, and the inability to enforce collateral outside of the slow and unpredictable judicial system. Recent measures taken to address these issues include amendments to the Financial Institutions (Recovery of Finance) Ordinance 2001 to improve the recovery of NPLs without court intervention, enactment of a new legal framework for secured transactions, passage of a strengthened Securities and Exchange Commission of Pakistan Act, and enhancements to the Credit Bureau Act. Several of these pieces of legislation had been pending for years. The Development Policy operations over the past three years have served as a catalyst in implementing these reforms; almost all of the financial sector legislative reforms implemented over the last 2-3 years have been supported by these operations. These reforms have strengthened the credit environment, but further efforts are needed to enhance the infrastructure and the policy, legal and regulatory framework for financial intermediation.

32. **The Government faces significant challenges in delivering its reform agenda.** While Pakistan's federal and provincial governments are pursuing an ambitious investment mobilization agenda, their ability

to implement necessary and technically sound reforms is hampered by a challenging political and security environment. Reform momentum in some areas such as privatization has been difficult to maintain, however, the Government has generally maintained focus on its economic reform program. Many of the reforms are medium-term in nature and full results will materialize in the medium-term, and only after a sustained effort. Some of the reforms on fiscal management, trade and business environment will be supported through the next Growth DPC.

## 4. THE PROPOSED OPERATION

### 4.1 Link to Government Program and Operation Description

33. **The proposed operation supports an agenda that builds on recent reform efforts supported by development policy lending and also complements other financial sector engagements.** The earlier FSIG DPC series supported a number of critical institutional and regulatory reforms structured around two main pillars: i) fostering private and financial sector development; and ii) mobilizing revenue and focusing on pro-poor spending. The CGDPF continued supporting reforms to improve the business environment and enhance fiscal management. A number of key financial sector reforms have been prior actions under the FSIG DPC or the CGDPC.<sup>17</sup> The WB will continue to support the broader growth agenda through another DPC operation to go to the Board in FY18, while in parallel focusing efforts on the financial sector in this operation. The proposed operation directly complements the FIIP project and takes forward earlier knowledge engagements under NFIS, FSAP and technical assistance for insurance.

34. **The preparation of this DPC benefited from the experience gained and lessons from the implementation of the earlier FSIG DPC series and CGDPC, which were generally more successful than earlier policy reform operations.** The Implementation Status and Results Reports (ISRs) and the draft Implementation Completion Report ((ICR) for the FSIG DPC series categorically state that the sequencing of reforms, both across DPCs and with other development partners (mainly the IMF's EFF program), put correct focus on stabilization at the outset, without which the feasibility and impact of other aspects of the reform agenda would have been limited. These operations provide valuable country-specific lessons, which have informed the design and preparation of this operation, notably:

- i. There is a need to understand the steps required to implement reforms and act when implementation is sufficiently advanced to achieve the desired results. In this case, the proposed reform agenda is well advanced and can realistically be expected to reach fruition within the projected timeline;
- ii. To minimize the potential risk of reform reversals, laws that were included as prior actions under the earlier DPCs had undergone an extensive stakeholder consultation process, along with awareness building for the relevant approval authorities; and
- iii. Complementary technical assistance to support implementation of development policy operations tends to result in more successful operations. Implementation of many of the prior actions included in this DPC is being supported by technical assistance or investment projects provided by the WB and other development partners, including the IMF, Gates Foundation, DFID, and US Aid. Experience suggests that ongoing projects also contributed to an improved supervision and monitoring by the WB.

### 4.2. Prior Actions, Results and Analytical Underpinnings

35. All three pillars of the program are critical to create a dynamic financial sector, which can contribute to sustained and inclusive economic growth including by supporting and creating better enabling conditions

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<sup>17</sup> The prior actions included: The Financial Institutions Recovery Ordinance (FIRO) 2016, the Securities and Exchange Commission of Pakistan (Amendment) Act 2016, the Secured Transactions Act, 2016 and the Credit Bureau Amendment Act 2016).

for investment operations that are being considered to enhance financial sector growth and intermediation in Pakistan. The operation focuses on reforms that will remove several key constraints to growth related to the financial sector's role in effectively intermediating resources for investment and private sector development and support a more enabling framework for financial intermediation. The reforms are based on solid analytical work (see Annex 5), which includes: the NFIS (and its 8 Technical Notes), technical assistance work on national risk assessment and on the insurance sector, as well as the recently concluded FSAP Development Module. The FSAP Development Module included four Technical Notes, namely; Islamic Finance, Financial Sector Intermediation of Sources and Uses of Funds, Debt Capital Markets and Infrastructure Finance.

#### **4.2.1. Pillar 1: Improving Access to Finance and Enhancing Financial Inclusion**

36. **Low access to both credit and other financial services have dampened economic growth and contributed to inequality in Pakistan.** Pakistan ranked 144 out of 190 economies on the overall ease of doing business rankings in 2017, having slipped in the rankings in the last five years across all indicators. Getting credit is one of the areas in which Pakistan is doing particularly poorly and which directly impacts private sector investment. Pakistan also fares badly with respect to financial inclusion.<sup>18</sup> And credit to the private sector, at just 15.3 percent of GDP, is less than half the average of lower-middle income countries (33 percent) clear evidence of the very low level of financial intermediation in the country.<sup>19</sup> Prior actions 1-6 above are intended to promote a more diverse and inclusive financial sector and improve access to credit, which is needed to support private sector-led growth.

***Prior Action 1: The NFIS Council has approved the Digital Transaction Accounts (DTA) Scheme***

37. **Sustained efforts to promote financial inclusion in Pakistan have yielded mixed results.** On one hand, the microfinance sector and branchless banking landscape has grown rapidly in the past decade led by the Pakistan Poverty Alleviation Fund (PPAF) and the SBP. On the other hand, financial access for underserved groups remains persistently low. Only 4.8 percent of women are included in the formal financial sector compared to the South Asian average of 37.4 percent.<sup>20</sup>

38. **However, while financial inclusion remains low, Pakistan has been leading the way in South Asia when it comes to digital finance and branchless banking.** A proactive regulator (SBP), a relatively vibrant private sector, and widespread computerized national identity cards have all contributed to significant growth in digital transaction accounts in Pakistan. As a result, Pakistan has the highest penetration of mobile accounts in South Asia at 5.8 percent of the adult population, compared to the South Asian average of 1.9 percent. Moreover, the gap between male and female mobile accounts is 7.1 percent, which is much narrower than the gap for overall accounts (16.1 percent). Mobile accounts are showing promising signs of addressing the gender gap more effectively than traditional accounts.

39. **Building on this enabling environment and promising growth, the NFIS formalizes the vision to develop DTAs.**<sup>21</sup> DTAs are expected to contribute significantly to an increase in usage of financial services by improving access to accounts through efficient and convenient account opening, particularly in rural areas; and developing a wide acceptance network infrastructure. In addition, DTA's can contribute to the

<sup>18</sup> World Bank Global Financial Inclusion Database (Global Findex 2014)

<sup>19</sup> Finstats 2015

<sup>20</sup> World Bank Global Financial Inclusion Database (Global Findex 2014).

<sup>21</sup> Note that the prior action is being complemented by two interventions which are supporting the implementation of the DTA Scheme once launched. The Financial Inclusion Support Framework Trust Fund, which is an ongoing 3-year \$3 million engagement, is providing design, analytical and advisory support. The Financial Inclusion Infrastructure Project which is a \$130million IPF, aims to support investments to implement the DTA Scheme in the area of payments systems infrastructure, awareness campaigns, product development, and TA/financing support for SMEs.

development of the payment acceptance network through agents that facilitate cash-based services and leverage investments in non-branch infrastructure, such as automated teller machines (ATMs) and points-of-sale (POS), operating on interconnected electronic payment networks. The DTA scheme focuses on the following specific elements: (i) Common brand for customer recognition; (ii) Unified platform for account acquisition and improved user experience, (iii) Creation of industry wide shared call center/helpdesk for customer facilitation, redressal and awareness/guidance, (iv) Open loop architecture for increasing synergies among branchless banking providers, (v) Agent level interoperability, (vi) Easy process and direct support for increase in merchant acquisition for digital payments, (vii) Merchant activation, training, recurring costs, signage and branding, (viii) Innovative products & services to enhance usage, (ix) Development of innovative businesses and products to increase access to financial inclusion, (x) Unified mass media and financial literacy campaign for customer awareness of products.

40. **The DTA scheme and its implementation have significant potential to increase women’s access to finance in Pakistan.** The DTA scheme specifically contains the following elements that are expected to provide the impetus for increasing women’s access to finance: (i) awareness and literacy campaigns about access points and products for women; and (ii) more convenient affordable and interoperable access to finance, which can address some of the more conventional social and mobility constraints. In addition, complementary technical assistance and investment projects are providing support for more gender disaggregated data and interventions, such as increasing women accounts, developing tailored products, and supporting women entrepreneurs.

41. **Results to be achieved with implementation of Prior Action:** The proposed program aims to contribute to the rapid expansion of DTAs to achieve Pakistan’s ambitious NFIS 2020 targets of 50 percent of the population having access to accounts (from 13 percent in 2015), with women’s access increasing to 25 percent (from 5 percent).<sup>22</sup> The FGDP aims to serve as a catalyst for launching a unified DTA scheme, which is expected to contribute significantly to developing an affordable, accessible, inter-operable, and technology-led platform for individuals to access and use a range of financial services including payments, savings, insurance and credit. To contribute towards achieving this, the National Financial Inclusion Council will guide the sector towards the development of an industry-wide scheme for promotion of DTAs. The scheme would involve the design of a common platform managed through a series of shared rules and supported by a unified brand, all defined by the growing national digital finance industry. Through collaboration on these three aspects as part of a cohesive scheme, the branchless banking industry will develop an expanded environment for the delivery of digital financial services, leading to higher adoption of DTAs, higher use of financial services, and greater levels of financial inclusion. The prior action specifically aims to increase the total number of accounts in the country by 5 million disaggregated by gender by FY18 and expected to contribute to the NFIS 2020 targets once the DTA Scheme’s implementation gains momentum.

**Prior Action 2:** *The SBP has granted clearinghouse membership of the National Institutional Facilitation Technologies (NIFT) to the Central Directorate of National Savings (CDNS) to allow for distribution of NSS profits through bank accounts.*

42. **The National Savings Schemes (NSS) of Pakistan represent important savings vehicles for individuals and a major source of funding for government.** NSS instruments are administered by CDNS, which was established in 1960 as a department of the Ministry of Finance and is governed by the Government Savings Act 1873 and the Public Debt Act 1944. The CDNS has a twofold mandate: 1) to provide budgetary support to the GoP; and 2) to be the preferred institution for small savers to facilitate financial

<sup>22</sup> World Bank Global Financial Inclusion Database (Global Findex 2014).

inclusion. It has a network of 374 National Savings Centers across Pakistan. NSS deposits are equal to 30 percent of total banking deposits and account for 24 percent of the GoP's domestic debt. CDNS's vast retail network, limited Know Your Client (KYC) requirements and government guarantee make NSS a preferred savings option for many retail investors to support financial inclusion and provide the necessary social security net.

