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MICRO, SMALL & MEDIUM ENTERPRISES:
an engine of growth & prosperity

Economic Growth in Pakistan

Need for Vast Spread of ATMs in Pakstan

Private Equity Investments On the Horizon of Pakistan's Financial Landscape

Money Laundering & Terrorist Financing

editorial

"Conduct Risk – The New Buzz Word in Banking Regulation"

What is an organization's reputation worth? The answer is simple: everything.

The results of a study by the World Economic Forum reveal that, on average, more than 25 percent of an organization's market value is a result of its reputation. An organization's reputation is what determines its success. When tarnished, it is also what determines organizational failures.

One of the greatest lessons that the banking industry learned from the global financial crises of 2008 is that reputational risk is as important as the more conventional banking risks such as market risk, credit risk, liquidity risk and operational risk. Post financial crises, reputation and conduct risks have emerged as high importance buzzwords on bankers' radars.

A reputation risk that is not timely and effectively managed can escalate into a major strategic crisis at an alarmingly fast pace. The cost of poor conduct is high; not just in terms of legal repercussions, but also in terms of the reputational erosion and the ensuing loss of business.

As a consequence of the many financial scandals that emerged during the financial crises, banking regulatory authorities introduced stringent preventative regulation, with particular focus on ethical aspects of banking service delivery and operations. This paradigm shift towards increased regulation is enhancing banking vigilance, controls and compliance. However, in some instances, stricter regulation alone does not remedially address the cause of improper, unethical conduct.

Simply put, this popular buzzword 'conduct risk' is the