43. **There is a need to bring greater formality and automation in the CDNS product offerings to ensure they are better integrated into the formal banking system and provide better service access and efficiency to its 7 million customers.** This would also lead to greater financial inclusion of retail savers. NSS transactions are partially automated and are based on a cash-based accounting system. The purchase, retirement and interest collection of each savings certificate is largely in cash, and each transaction must be made in person at a CDNS outlet. With limited automation of its records, NSS has fragmented knowledge of its customer base. Given its large outstanding savings accumulation – around PKR 3.2 trillion (US\$30.2 billion), or 32 percent of all banking system deposits – banks and mutual funds see NSS as a direct competitor. National savings in Pakistan stand at 13 percent of GDP, and NSS is 10 percent of GDP; this suggests that NSS represents the lion's share of Pakistan's overall savings. At the same time, NSS has softer account holding requirements and does not subject its savers to the more stringent KYC requirements that are applicable to bank and mutual fund clients.

44. **The proposed FGDP aims to support digitization of the NSS through stronger linkages with the banking system.** As a first step, the prior action requires that a mechanism is put in place to allow for NSS profit distributions of savers to be made electronically into banking system accounts. Through subsequent investments in up-gradation of internal systems, the next step would be to move all NSS functions to electronic platforms linked to digital transaction accounts. This will provide an opportunity to bring many currently unbanked NSS savers into the formal banking system and give them access to a broader range of financial services. In addition, as a result of this mechanism, the timeframe for processing the purchase of NSS through cheques and the payment of profits through bank accounts will be reduced from 7 and 15 working days respectively, to one working day for both transactions.

45. **Results to be achieved with implementation of Prior Action:** The successful implementation will represent a significant milestone towards achieving broader financial inclusion as outlined in Pakistan's NFIS. It is expected to result in distribution of profits through bank accounts to 5 percent of the 7 million NSS clients by FY18. The prior action is also expected to increase formal savings.

**Prior Action 3:** *The National Assembly has approved the new Companies Bill to modernize the regulatory framework for companies*

46. **There has been a need for some time to modernize the regulatory framework for companies in Pakistan.** The law governing the creation and operation of companies is a cornerstone of any commercial system. It governs the formation and registration of different types of companies, body corporates, deals with the company registrar, public access to the registry, capital requirements, corporate governance, and accounting and auditing requirements. Pakistan's Companies Act 1913 was adopted as the company law of the country, and was subsequently replaced by the Companies Ordinance in October 1984. The evolving economic and social landscape of Pakistan has resulted in multiple amendments to the law (in 1991, 1999, 2002, 2007 and 2008). The amendments have been piecemeal and have resulted in layers of subsidiary legislation. There have been efforts underway to consolidate the law since 2005, when the Corporate Law Review Commission was constituted by the SECP to review and update the current law. A new draft law--the Companies Bill has been prepared after extensive stakeholder consultation and is ready for the parliamentary approval process. The new bill is designed to foster a more transparent and efficient corporate

sector. The Government is also planning to complement this legislation with a new Corporate Rehabilitation (CRA) Bill to improve the process of corporate rehabilitation and recovery. The draft CRA Bill has already undergone an extensive consultative process and will be presented for Parliamentary approval in the coming months.

47. **Results to be achieved with implementation of Prior Action:** Pakistan is working towards sustained economic growth, and the private sector has a key role to play in this. The new Companies Bill revamps the governance structure of companies, enhances reporting, and streamlines company procedures, encourages electronic filing and more efficient use of technology, thus potentially increasing corporate efficiencies. Companies, which are operating with enhanced corporate governance and transparency are also better positioned to access credit. It will also positively impact the Starting a Business indicator for Doing Business and support the GoP's efforts to improve the investment climate. The streamlined processes and procedures are expected to increase the number of registered companies by 6 percent by FY18.

**Prior Action 4:** *The Deposit Protection Corporation Act 2016 has been approved by Parliament.*

48. **Deposit insurance promotes financial sector stability, fosters consumer confidence in the banking system and facilitates consumer protection.** The GoP had been considering establishing a Deposit Protection Scheme for several years, the IMF has also been urging the Government to set up a Deposit Protection Fund. While the banking sector's stability and solvency is currently sound with CAR at 17 percent, and the lack of explicit deposit protection complicates the resolution of troubled institutions. At a time when the SBP is implementing the NFIS to foster greater inclusion in the formal financial sector, new retail customers will be more comfortable with deposit protection in place. Additionally, deposit protection creates a level playing field in the banking sector and can increase competition. Larger banks, due to their size ("too-big to fail"), track record and brand visibility have an edge over smaller banks in attracting customer deposits. A deposit protection mechanism protects depositors in smaller banks, hence neutralizing the size bias.

49. **The Deposit Protection Corporation Bill was enacted in August 2016<sup>23</sup>.** The GoP and SBP are in the final stages of establishing and operationalizing the Deposit Protection Corporation which will manage the deposit protection scheme and its fund. After the commencement of business the Corporation will determine initial coverage limit, type of depositors to be covered, rates and basis of premium. The Deposit Protection Corporation will be a subsidiary of SBP, with its own governance structure. In the meantime, the SBP has initiated preparatory work to establish the corporate infrastructure of the corporation, supported by IMF technical assistance (TA). Microfinance Banks can be covered by the Deposit Protection Corporation subject to amendments in the relevant legislation.

50. **Results to be achieved with implementation of Prior Action:** A depositor protection scheme, in the absence of bank failures, over time would result in a more stable and inclusive banking sector. Deposit protection will increase confidence in the banking system thereby leading to an expected increase in the deposit base by 15 percent, and will foster greater financial inclusion. The DPC set up under the Act will be particularly beneficial to small depositors in saving them from losses in case of financial institution's failure.

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<sup>23</sup> Pakistan is aggressively pursuing a National Financial Inclusion Strategy, which is aimed at significantly increasing the banked population. These efforts, targeted largely at low-income Pakistanis, should result in an increase in the percentage of depositors covered over time. The guaranteed cap of PKR 100,000 is not in the law, but is determined from time to time by the Deposit Protection Corporation. The Corporation has used a variety of criteria in determining the initial coverage cap, with a focus on the current and evolving structure of bank deposits. It also endeavors to follow IADI Core Principles for Effective Deposit Insurance Systems

#### 4.2.2. Pillar 2: Fostering Long-term Finance

51. **In order to sustain economic growth, Pakistan needs to significantly ramp up investment in infrastructure, to a level estimated at over USD 30 billion (10 percent of GDP) annually.** According to the World Economic Forum, Pakistan ranks 117 out of 140 countries in infrastructure competitiveness. Lack of investment, along with poor maintenance, have undermined economic growth and the population's welfare. During the last decade, gross fixed capital formation in energy, transport and communications has fallen from 4.3 percent of GDP in 2005-06 to only 2.2 percent of GDP in 2014-15. During the same period, infrastructure project finance volumes have averaged just US\$ 300 million annually or 0.1 percent of GDP. This compares very unfavorably with peers such as Indonesia (1.5 percent) and Malaysia (3.5 percent)<sup>24</sup>. The proposed operation will assist the GOP in taking a more holistic approach towards creating an enabling environment for long term finance and the regulatory framework will effectively take into account the risks in long term financing.

**Prior Action 5:** *The Economic Coordination Committee (ECC) has approved a National Policy on Infrastructure Finance.*

52. **Formulating a National Policy on Infrastructure Finance will help to better harness Pakistan's funding sources for infrastructure and to align them with the infrastructure needs of the country.** The Policy focuses on building synergies between local sources of funds (GoP budget allocations, banks, Islamic deposits, cash held by SOEs and capital markets) and potential international sources (i.e. FDI and donor assistance). The CPEC Agreement anticipates a large pipeline of projects and investments in infrastructure (energy, highways, railways, fiber optics etc.); China has committed to invest US\$ 45.6 billion under the agreement. Through this prior action the GoP will develop a strategic and holistic approach to tackle its growing infrastructure finance needs. The Policy is expected to generate momentum for other actions that can spur the development of the infrastructure financing market, critically needed for Pakistan if it is to address its crippling infrastructure deficit, without which achieving inclusive growth will be difficult. It will also ensure that environmental considerations are taken into account as this area of investment grows. This Policy has been devised after an extensive consultative process and is both timely and relevant given the GoP's commitment to infrastructure development. The GoP is also establishing the Pakistan Development Fund (PDF) to serve as a catalyst to promote infrastructure investment in the economy.

**Prior Action 6:** *The SBP has issued Prudential Regulations for long-term finance (in line with Basel III requirements)*

53. **There is a need for SBP to further develop data, guidelines and regulations for long-term lending.** The SBP issued Guidelines for Infrastructure Project Finance in 2010, but little has been done in the long-term and infrastructure finance space since then. The SBP should now focus on the development aspects of long-term finance along with addressing stability considerations as long-term finance expands in Pakistan. This should include publication of more detailed data on long-term sources and uses of funds in the banking system (e.g. distinguishing medium-term and long-term advances/deposits), and closer monitoring of maturity transformation indicators such as a Net Stable Funding Ratio consistent with Basel III guidelines. Pakistan's banking deposits are dominated by short term investments and thus longer-term lending portfolios will invariably lead to liquidity mismatches which can adversely impact financial stability going forward. Long-term lending portfolios will bring a new array of risks and it is imperative that there are regulations in place to effectively mitigate these risks. Infrastructure finance/investments involve complex risk analysis, risk allocation and risk mitigation due to the highly idiosyncratic and illiquid nature of the

<sup>24</sup> Infrastructure Investment, Private Finance, and Institutional Investors: Asia from a Global Perspective. ADB Working Paper Series No. 555, January 2016.

investments. Prudential regulations in this space must be designed to ensure that risks are better understood and monitored throughout the life-cycle of the projects/investments. In addition, in light of the large-scale infrastructure projects and energy initiatives in the pipeline for Pakistan, there is a need to develop guidelines for environment and social risk safeguards for financial institutions providing infrastructure finance.

54. **The new prudential regulations for long-term finance are focused on infrastructure project finance.** Project finance is seen as the key building block for building infrastructure and long-term finance in Pakistan. The regulations provide guidance on liquidity mismatch reporting, credit appraisal and collateral arrangements etc. – this guidance, complemented by a changing economic landscape, will create more appetite for banks to lend in this space and thus contribute to greater long-term lending. At present, there is very little guidance in this space, and as such, banks have been hesitant to engage in longer term lending. The new guidance under the Regulations will spur banks to increase lending tenors. The Regulations will also lead to greater data on the loan maturities through publication of statistics on long-term finance in the banking sector, including long-term loans. The regulations will promote a better adherence to environmental safety standards in the long-term, which is crucial for the sustainability of infrastructure finance initiatives.

55. **Results to be achieved with implementation of Prior Actions 5 and 6:** Both the National Policy on Infrastructure Finance and the SBP Prudential Regulations on Long Term Finance are expected to contribute to an increase in the supply of long-term loans. The sector will have an enhanced understanding of the framework laid down by the government and of the risks of long-term lending.

#### 4.2.3. Pillar 3: Enhancing transparency of the financial sector:

56. **Enhanced transparency and resultant market integrity will provide the foundation for financial sector development and effective market discipline.** The disclosure, governance and integrity practices in the financial and non-financial sectors should be seen in the broader context of public sector governance. Unsound practices can destabilize and undermine confidence in the financial system. Insufficient attention to market integrity anti-money laundering/counter financing of terrorism (AML/CFT) opens the financial system to abuse by criminal elements, and can result in costly international sanctions. While progress has been made in strengthening the corporate governance, disclosure and AML/CFT practices of regulated financial institutions in Pakistan in recent years, there remain some gaps to be addressed, such as in the insurance sector in which dominant state-owned insurers have weak governance, enjoy statutory monopoly powers (in case of National Insurance Company Limited and Pakistan Reinsurance Company Limited) and the sector remains underdeveloped. The prior actions outlined below, which constitute the third pillar of the FGDP, address some of the remaining gaps.

**Prior Action 7: The Benami Transactions Prohibition Bill has been approved by Parliament**

57. **The widespread practice of “benami” transactions to buy and hold property in Pakistan facilitates tax avoidance and money laundering.** A benami transaction is an arrangement whereby: (a) property is held by a person (other than in fiduciary capacity) on behalf of another person who has paid for it; or (b) the transaction is made for a property in a fictitious name; or (c) the owner of the property is not aware of or denies knowledge of such ownership. A "benamidar" is a person or fictitious person in whose name the property is held or transferred. Practices like “benami” transactions are detrimental to the government’s

efforts to increase tax revenues and also have money laundering implications. The informal economy of Pakistan is estimated within a wide range of 30-60 percent of formal GDP.<sup>25</sup>

58. **The Benami Transactions Prohibition Bill has been approved by Parliament.** The Bill has been framed to consolidate and amend the law relating to "benami" transactions, prohibit holding property in benami and restricting the right to recover or transfer property held "benami". The draft law also provides a mechanism and procedure for changing the legal status of property held in benami. Under this new legislation, once enacted, no one will be able to buy property in someone else's name. The Bill restricts the right of any person who is claiming to be the real owner to recover such property. In addition, no person will be able to re-transfer such property to the beneficial owner. Under the new legislation, all benami properties will be confiscated by the Federal Government. The Bill lays out a robust mechanism for confiscation of benami property. An Adjudicating Authority will be set-up and will work with the Department of Inland Revenue to identify properties held in benami. The onus for proving that they are in fact the rightful owner of the property will fall on the "benamidar"; this will entail proving source of funds etc. If it is determined that the property is in fact held in benami, the Adjudicating Authority will issue a confiscation notice for the property. The law also calls for criminal charges to be pressed against the 'benamidar' and the beneficial owner, with jail times of up to seven years.

59. **Results to be achieved with implementation of Prior Action:** Implementation of the Bill will lead to the appointment and operationalization of the Adjudicating Authority, which will act as a strong deterrent to holding property in benami. This in turn will reduce tax evasion and money laundering, and result in a more transparent property market. The GoP has been making strong efforts to increase the tax revenue and to widen the tax net. The abolishment of benami transactions will assist these efforts and should lead to an increase in the tax to GDP ratio. Greater transparency in property ownership will also create a better enabling environment for the development of the housing market, which is a key area of focus for the GoP; and where the WB is developing a Housing Finance Project to spur reform and growth.

**Prior action 8:** *The Ministry of Finance has completed the National Risk Assessment (NRA) for Anti-Money Laundering and Combatting Financing of terrorism (AML/CFT).*

60. **The GoP has been seeking to strengthen the AML/CFT regime of the country.** This keen interest in realigning Pakistan's AML/CFT regime with international standards stems from sustained efforts to curb money laundering (ML) and terrorist financing (FT) in Pakistan. The Financial Action Task Force (FATF) had identified certain weaknesses in the AML/CFT framework, which has led to stepped-up efforts by the GoP to establish risk mitigating strategies. It is expected that the on-going implementation of the AML Act (AMLA) 2010 will strengthen Pakistan's efforts towards compliance with international standards. The AMLA's key features include legal provisions for criminalization of ML offences, confiscation of proceeds of crime, role of the law enforcement agencies and cooperation with international agencies. Conducting a National Risk Assessment (NRA) supports risk-based approaches for the country's AML regime.

61. **In order to identify the key risks and develop a risk based supervision regime for AML/CFT, the FATF recommends that countries self-identify, assess and understand their AML/CFT risks and develop mitigation procedures, as required.** Pakistan initiated its NRA in April 2015. The NRA process consists of three phases: 1) Preparation 2) Assessment 3) Conclusion. Given the GoP's commitment to implement the National Financial Inclusion Strategy and its aggressive account opening targets, it is essential that the NRA is completed in a timely manner to ensure that AML/CFT risks are not augmented in an aggressive account

<sup>25</sup> Kemal, M. Ali and Ahmed Waqar Qasim. 2012. Precise Estimates of the Informal Economy. Pakistan Institute of Development Economics; Arby, Muhammad Farooq, Muhammad Jahanzeb Malik and Muhammad Nadim Hanif. 2010. The Size of Informal Economy in Pakistan. State Bank of Pakistan Working Paper Series No. 33.

opening era. The NRA exercise is a very robust risk assessment exercise which charts out the vast risk universe in the AML space, it involves identification and assessment of the threats and vulnerabilities related to money laundering and terrorist financing. The exercise also entails the development of an implementable and time bound action plan with roles and responsibilities assigned to mitigate these risks. The implementation of the action plan and other areas identified in the NRA report are critical when it comes to ensuring the integrity of financial sector and the country's status in FATF. The NRA exercise will help the authorities prepare well in advance of the Mutual Risk Assessment scheduled for 2019.

62. **Results to be achieved with implementation of Prior Action:** Completion of the NRA will help Pakistan to achieve compliance with FATF Recommendation-1, as revised in February 2012. It will also allow Pakistan to better target and mitigate money laundering and terrorist financing risks in the country. The NRA will help Pakistan implement streamlined due diligence procedures to facilitate account openings for small digital transaction accounts for low-income Pakistanis, thereby fostering a better enabling environment for international transaction banking. The prior action is also expected to contribute to strengthening the legal and regulatory framework for AML/CFT based on NRA findings, and improve the reporting and investigative capacity of law enforcement agencies for AML/CFT. Additionally, the NRA will highlight what the key risks are in this space, and will thus assist authorities to strengthen the risk based framework for AML supervision.

**Prior Action 9:** *The Cabinet has approved the rules for a new registered prize bonds scheme with denomination of PKR 40,000 and above*

63. **Prize bonds are open-ended bearer certificates with an outstanding value of PKR 646 billion (US\$ 6.20 billion), almost 20 percent of currency in circulation.** These opaque instruments are used to tap long-term retail savings by the GoP but are often used as a medium of exchange (i.e. currency substitute). The unregistered nature of the bonds has significant tax avoidance and money laundering implications. The prize bond instruments are administered by the Central Directorate for National Savings (CDNS) while policy making responsibility rests with the Ministry of Finance. CDNS prepared Rules for registered prize bonds and after seeking comments from the SBP, the Rules were vetted by the Ministry of Law and Justice and thereafter approved by the Cabinet.

64. **The proposed program aims to formalize large denomination prize bonds to ensure greater transparency.** The prior action aims to support registration of prize bonds of denominations of PKR 40,000, this denomination of bonds already exists as unregistered bonds, but the GoP will also introduce new registered bonds of the same denomination. In addition, new PKR 100,000 (US\$961) prize bonds will also be introduced, this will only be issued as registered bonds. This will serve to align a very significant financial instrument with other saving and investment instruments in the financial sector. Registered high denomination prize bonds are expected to restrict the ability of individuals to transact in undocumented cash (or bearer instrument) markets. Moreover, registered prize bonds would be subject to similar know-your client (KYC) requirements as products offered by regulated financial intermediaries, thus promoting greater transparency and integrity, leveling the playing field and allowing market-led growth of savings and investment in the formal financial sector.

65. **Results to be achieved with implementation of Prior Action:** Successful implementation will contribute to greater formalization of the economy by reducing the use of cash or cash-equivalent bearer instruments. The prior action is expected to lead to a 2 percent increase in the percentage share of registered prize bonds in the total value of prize bonds by FY18. It will also contribute to Pakistan's efforts to combat money laundering and tax evasion.

**Prior Action 10:** *The Ministry of Commerce has endorsed the Corporate Governance Assessment for SLIC to monitor compliance with the Public Sector Companies (Corporate Governance) Rules 2013.*

66. **The FGDPC will support governance reforms of state-owned insurers, which are dominant players in the market.** There are three formal state-owned insurance enterprises, (i) State Life Insurance Corporation (SLIC), (ii) National Insurance Company Limited (NICL), and (iii) Pakistan Reinsurance Company Limited (PRCL).<sup>26</sup> SLIC is the life insurer which caters to almost 50 percent of the life insurance market. NICL is the non-life public insurer with about 10 percent market share in the non-life segment, but has a statutory monopoly insuring all public property and risks or liabilities pertaining to public property. PRCL is the only reinsurance company in Pakistan, and also has statutory protection in that all non-life insurers are mandated to place 35 percent of their surplus business with PRCL.

67. **There is a need for improved corporate governance of these state-owned insurance institutions, particularly in light of their dominance in the market.** SLIC is undergoing corporatization to be converted into a company, while NICL and PRCL are companies which are required to comply with the Public Sector Companies (Corporate Governance) Rules 2013 and SECP Code of Corporate Governance for Insurers 2016. However, all three institutions have operated without a full-time chairperson or a full Board of Directors for extended durations in recent years. The current program proposes that a detailed Corporate Governance Assessment is done for SLIC to fully analyze compliance with corporate governance requirements. The Ministry of Commerce engaged the IFC to undertake the assessment and endorsed the executive summary. The assessments for NICL and PRCL are being considered. Following these assessments, requisite statements of compliance can be issued and remedial measures can be undertaken to address gaps. The prior action reaffirms the Government's commitment to continue the reform process for the state-owned insurance sector following the corporatization process of SLIC in 2016.<sup>27</sup> Separately, the WB remains engaged with the Government through technical assistance on: (i) broader state-owned enterprise reforms on corporate governance and transparency; and (ii) to modernize the legal and supervisory framework of the insurance sector to enable and foster growth in the sector

68. **Results to be achieved with implementation of Prior Action:** Corporate Governance Assessments are expected to provide a detailed and structured analysis of corporate governance within the state-owned insurance institutions. Such analysis is currently limited only to board existence and composition, and does not extend to a comparative assessment with respect to international best practices, or to Public Sector Companies (Corporate Governance) Rules 2013 and SECP Code of Corporate Governance for Insurers 2016. The full assessment will form the basis for actionable policy or administrative measures focused on specific gaps that are highlighted. For instance, the Chairman and Chief Executive Officer (CEO) will be hired as per the fit and proper criteria. This measure will lead to better governance and improved efficiency at SLIC. Addressing this and other gaps is an important and foundational step towards building a stronger insurance sector which can enhance the coverage of insurance products to Pakistan's vulnerable households and firms (premium to GDP ratio is a miniscule 0.5 percent).

#### **4.3. Link to Country Partnership Strategy, Other Bank Operations and the WBG Strategy**

69. **The FGDPC directly supports key pillars of the FY 15-19 Country Partnership Strategy (report 84645-PK, April 4, 2014). Improved access to finance and an improved business environment have been identified as key constraints to growth in Pakistan.** The program development objective — to support Government of Pakistan efforts in promoting an inclusive and transparent financial sector that is able to better intermediate resources for long term finance — contributes both directly and indirectly to two pillars

<sup>26</sup> Additionally, Pakistan Post Office runs a Postal Life Insurance department which provides life insurance policies.

<sup>27</sup> Note that SLIC represents about 50 percent of the life insurance sector and is the largest institutional investor in Pakistan.

of the CPS (private sector development and inclusion). The operation also contributes directly to WBG's twin goals: greater financial inclusion can bring the poor and vulnerable into the financial mainstream, with positive effects on reducing poverty, while removing the obstacles to private sector credit and growth contributes to promoting shared prosperity in a sustainable manner.

70. **There are several WB operations which complement the FGDPC.** The WB was instrumental in developing Pakistan's NFIS, and it is supporting implementation of the strategy through the Financial Inclusion Support Framework, a WBG-led multi-donor initiative to support countries that are implementing national financial inclusion strategies. There is also an investment operation under preparation, the FIIP, which will provide further support to promote financial inclusion through, inter-alia, on-lending to micro-finance providers, providing risk-sharing facilities and technical assistance to lenders to SMEs, and supporting the development of payment systems and the establishment of a collateral registry. The proposed FGDPC complements the Pakistan Social Safety Net and Pakistan National Social Protection projects which are supporting social safety transfers to over 5.3 million poor women, and the Public Financial Management and Accountability for Service Delivery project which is increasing efficiency and transparency of the overall Government-to-Person payment stream. The WB has undertaken significant financial sector analytical work in the past two years, including a diagnostic of consumer financial protection, an FSAP Development module, and technical assistance on credit information and investor education. It is currently discussing an umbrella Reimbursable Advisory Service (RAS) on Risk-Based Supervision and Enterprise Risk Management with the State Bank of Pakistan as well as continuing technical support on credit infrastructure, including secured transactions framework. IFC has several investments and advisory mandates with financial institutions in Pakistan, focused on SME finance and is also exploring the infrastructure finance space.

#### 4.4. Consultations and Collaboration with Development Partners

71. **Consultations:** This operation supports the implementation of the Government's NFIS, which benefitted from broad-based consultations with stakeholders in the public and private sectors. It also supports reforms that are included in the Government's broader economic reform program, which has benefitted from extensive consultations. Additional consultations were conducted during project preparation with regulators, parliamentarians, financial institutions, donors, and professional associations.

72. **Collaboration with development partners.** The WB's development policy operations have been complementary to the recently completed IMF Extended Fund Facility (EFF) structural agenda, including on financial sector reforms. Two earlier FSAPs, which provided some of the analytical underpinnings to the current financial sector reform agenda were jointly conducted by the WB and IMF. The program is also informed by the FSAP Development Module recently completed by the WB. In addition, the NFIS developed through WB and the Consultative Group to Assist the Poor (CGAP) support provides the analytical underpinning to the overall financial inclusion reform agenda in Pakistan. The WB has also developed a close collaboration with DFID on financial sector issues. DFID is financing technical assistance and investment to SBP through the Financial Inclusion Program (FIP), and the WB is complementing this support through the Financial Inclusion Support Framework (FISF) technical assistance and the proposed FIIP in FY17 to support NFIS implementation. Additionally, the GoP has sought the WBG's assistance in developing the Housing Finance market in Pakistan. The WB is also collaborating closely with both DFID and the Gates foundation on DTAs, and the National Payments Systems Strategy and with USAID on promoting SME finance.

## 5. OTHER DESIGN AND APPRAISAL ISSUES

### 5.1 Poverty and Social Impact

73. **The proposed operation supports sustained poverty reduction and shared prosperity through greater access and transparency of the financial sector.** Greater financial inclusion can bring the poor and vulnerable people into the financial mainstream, with positive effects on economic growth, financial stability and social cohesion. Access to credit allows the poor to smooth their consumption in response to income shocks; deposit accounts offer a secure mechanism for the poor to make longer-term investments; and general access to banks eases financial transactions that enable economic activities and lower costs of remittances and transfers, on which many of the poor are dependent. Both theoretical and empirical studies<sup>28</sup> have shown that financial exclusion inhibits human and physical capital accumulation, contributing to persistent income inequality and poverty.

74. **Access to financial services is particularly low among the poor in Pakistan.** The unbanked predominantly include: (i) women – only 4.8 percent included in the formal financial sector, compared to the South Asian average of 37.4 percent; (ii) rural households; and (iii) MSMEs. Among the poor households, which accounted for 23.5 percent of all households in 2013-14, only 4.2 percent have deposits, compared with 12.1 percent among the non-poor. Of the few poor households who reported receiving remittances in the same year, only 34.6 percent received them through bank or mobile banking while this share is close to 75 percent for the non-poor.<sup>29</sup> Remoteness and lack of financial products appropriate for the poor may contribute to this extremely low financial access. In 2014-15, almost 36 percent of the bottom 40 never used a bank facility, of which 19 percent cited the reason that the bank is too far away.<sup>30</sup>

75. **Building inclusive and transparent financial systems offer several welfare effects.** These include increased access to financial services, lower costs, including through new technology; proportionate regulatory framework that balances financial inclusion, integrity and stability; and focus on consumer protection and empowerment. In particular, prior actions related to inclusion have an implicit focus on poverty and social impacts. The launch and implementation of the DTA scheme aims to increase the currently very low levels of financial access in the country by fostering tailored, responsible, and affordable financial products made available through convenient access points. Similarly, the NSS has an outreach of 7 million account holders through over 375 branches, and holds about 32 percent of banking systems deposits. Creating a more convenient option to purchase NSS instruments and receive NSS profits through bank accounts enables easier financial access and promotes integration of the NSS into the formal financial sector. Even the actions on transparency not merely contribute towards strengthening governance and performance of financial markets, but can also support efforts to enhance financial intermediation and deepen access at reasonable costs – for instance the NRA is an essential step for fulfilling FATF recommendations and helps contain costs of remittances to Pakistan which might otherwise rise. Similarly, strengthening state owned insurance firms can help them contribute more to market development functions, crucially needed if insurance coverage is to expand from the current low levels. Annex 9 provides a detailed process analysis to substantiate the potential impact. The prior actions related to transparency also have broad-based social impact. The Benami Transactions Prohibition Bill aims to increase more accurate documentation of financial transactions and provides for a legal framework to enable transition of cash-based or undocumented financial transactions into the formal financial sector. The Deposit Protection

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<sup>28</sup> See, inter-alia, Khandker, 2005, Karlan and Zinman, 2010, Banarjee et al, 2009, and Beck Levine and Levkov, 2010.

<sup>29</sup> Household Integrated Economic Survey 2013-14

<sup>30</sup> Pakistan Social and Living Standards Measurement Survey

Corporation Act provides the legal framework for protecting depositors and increasing trust and confidence in the financial sector.

## 5.2 Environmental Aspects

76. **The proposed reform program is generally environmentally benign with impacts on natural resources and forests expected to be limited and manageable (see Annex 3).** This operation is not likely to cause any significant effect on Pakistan’s environment, forests, and other natural resources. In fact, the operation is expected to have a positive impact on the environmental and social safeguards agenda, as Prior Action 6 (related to the issuance of Prudential Requirements for long-term finance) and Prior Action 5 (related to the approval of the Infrastructure Finance policy), both include provisions to ensure that environmental considerations for financing of infrastructure investments are incorporated. Incorporating requirements for adherence to environmental standards at the policy and regulatory level will ensure that the implementation risks are monitored across stakeholders. Concurrently, the IFC Advisory team is actively engaged with SBP in developing policies, guidelines and Green Business best practices for the industry. It is also providing capacity building to SBP and financial institutions for implementing green financing.

77. **Pakistan has adequate legislative cover, policy guidelines, and institutional mechanisms in place for managing the environment.** The Pakistan Environmental Protection Council, headed by the Prime Minister, is responsible for overall guidance on national environmental programs and policies. After the 18th amendment to the constitution, environment became a provincial subject and provinces have been empowered to legislate and formulate policies. All provinces have enacted their own provincial Environmental Protection Act which is similar to Federal Environmental Protection Act of 1997. At the federal level, the Ministry of Climate Change is responsible for environmental protection. The Government has prepared a number of environment related policies including the National Climate Change Policy, National Disaster Risk Reduction Policy, the National Environment Policy, National Drinking Water Policy, Pakistan Clean Air Program, and the National Environmental Quality Standards (NEQS). In 2013 the climate change policy framework of implementation (2014-2030) was launched, which outlines the vulnerabilities of the various sectors to climate change and identifies appropriate mitigation actions. Pakistan intended to reduce up to 20 percent of its 2030 projected Greenhouse Gas emissions. Similarly, the environmental tribunals are also in place at both federal and sub-national provincial levels to address the various cases on environmental issues. While institutional arrangements for environmental management are quite elaborate at the national and sub-national level, implementation remains the key challenge across most of the country. For sustained growth, Government has to prioritize and integrate environmental management aspects into its development agenda to reduce the cost of environmental degradation and thereby impact on the poor segments of the society.

## 5.3 Public Financial Management, Disbursement and Auditing Aspects

78. **Pakistan has a fairly well-developed infrastructure for public financial management (PFM).** According to the Pakistan Federal Government Public Expenditure and Financial Accountability (PEFA) Update (2012), the trajectory of change is positive with PEFA scores comparing favorably with other countries in the South Asia region. With the implementation of the Financial Accounting and Budgeting System, a repository of all government expenditure and receipt transactions throughout the country is now readily available in a single database for decision-making. The audit cycle has been reduced from 33 to 8 months. The overall fiduciary risk associated with the proposed operation is “substantial”. The Federal Government has prepared a PFM reform strategy aiming to prioritize and focus the Government’s efforts to mitigate the PFM risks. The strategy is currently under approval process. This assessment is made with due regard to the Government’s commitment to overall PFM reform exemplified by actions already taken at the

federal and provincial levels, as well as the weaknesses in the PFM cycle identified in PEFA and other analytical reports. Pakistan's national budget is published by the Government and accessible to the general public in printed form and through the Ministry of Finance website.

79. **Recipient and credit agreements.** The Credits would be made to the Islamic Republic of Pakistan, represented by the Economic Affairs Division of the MoF. The Credit proceeds would be transferred to the government in accordance with the terms of the Financing Agreements.

80. **Funds flow arrangement for the DPC.** The Government will identify a foreign exchange account with SBP, which forms part of the country's official foreign exchange reserves, into which the proceeds of the Credits will be disbursed. The proceeds will be released in one tranche for each Credit following approval and official communication of Credit effectiveness by IDA. The completion of the prior actions and the maintenance of a satisfactory macroeconomic framework are sufficient to release the funds. The Pakistan Rupee equivalent of the funds in the account will, within two working days, be transferred into the consolidated fund of the government Account No. 1-Non-Food, held with SBP, which is used to finance budgetary expenditures. Within 45 days of disbursement of the IDA Credits, an authorized officer of the MoF, will provide a written confirmation to IDA certifying the receipt of Pakistan rupee equivalent of the Credits into the consolidated funds account of the Government, the date of receipt, and exchange rate to translate the credit currency into Pakistan Rupees.

81. **Disbursements.** Disbursements from the Consolidated Fund by the Government will not be linked to any specific purchases, and no special procurement requirement shall be needed. The proceeds of the Credits shall, however, not be applied to finance expenditures in the excluded expenditures as defined in the Financing Agreements. If any portion of the Credit is used to finance excluded expenditures as defined in the Financing Agreements, the WB will require the Government promptly upon notice, to refund the amount equal to the amount of the said payment to the IDA Credit, as the case may be. Amount refunded to IDA Credit upon such request will be cancelled from the Credit accordingly.

82. **The financial statements of SBP for the financial year ended 30 June 2015 were audited.** The auditors gave an unqualified opinion on the statements concluding that the statements gave a true fair view of the financial position, financial performance and cash flows. SBP, on behalf of the Government, will continue to maintain an appropriate accounting system in accordance with generally accepted accounting principles. An IMF Safeguards Assessment of the SBP was done in 2009 and updated in 2010 and 2013. The 2013 update confirmed that the majority of actions previously agreed with the SBP have been implemented, with some work still required for incorporating the remaining critical recommendations. .

#### **5.4 Monitoring, Evaluation and Accountability**

83. **The MoF is responsible for overall oversight and implementation of the FGDPC.** The External Finance Division in the Ministry of Finance is the main counterpart, while parallel technical discussions related to the individual prior actions are conducted between the WB teams and government counterparts, often linked to ongoing projects and technical assistance programs. Through this operation, these agencies beyond MoF are collaborating in the monitoring of these reforms, i.e. Ministry of Commerce, Planning Commission, SBP, and SECP, Federal Board of Revenue (FBR), Law enforcement agencies. MoF, as the lead implementing agency, has extensive experience and is fully conversant with WB policies and procedures through investment-lending and policy operations.

84. **A results framework has been developed for the operation (see Annex 1).** This operation will benefit from the Government's own monitoring and evaluation mechanisms. Timely achievement of targets

will be assessed and documents made promptly available, drawing on the regular supervision function of national accounting, fiscal, and household survey data and, if required, specialized surveys on access to finance. The WB will supervise and monitor progress, making adjustments as necessary, based on this results framework. Monitoring of the achievement of results will be facilitated by regular engagement of the teams implementing technical assistance programs in support of the reforms included in this operation (such as TA on financial inclusion, capacity building of financial sector regulators, DFID funded TAGR, etc.) as well as the implementation of projects financed by the WB (on financial inclusion and PFM).

85. **Grievance Redress.** Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a WB Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the WBs attention, and WB Management has been given an opportunity to respond. For information on how to submit complaints to the WBs corporate Grievance Redress Service (GRS), please visit <http://www.worldbank.org/GRS>. For information on how to submit complaints to the World Bank Inspection Panel, please visit [www.inspectionpanel.org](http://www.inspectionpanel.org).

## 6. SUMMARY OF RISKS AND MITIGATION

86. **The overall risk rating level of FGDPC is moderate.**

87. **Political risks to the operation are high, stemming from both the broader political and security situation in Pakistan which may distract policy makers, as well as from political resistance to the reform program itself.** In principle, the government – with a majority in the lower house of Parliament – should have the support needed to implement legal, institutional, and regulatory reforms. However, in practice, opposition could emerge on specific reforms from opposing interests. Political risks are mitigated by extensive consultative processes with different stakeholders, across political affiliations on the design and implementation of reforms as well as a successful record of reform implementation over the past few years.

88. **Macroeconomic risks stemming from possible domestic and external shocks are substantial.** Domestically, the country is exposed to frequent natural disasters. Slippages in the projects under CPEC may lead Foreign Direct Investment (FDI) not to materialize as originally expected (when the government initiated its economic reform program). Spillovers from the materialization of the unresolved circular debt arrears may affect fiscal consolidation. A persistent dollar appreciation with limited exchange rate flexibility may erode export competitiveness. Delays in much-needed structural reforms may weaken growth prospects and discourage private investment. Externally, remittances might grow slower than expected if tougher migration policies in labor-recipient and oil-rich countries stop or reduce migration. Protracted global economic weakness could impair exports. The end of quantitative easing in the United States may lead to rising foreign borrowing costs. Security risks may disrupt economic activity, discourage investment and undermine fiscal consolidation. Macroeconomic risks have declined over the last three years as the government successfully addressed external and domestic imbalances, by tightening fiscal policy and efforts to increase the level of international reserves. Macroeconomic risks will be further mitigated if the Government maintains prudent fiscal and monetary policies, which result in a large reserve cushion and healthy fiscal accounts. In addition, the WB will support the government's efforts (in collaboration with the IMF) to establish and maintain an appropriate macroeconomic policy framework.

89. **The depth of the reforms being supported requires several mitigation measures to address risks regarding stakeholders and risks of litigation.** Reforms that affect economic rents of stakeholders (e.g. NSS formalization, non-bearer bonds with KYC requirements, Benami Transactions law), may encounter significant resistance or even be challenged in court, as has happened in the past in the case of energy reforms. These risks are mitigated in three ways. First, the WB continues to support government and other stakeholders’ efforts to build consensus on key economic reforms through broadening the development discourse and research/knowledge products. Second, in parallel to the FGDPF, the WB and other development partners have continued to provide extensive and timely technical assistance (TA) required to advancing reforms. Third, loss of social support to the reform agenda can be mitigated by the Government’s strong electoral mandate, ratified in recent local elections, its strong reform implementation record to date, more effective media dissemination of the reform benefits and their trade-offs to the stakeholders and citizens, and extensive consultations.

90. **The fiduciary risks of the operation are deemed Substantial.** However, Pakistan has a fairly well-developed PFM system and the PEFA Update 2012 shows a positive trajectory of reforms. The PFM reform strategy aims to prioritize and focus the Government’s efforts on addressing the gaps identified in PEFA and other analytical work. The Bank will continue to support the government in strengthening the country systems through TA and operational support.

**Table 5: Summary Risk Ratings**

<b>Risk Categories</b>	<b>Rating (H, S, M or L)</b>
1. Political and governance	<b>H</b>
2. Macroeconomic	<b>S</b>
3. Sector strategies and policies	<b>L</b>
4. Technical design of project or program	<b>L</b>
5. Institutional capacity for implementation and sustainability	<b>M</b>
6. Fiduciary	<b>S</b>
7. Environment and social	<b>L</b>
8. Stakeholders	<b>M</b>
9. Other	<b>NA</b>
<b>Overall</b>	<b>M</b>

## ANNEX 1: Policy and Results Matrix

	Prior Actions	Results (Target= June 30, 2018; Baseline= July 1, 2016)
<b><i>Pillar 1: Improving access to finance and enhancing financial inclusion</i></b>		
1.	The NFIS Council has approved the Digital Transaction Accounts (DTA) Scheme.	<b>Results Indicator:</b> Number of transactional accounts, segregated by gender <b>Baseline:</b> 45 million (women 7 million) <b>Target:</b> 50 million (women 7.5 million)
2.	The SBP has granted clearinghouse membership of the National Institutional Facilitation Technologies (NIFT) to the Central Directorate of National Savings (CDNS) to allow for distribution of NSS profits through bank accounts.	<b>Results Indicator:</b> (%) of NSS profits distributed through bank accounts <b>Baseline:</b> 0% <b>Target:</b> 5% out of more than 7 million NSS account
3.	The National Assembly has approved the new Companies Bill to modernize the regulatory framework for companies	<b>Results Indicator:</b> (%) increase in number of companies registered <b>Baseline:</b> 65735 (source: SECP website) <b>Target:</b> 70000
4.	The Deposit Protection Corporation Act 2016 has been approved by Parliament.	<b>Results Indicator:</b> Deposit base of banking sector <b>Baseline=</b> PKR 11 trillion (US\$105 billion) <b>Target =</b> PKR 12.65 trillion (US\$120.7 billion) (15 percent)
<b><i>Pillar 2: Fostering Long-term finance</i></b>		
5.	The ECC has approved the National Policy on Infrastructure Finance	<b>Results Indicator:</b> long-term loans (contractual tenor greater than 5 years) as (%) of total banking sector loans
6.	The SBP has issued Prudential Regulations for long-term finance (in line with Basel III requirements)	<b>Baseline:</b> 8.8% (June 2015) <b>Target=</b> 10%
<b><i>Pillar 3: Enhancing Transparency of the financial sector</i></b>		
7.	The Benami Transaction Prohibition Bill has been approved by Parliament.	<b>Results Indicator:</b> Adjudicating authority appointed and operationalized <b>Baseline:</b> No Adjudicating body in place <b>Target:</b> Adjudicating authority appointed and operationalized
8.	The Ministry of Finance has completed the National Risk Assessment (NRA) for Anti-Money Laundering and Combatting Financing of Terrorism (AML/CFT).	<b>Results Indicator:</b> Pakistan remains in compliance with FATF Recommendation-1 <b>Baseline</b> Pakistan has been in compliance with FATF recommendation 1 since 2014 <b>Target:</b> Pakistan remains in compliance with FATF

		Recommendation-1
9	The Cabinet has approved the rules for a new registered prize bonds scheme with denomination of PKR 40,000 and above	<b>Results Indicator:</b> value of registered prize bonds as a share of outstanding prize bonds <b>Baseline:</b> 0 percent <b>Target:</b> 2 percent
10.	The Ministry of Commerce has endorsed the Corporate Governance Assessment for SLIC to monitor compliance with the Public Sector Companies (Corporate Governance) Rules 2013.	<b>Results Indicator: The Chairman and</b> Chief Executive Officer (CEO) of SLIC meets the fit and proper criteria <b>Baseline:</b> Chairman and CEO role is merged and thus not fit and proper <b>Target:</b> Fit and Proper Chairman and CEO

## ANNEX 2: Letter of Development Policy



**Senator Mohammad Ishaq Dar**  
Minister for Finance, Revenue,  
Economic Affairs, Statistics and  
Privatization

No.415-FM(1)/2017

**ISLAMABAD**  
6th February, 2017

**Subject: LETTER OF DEVELOPMENT POLICY FOR  
FINANCE FOR GROWTH DEVELOPMENT  
POLICY FINANCING**

**Dear President Kim,**

**The Government of the Islamic Republic of Pakistan (Government) continues to pursue a comprehensive program of economic and financial sector reforms.** These reforms are intended to spur investment, increase financial inclusion and accelerate economic growth that is inclusive, broad based and sustainable.

**On behalf of the Government, I am writing to request approval of the Pakistan Finance for Growth Development Policy Financing (FGDPF), which is an IDA Development Policy Credit in the amount of USD 300 million.** The IDA credit will provide needed external financing and signal our determination to implement sustainable economic and financial sector reforms. This Letter of Development Policy sets out the Government's key policy actions to be supported by this operation.

**Main objective of the FGDPF is to deepen and sustain the financial sector reforms supported by the previous DPC series so that greater financial inclusion and transparency is achieved, leading to increase in economic activity and businesses, availability of long term finance for investment, strengthening of confidence in the financial sector and reduced poverty.** This builds on continued macroeconomic stability, fiscal discipline and an improving business environment, which will lead to enhanced private sector investment and private sector-led economic growth. We have prepared this operation in close collaboration with the World Bank Group.

**The Government has successfully designed and implemented its economic reform program.** Pakistan's economy is on the rise in the wake of sustained economic reforms agenda being implemented since June 2013. Key elements of the reforms include fiscal consolidation, transparency, and improved energy supplies by comprehensive energy sector reform program, as well as financial sector reforms. After having achieved macroeconomic stability in first three fiscal years, the Government is now focused on attaining higher sustainable and inclusive growth. Growth rate target of 6–7 percent has been set to be achieved by FY 2018/2019.

Fiscal consolidation has been achieved by increasing revenues, reducing tax exemptions, eliminating wasteful expenditures, rationalizing subsidies and improving debt management. Fiscal deficit has been reduced from a high of 8.2 percent of GDP in FY 2013 to 4.6 percent in FY 2016.

The balance of payments position has significantly improved with an increase in international reserves resulting from strong remittances, foreign capital and financial inflows and improved current account due to lower global commodity prices including oil. As a result of prudent monetary and fiscal management, the external sector challenges have moderated and the forex market has stabilized. Headline inflation remains low (average inflation during July-January FY 17 stood at 3.85 percent).

In the past decade and a half, growth has been broadly pro-poor in Pakistan. We have also updated and revised the poverty line working using a more advanced methodology of Cost of Basic Needs (CBN) instead of the previously used Food Energy Intake (FEI) method which does not take into account non-food needs of households. Under the old FEI method, the poverty headcount, which was 34.7% in 2001, has come down to less than 10% in 2014. While adopting the new CBN method, the poverty headcount which was 64% in 2001 has now come down to 29.5% in 2014. The Government is committed to transpose the updated poverty line in its development policy framework.



### **Completed Reforms in Previous DPC**

**Doing business reforms in order to enable economic growth and private-sector led creation of more jobs.** Pakistan is ranked 144 out of 190 economies on the overall ease of doing business rankings in 2017, having improved four points from 148 in 2016. The Government has prepared and implemented a National Doing Business Reform Strategy, which comprehensively covers all 10 indicators. The plan is currently being implemented both at the national and provincial levels. As a result, Pakistan was recognized as one of the top ten reformers in DB 2017.

**Strengthening financial intermediation and allowing more dynamic private sector growth.** The Government has revised the legislative framework governing the financial sector. Some of these reforms were supported by previous DPC operations; these included the Financial Institutions (Secured Transaction) Act, 2016, the Amendment to the Credit Bureau Act, the Amendment to the Securities and Exchange Commission of Pakistan (SECP) Act and the Financial Institutions (Recovery of Finances Amendment) Bill.

**Present Operation (FGDPF) to support continuity of reforms.** The Government has stepped up reform efforts in the financial sector to increase access to finance and enhance transparency. These reforms will have significant positive impact on poverty reduction, shared prosperity and gender equality. The Government has completed following reforms through the current DPC operation:

**Improving access to finance and enhancing financial inclusion: Launching of Digital Transactions (DTA) Scheme and Reforms in Central Directorate of National Savings (CDNS).** The National Financial Inclusion Council has approved a Digital Transactions Accounts (DTA) Scheme in January 2017 (prior action) to accelerate growth in convenient and affordable access to financial services by all segments of the population, including women, SMEs and rural segments. The approved DTA scheme will increase the total number of accounts in the country and once implemented, the scheme is expected to contribute to the National Financial Inclusion Strategy 2020 targets.



The Government is also undertaking an ambitious reform program for Central Directorate of National Savings (CDNS) which serves 7 million account holders across Pakistan. CDNS's integration with the financial sector (prior action) is expected to facilitate a large segment of the population to access retail savings and payment services. Enactment of the Deposit Protection Corporation Act will further build consumer confidence in the banking system.

**Fostering availability of long-term finance: Developing National Policy on Infrastructure Finance, Operationalizing the Pakistan Development Fund (PDF) and Issuance of Prudential Regulations by State Bank of Pakistan.** The Infrastructure Finance Policy (prior action) provides a holistic view of infrastructure finance and prospective infrastructure needs of the country. The Government has also set up the Pakistan Development Fund (PDF) to serve as a vehicle for infrastructure investment. The Government recognizes that for sustained investment in infrastructure, private sector investment and engagement is essential. The State Bank of Pakistan (SBP) has issued Prudential Regulations (prior action) for long-term finance that are focused on infrastructure project finance. The new Infrastructure Finance Policy and supporting new Prudential Regulations for long-term finance will create an enabling environment to unlock long-term finance to spur growth.

**Enhancing transparency of the financial sector: Completion of National Risk Assessment Report (NRA) and Enactment of Benami Transactions (Prohibition) Act 2017.** The Government continues its efforts for documentation of financial transactions and curtailment of money laundering/financing of terrorism (ML/FT) risks. The National Risk Assessment (NRA) has been completed (prior action) as part of financial sector reforms. Similarly, the practice of "benami" transactions which facilitates tax avoidance and money laundering has also been curtailed through legislation of the Benami Transactions (Prohibition) Act 2017 (prior action).

**Improving Corporate Governance of Insurance Sector:** SLIC is undergoing corporatization which will convert it into a company. NICL and PRCL have become compliant with the Public Sector Companies (Corporate Governance) Rules 2013 and SECP Code of Corporate



Governance for Insurers 2016. The FGDPF assisted in carrying out a detailed Corporate Governance Assessment for SLIC to facilitate compliance with corporate governance requirements. The Government will consider assessments for NICL and PRCL in due course.

**Further improving the investment climate:** Modernizing the legal framework for companies through the new Companies Ordinance 2016 (prior action), to repeal 32 years old Companies Ordinance 1984, will enhance transparency for the private sector and increase efficiency.

**Completing the legislative agenda:** The Companies Bill 2016 has been passed by the National Assembly as part of the reform program that this operation supports. The Government will also work with the Senate for its approval.

**Reforms to continue beyond this operation (FGDFP)**

The Government acknowledges that reforms supported by the proposed operation (of FGDFP) require ongoing efforts in order to be fully implemented. The Government reaffirms its plan to continue with the broader reforms in order to promote an inclusive and transparent financial sector, enabling better intermediation for long-term finance. For all of the aforesaid supported actions, implementation efforts are underway.

**Pakistan Infrastructure Bank (PIB):** The Government is currently facilitating setting up of Pakistan Infrastructure Bank (PIB) through International Finance Corporation (IFC) which will have majority of share-holding by IFIs and private sector. It will mobilize private sector long term funding for infrastructure projects in Pakistan.

**Implementation of Digital Transaction Accounts (DTA) scheme** as approved by the NFIS Council will support the rapid expansion of DTAs and help achieve NFIS target of 50 percent of the population having access to accounts.

**The Government remains committed to strengthening institutions:** The Government has decided to place five regulators from the Cabinet Division to respective sectoral Divisions. This measure has been necessitated to better address issues of policy and administrative

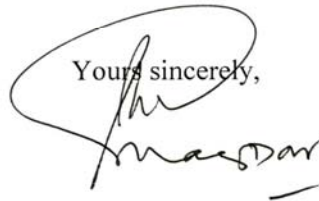


coordination to achieve greater efficiency in the delivery of regulatory functions. The Government is fully committed to protect autonomy and independence of regulatory institutions.

**Concluding remarks**

The Government believes that the ambitious reform program implemented in last three years and outlined above, supported by the proposed operation, will help develop and deepen Pakistan's financial sector. We are moving into the Pakistan Finance for Growth Development Policy Financing with complete commitment to the reforms noted in the foregoing paragraphs and very much appreciate the support of the World Bank Group with regard to our economic growth and reform agenda.

Best wishes and kind regards,

Yours sincerely,  


Mr. Jim Yong Kim,  
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**ANNEX 3: Environment and Poverty/Social Analysis Table**

<b>Prior Actions</b>	<b>Significant positive or negative environment effects</b>	<b>Significant poverty, social or distributional effects positive or negative</b>
<b><i>Pillar 1: Improving access to finance and enhancing Financial inclusion</i></b>		
The NFIS Council has approved the Digital Transaction Accounts (DTA) scheme.	No	Yes, positive
The SBP has granted clearinghouse membership of the National Institutional Facilitation Technologies (NIFT) to the Central Directorate of National Savings (CDNS) to allow for distribution of NSS profits through bank accounts. .	No	Yes, positive
The National Assembly has approved the new Companies Bill to modernize the regulatory framework for companies	No	Yes, positive
The Deposit Protection Corporation Act 2016 has been approved by Parliament.	No	Yes, positive
<b><i>Pillar 2: Fostering Long-term finance</i></b>		
The ECC has approved the National Policy on Infrastructure Finance	Yes, Positive	No
The SBP has issued Prudential Regulations for long-term finance (in line with Basel III requirements)	Yes, positive	No
<b><i>Pillar 3: Enhancing Transparency of the financial sector</i></b>		
The Benami Transactions Prohibition Bill has been approved by Parliament.	No	Yes, positive
The Ministry of Finance has completed the National Risk Assessment (NRA) for Anti-Money Laundering and Combatting Financing of terrorism (AML/CFT).	No	Yes, positive
The Cabinet has approved the rules for a new registered prize bonds scheme with denomination of PKR 40,000 and above	No	No
The Ministry of Commerce has endorsed the Corporate Governance Assessment for SLIC to monitor compliance with the Public Sector Companies (Corporate Governance) Rules 2013.	No	Yes, positive

**As noted in Section 5, the proposed reform program is generally environmentally benign with impacts on natural resources and forests expected to be limited and manageable.** In addition to the table above, this is substantiated by the results of the completed Climate and Disaster Risk Screening tool used to screen the project.

## ANNEX 4: Pakistan Debt Sustainability Analysis

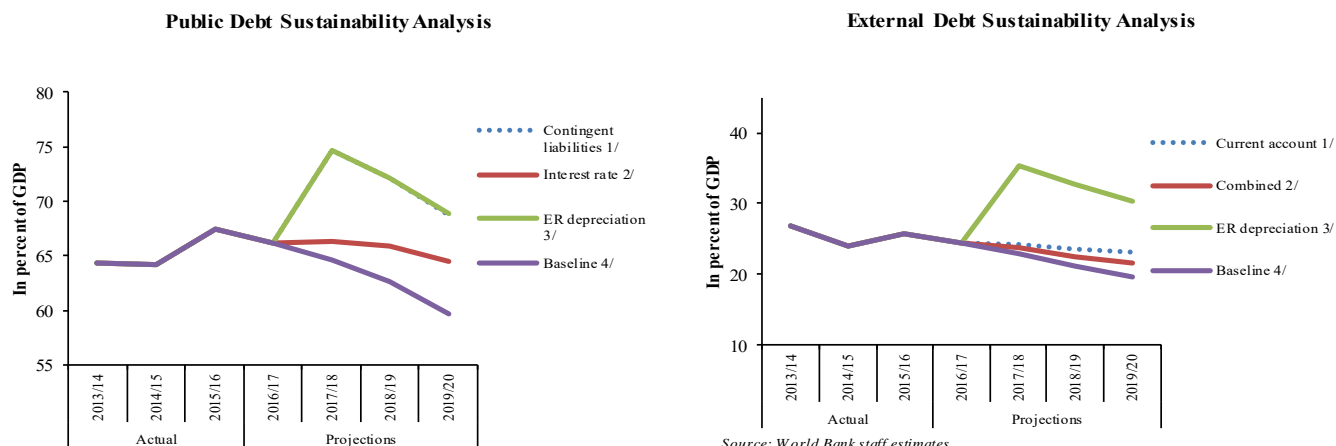
- 1. Under baseline scenario, Pakistan's public debt-to-GDP ratios are projected to decline over the medium term.** With a targeted consolidated fiscal deficit (excluding grants) of 4.6 percent of GDP by FY19/20, public debt is projected to fall from 67.5 percent of GDP in FY15/16 to a little less than 60 percent by FY19/20 (see *Figure 4* in Macroeconomic Outlook for a decomposition of debt dynamics). Moderately higher economic growth and declining primary deficit, particularly in the last two projection years, are expected to support the gradual decline in public debt ratios. Moreover, gross financing needs are expected to decline amounting to around 25.2 percent of GDP by FY19/20 but will remain sizeable due to: (i) the Eurobond bullet maturities continue to feature almost throughout the projection horizon<sup>31</sup>; (ii) in the ongoing FY16/17, these financing needs exhibit a hike on account of a substantial bullet repayment under the domestic debt<sup>32</sup>; (iii) repayments on the rescheduled Paris Club debt under Official Development Assistance (ODA) will start from the current fiscal year<sup>33</sup>; and (iv) those of recently finalized IMF-EFF are expected to initiate in FY17/18.
- 2. Stress tests show that public debt is particularly sensitive to a real exchange rate depreciation shock and a contingent liabilities shock.** The most important deterioration of public debt levels vis-à-vis the base case scenario takes place under a real depreciation shock, a one-time contingent liability shock and a real interest rate shock (see *Figure 1* below). In the case of the most extreme shock, a 30 percent one-time real depreciation, the debt stock rises to 68.8 percent of GDP by FY19/20, almost 9.1 percentage points of GDP above the baseline. A similar pattern is observed in the second important shock of a one-time contingent liabilities shock equivalent to 10 percent of GDP to the baseline.
- 3. Public debt dynamics will remain a source of fiscal vulnerability.** Despite the gradual decline in public debt ratios, total interest payments will continue to absorb a large share of fiscal revenues (including grants), averaging to 26.5 percent of total revenues. Similarly, the public debt during the projection period is projected to average around four times the total revenue.
- 4. However, external debt sustainability risk is projected to remain manageable under the baseline scenario.** External debt-to-GDP is projected to decline from a high of 25.8 percent in FY15/16 to 19.6 percent by FY19/20, owing to moderately estimated financial (debt-creating) net flows, expected Eurobonds, and sustained economic growth. External debt is robust to most shocks and is expected to follow a declining path under most standardized-shock scenarios (see *Figure 1* below). Most extreme shock appears to be one time 30 percent real depreciation shock which increases the external debt to GDP ratio to 30.3 percent of GDP by end-June 2020, which is 10.7 percent of GDP higher than the base case. A non-interest current account shock raises the external debt by about 3.4 percent of GDP in FY19/20 relative to the baseline. Shocks to the growth rate and the external interest rate make only small difference to the baseline scenario.

<sup>31</sup> These are US\$750 million in June 2017, and US\$1.0 billion each in April 2019 and December 2019.

<sup>32</sup> Maturity of around Rs. 1.2 trillion for 3-year PIBs was due on July 18, 2016.

<sup>33</sup> An average of US\$550 million will be repaid to Paris Club creditors during the projection horizon.

**Figure 1: Debt Sustainability Analysis**



Source: World Bank staff estimates  
 Notes: 1/ One time 10 percent of GDP increase in other debt creating flows in FY17/18  
 2/ Real interest rate is at baseline plus one standard deviation  
 3/ One time 30 percent real depreciation in FY17/18  
 4/ Country team projections

Source: World Bank staff estimates  
 Notes: 1/ Non-interest current account is at baseline minus one-half 10-year historical standard deviations  
 2/ Combination of three shocks: i. Non-interest current account is at baseline minus one-quarter standard deviation, ii. Real GDP growth is at baseline minus one-quarter standard deviation, iii. Nominal interest rate is at baseline plus one-quarter standard deviation  
 3/ One time 30 percent real depreciation in FY17/18  
 4/ Country team projections

**External Debt Composition as of June 30, 2016**

	USD (mn)	Share of total debt	% of GDP
Monetary authorities	9,643	13.2%	3.4%
General Government	51,714	70.8%	18.2%
Banks	2,696	3.7%	1.0%
Other sectors	9,011	12.3%	3.2%
<i>Of which intercompany lending</i>	2,857	3.9%	1.0%
<b>Total External debt</b>	<b>73,063</b>	<b>100.0%</b>	<b>25.8%</b>
<i>Long term</i>	66,147	90.5%	23.3%
<i>Short term</i>	6,916	9.5%	2.4%

Source: State Bank of Pakistan

## ANNEX 5: Rationale, Impact and Analytical Underpinnings of the Proposed Prior Actions

Prior Action		Rationale and Impact	Analytical Underpinnings
<b>Pillar 1: Improving Access to Finance and enhancing financial inclusion</b>			
1	The NFIS Council has approved the Digital Transaction Accounts (DTA) Scheme.	Support achievement of NFIS targets which would increase the number of people with access to transactional accounts and financial services	<ul style="list-style-type: none"> <li>• NFIS 2015</li> <li>• FSAP 2016</li> <li>• Debt Capital Markets Technical Note (TN) 2016</li> </ul>
2	The SBP has granted clearinghouse membership of the National Institutional Facilitation Technologies (NIFT) to the Central Directorate of National Savings (CDNS) to allow for distribution of NSS profits through bank accounts	Convert NSS profit payments of retail savers from over-the-counter cash to electronic bank account transfers thereby making the system safer and more affordable.	<ul style="list-style-type: none"> <li>• NFIS 2015</li> <li>• FSAP 2016</li> <li>• Debt Capital Markets Technical Note (TN) 2016</li> </ul>
3	The National Assembly has approved the new Companies Bill to modernize the regulatory framework for companies	Support more companies to be established in the formal economy, promote greater corporate transparency and enhanced due diligence which would lead to more entrepreneurs in the formal economy under a modern legal framework.	<ul style="list-style-type: none"> <li>• Accounting &amp; Auditing ROSC 2017</li> <li>• Business Registration Diagnostic 2014</li> <li>• Doing Business Reform Strategy 2016</li> </ul>
4	The Deposit Protection Corporation Act 2016 has been approved by Parliament	Protect banking sector depositors through deposit insurance to improve trust and confidence of depositors in the banking sector.	<ul style="list-style-type: none"> <li>• FSAP 2010</li> </ul>
<b>Pillar 2: Fostering Long-term Finance</b>			
5	The ECC has approved the National Policy on Infrastructure Finance	Use unified policy framework to finance the country's infrastructure requirements through strengthened policy focus on infrastructure financing so that different sources of funding are identified	<ul style="list-style-type: none"> <li>• FSAP 2016</li> </ul>
6	The SBP has issued Prudential Regulations for long-term finance (in line with Basel III requirements)	Improve banking sector best-practices in providing long-term finance to maintain financial sector stability in the wake of increased long-term lending.	<ul style="list-style-type: none"> <li>• Infrastructure Finance TN 2016</li> </ul>
<b>Pillar 3: Enhancing transparency of the financial sector</b>			
7	The Benami Transaction Prohibition Bill has been approved by Parliament.	Promote formality and reduce tax evasion by prohibiting transactions conducted under fictitious names or name-less arrangements thereby expanding the tax net and increasing the size of the financial sector	<ul style="list-style-type: none"> <li>• Trust-fund for Accelerating Growth and Reform (TAGR) TA 2016</li> </ul>
8	The Ministry of Finance has completed the National Risk Assessment (NRA) for Anti-Money Laundering and Combatting Financing of terrorism (AML/CFT)	Increase transparency within the financial sector, which would lead to increased confidence of international financial markets in Pakistan's AML/CFT regime thereby allowing remittance and other financial flows to persist.	<ul style="list-style-type: none"> <li>• AML/CFT Assessment 2014</li> <li>• National Risk Assessment and capacity building 2016</li> </ul>
9	The Cabinet has approved the rules for a new registered prize bonds scheme with denomination of PKR 40,000 and above	Regulatory framework in place to reduce the usage of bearer/unregistered prize bonds in the informal cash economy which would increase formality in the economy.	<ul style="list-style-type: none"> <li>• NFIS 2015</li> <li>• FSAP 2016</li> </ul>
10	The Ministry of Commerce has endorsed the Corporate Governance Assessment for SLIC to monitor compliance with the Public Sector Companies (Corporate Governance) Rules 2013	Identify gaps in and improve corporate governance of market dominating state-owned insurance companies leading to wider coverage of insurance policies for individuals and businesses to manage an array of risks	<ul style="list-style-type: none"> <li>• FSAP 2016</li> <li>• Insurance TN (NFIS 2015)</li> <li>• Strengthening Pakistan's Insurance Regulatory and Supervision Framework (FIRST TA) 2016</li> </ul>

## ANNEX 6: Financial Sector Overview and Recent Developments

1. **Credit intermediation in Pakistan’s financial sector remains low, and is concentrated largely within short term banking sector loans.** The credit to Gross GDP ratio is very low (15 percent), only above Afghanistan in the region. The banking sector loans to deposits ratio is 47 percent and the loans to total assets ratio is 34 percent as of June 2016, implying that the banking sector’s sources of financing are not being adequately intermediated for offtake of credit. Instead, a sizeable portion of the banking sector balance sheet (about 47 percent of assets) remains invested in government securities. Finally, non-bank intermediation of credit is almost non-existent, as evidenced from the low shares of institutions such as leasing companies, *Modarabas* and development finance institutions.

2. **In terms of assets, banks dominate the financial sector, representing about 74.7 percent of financial sector assets.** The remaining assets of the financial system are in the National Savings Scheme (16.5 percent), Insurance companies (4.8 percent), non-bank financial institutions (4.0 percent), and microfinance institutions (0.1 percent). Table 1 provides a detailed asset composition of the financial sector.

3. **The size of Pakistan’s financial sector is about 64.2 percent of GDP, which compares well within South Asia, but is behind relevant emerging markets.** Banking sector assets are approximately 48.5 percent of GDP, lower than India (79.8 percent) and much lower than Malaysia (202 percent). Excluding the NSS, the non-bank financial sector constitutes about 5.8 percent of GDP. There is limited diversification within the non-bank financial sector. Insurance companies represent the highest share but insurance outreach is among the lowest in the comparable markets. Mutual funds represent an increasing share and are at about 1.6 percent of GDP, low compared to India (5.6 percent) or Malaysia (34 percent). Another weak sector is pensions, representing only 0.1 percent of GDP. Similarly, mortgage, leasing, *Modarabas* and other development finance institutions are still very small in terms of outreach and asset bases.

**Table 1: Financial Sector Asset Composition as of June 2015**

	Number of Institutions	Assets (PKR Billion)	% of Assets	% of GDP
<b>Banking Sector</b>				
Public Sector Commercial Banks	5	2,352	13.2%	8.6%
Local Private Banks	16	9,542	53.5%	34.8%
Foreign Banks	5	224	1.3%	0.8%
Specialized Banks	4	196	1.1%	0.7%
Islamic Banks	5	929	5.2%	3.4%
Microfinance Banks	11	82 <sup>6</sup>	0.5%	0.3%
	<b>46</b>	<b>13,325</b>	<b>74.7%</b>	<b>48.7%</b>
<b>Non-Bank Financial Sector</b>				
Insurance Companies	51	855	4.8%	3.1%
<i>Modarabas</i>	25	30	0.2%	0.1%
Mutual Funds	180	449	2.5%	1.6%
Investment Banks	3	7	0.0%	0.0%
Leasing Companies	10	36	0.2%	0.1%
Microfinance Institutions	28	20	0.1%	0.1%
National Savings Scheme (NSS)	1	2,939	16.5%	10.7%
Development Finance Institutions <sup>2</sup>	8	184	1.0%	0.7%

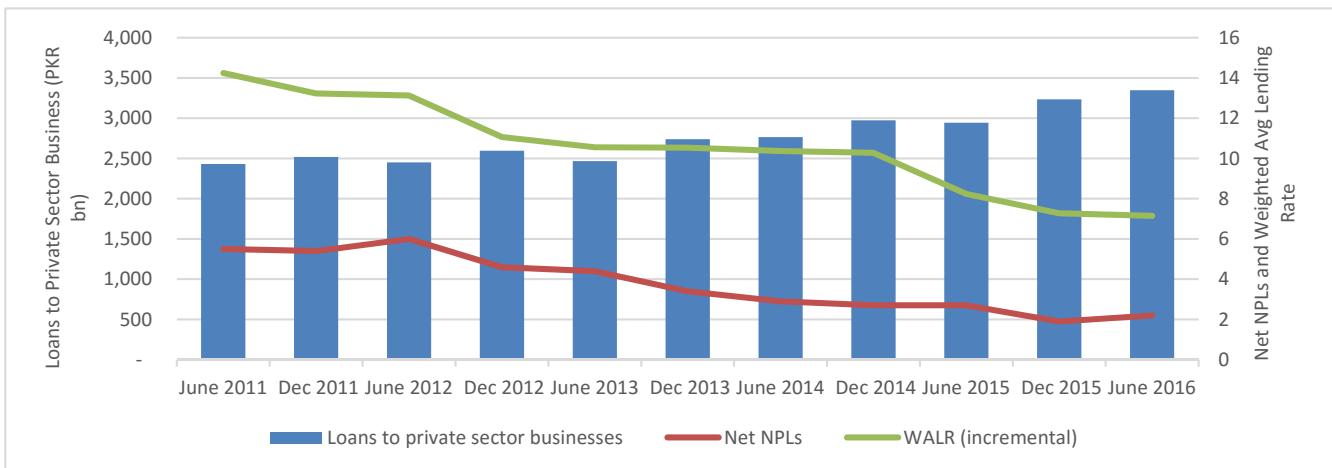
	306	4,520	25.3%	16.5%
<b>Total Financial Sector</b>		<b>17,846</b>	<b>100.0%</b>	<b>68.5%</b>

Sources: SBP, SECP, Insurance Association of Pakistan, NBFI and *Modaraba* Association of Pakistan, and Pakistan Microfinance Network.

4. **The banking system remains robust based on standard solvency indicators, largely because of the high stock of government borrowing.** The key driver of robustness in the banking sector has been a shift in risk behavior of banks from private sector loans to risk-free government securities in recent years. The banking sector has achieved sizable growth, driven primarily by increased government borrowing. Commercial banks hold about PKR 7.17 trillion (US\$68.9 billion) of government domestic debt as of June 2016, which is about 47.4 percent of total assets. Furthermore, investments in government securities constitute approximately 92 percent of total banking system investments. Even with the mild recovery in private sector off-take, the outstanding stock of government debt continues to significantly reduce the risk-weighted assets of the banking system. As a result, the sector’s capital adequacy ratio remains strong at 16.1 percent and liquid assets to deposits are at 77 percent as of June 2016 (see table 2).

5. **The easing interest rate environment and lower yields on incremental government borrowing have allowed for some growth in private sector credit off-take.** Stronger macroeconomic fundamentals and structural reforms have allowed for considerable easing of the interest rate environment. The weighted average lending rate (WALR) on incremental borrowing is at 6.9 percent in July 2016 compared to 7.9 percent a year ago. However, the deposit rate on new deposits is lower at 3.7 percent in July 2016 compared to 4.1 percent a year ago. The trend in deposit rates has been declining since the change in methodology for minimum rate of deposits from a fixed rate of 5 percent to a floating minimum rate of 50 bps below the SBP repo rate in FY14. In addition, the government’s incremental borrowing requirements have reduced and offer lower yields, allowing more liquidity to potentially be available for the private sector. There are also early signs of constraints easing from the government’s effort to address structural weaknesses of the economy like power shortages, and law and order. As a result, private sector credit has grown by 11.5 percent (y-o-y) in FY16 following growth of 5.9 percent in FY15 and 12.6 percent in FY14. Much of this increase is stemming from the manufacturing sector (particularly chemicals with growth of 29 percent in FY16), construction (48 percent growth in FY16), and transport and communication (24 percent). Consumer financing has also seen healthy growth of 12 percent in FY16 and 13 percent in FY15, driven by auto-financing and personal loans.

**Figure 2: Loans to Private Sector vis-à-vis lending rates and non-performing loans (FY11 – FY16)**



Source: State Bank of Pakistan

## ANNEX 7: Summary of FSAP Development Module Findings

- 1. Stability of the banking sector has been strong over the last decade.** The last Basel Core Principles assessment conducted in 2011 indicated that the sector was largely compliant with the Principles. Nevertheless, the risks have evolved and so have the principles. Among other issues, the risk of sizeable exposure to government securities which are zero-weighted for credit risk for capital adequacy purposes may not be adequately reflected, since these securities are not very liquid (the secondary market trading is nascent) and banks' overexposure to government debt means they are exposed to the government's vulnerable external account and fiscal positions, presenting the possibility of a reverse shock transmission.
- 2. The financial sector is at an inflection point.** Going forward, it has to resume a meaningful role of intermediation of finance to private sector. The banking sector which dominates the financial system can be viewed as a strong proxy of the entire system. Banking sector assets, at around half of GDP, are relatively low compared to peer countries, despite strong deposit growth over the past decade. Furthermore, bank advances make up only 34 percent of the total assets. Investments, on the other hand, now constitute half of the assets and are mostly placed in government securities. Further development of the financial sector has three key trajectories ahead of it. First, the government should rebalance its borrowing requirements and source more financing from external sources, within the mandated debt ceiling of 60 percent of GDP. Second, new pools of funding should be encouraged in Pakistan, through financial inclusion and increasing the formal sector of the economy. Finally, capital markets should be further developed in order to assume a stronger intermediation role. This will allow the financial sector to resume its role of financing Pakistan's huge development needs.
- 3. Pakistan's economy is significantly underleveraged and therefore is not utilizing its capital formation potential.** Deepening Pakistan's capital markets would help reverse the situation. The capital market has undergone a series of regulatory reforms in recent years aimed at effective regulation of the securities market and enhanced protection of investors and public in general, and exhibits strong compliance with the International Organization of Securities Commissions (IOSCO) Principles for securities regulations.
- 4. While the equity market is relatively vibrant, the sizeable debt market, which is dominated by government securities, lacks efficiency, depth and liquidity.** At present, 80 percent of marketable government debt is with the banks, with almost no market making activity while corporate debt accounts for a negligible percentage (.03 percent) of total government domestic debt. The debt management function has been fragmented across different agencies with weak coordination, resulting in an underdevelopment of the domestic debt market, exposure to financial risks and limited control over cost of funding. Successful implementation of the Government's Medium Term Debt Strategy (MTDS 2013/14–2017/18), coupled with fiscal consolidation and discipline, holds a strong potential of unlocking private sector credit flows in Pakistan. There is also a need to develop the Islamic debt market, particularly the sovereign Sukuk market. This will allow the sector deploy excess liquidity while at the same time diversifying the government's funding portfolio.
- 5. The domestic financial system needs to increase its intermediation role in long-term finance.** The annual production of long-term loans is below potential, and needs to ramp up in order to meaningfully support productive investments, housing and infrastructure which are critical to further growth in Pakistan. Long-term loans, like private sector credit generally, are being crowded out by government debt securities, in addition to being dissuaded by a lack of confidence in the debt recovery regime and judicial enforcement. The Islamic finance industry attracts medium- and long-term deposits and has the capacity to finance infrastructure assets but has limited long-term financing avenues. Formulating a national infrastructure finance strategy could help better harness long-term funding sources. To ensure coordination and momentum, such a strategy would need to be owned at a high level of the government.

## ANNEX 8: Summary of National Financial Inclusion Strategy

1. Pakistan has been a pioneer in championing financial inclusion for over a decade under the committed leadership of SBP. There have been a large number of significant milestones which include: the creation of a regulatory framework for MFBs (2001); the expansion and modernization of the online credit information bureau (e-CIB, 2005); establishment of the Pakistan Interbank Settlement System (2008); adoption of Branchless Banking Regulations (2008, amended in 2011); adoption of a tiered approach to know-your-customer (KYC) requirements; establishment of a specialized microfinance credit information bureau (m-CIB, 2009-2012); and work on an Inclusion, Stability, Integrity, and Protection (I-SIP) methodology (2014).

2. Despite these sustained efforts, the level of financial inclusion remains very low. Just 10.3 percent of Pakistani adults have an account with a formal financial institution<sup>34</sup>, well below both the South Asian average of 33 percent and the average for all lower-middle-income countries of 41.4 percent<sup>35</sup>. The unbanked predominantly include (i) women; (ii) rural households; and (iii) MSMEs. Loans to women account for less than 3 percent of total bank loan volume with only about 5 percent. Fifty-six percent of adults use neither formal nor informal products, and while 36 percent of adults save, only 4 percent save with a formal financial institution<sup>36</sup>. Similarly, while one-third of adults borrow money, only 3 percent borrow from a formal financial institution. The use of mobile money is growing rapidly, but is still limited to 11 percent of males and 3 percent of females<sup>37</sup>. Insurance coverage is estimated at 7 percent, and only an estimated 7 percent of adults have a formal pension.

3. The persistence of financial exclusion in the face of long-standing efforts to promote inclusion resulted in efforts to develop a comprehensive National Financial Inclusion Strategy (NFIS) in 2015. The strategy comes at a particularly opportune moment as new technology and the rapid expansion of branchless banking offer unprecedented opportunities to transform financial inclusion in Pakistan. The NFIS provides a vision, a framework and a road map for priority actions aimed at addressing constraints and significantly increasing access to, and usage of, quality financial services.

4. The stated vision for financial inclusion in Pakistan is that: “individuals and firms can access and use a range of quality payments, savings, credit and insurance services which meet their needs with dignity and fairness”. A set of cross cutting conditions – the key enablers – will need to be put in place as they will lay the foundation for implementing this vision. The key enablers cut across all priority sectors and are: (1) public and private sector commitment to the NFIS and coordination; (2) enabling legal and regulatory environment; (3) adequate supervisory and judicial capacity; and (4) financial, payments and information and communications technology infrastructure. The key enablers will support targeted actions – the drivers – aimed at increasing access and developing an ecosystem of financial services that will have the quality and features required by the Pakistani population and enterprises. These drivers are: (i) promoting DTAs and reaching scale through bulk payments; (ii) expanding and diversifying access points; (iii) improving capacity of financial service providers; and (iv) increasing levels of financial capability.

5. The vision aspires to having universal access to formal accounts, not be limited to simply traditional savings and checking accounts but would also include digital transactional accounts (DTAs) such as branchless banking accounts. Universal access to formal accounts depends on a balanced KYC regime, improvements in the national payment system (NPS), and on shifting large payment streams from cash to digital platforms.

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<sup>34</sup> Financial Inclusion Insights, 2014.

<sup>35</sup> Findex, 2011. Pakistan is categorized by the World Bank Group as a lower-middle-income country, i.e. one whose per capita gross national income falls between USD 1045 and USD 4125.

<sup>36</sup> Financial Inclusion Insights, 2014. This excludes National Savings, which provides savings to approximately 7.7 million Pakistanis.

<sup>37</sup> Financial Inclusion Insights, 2014.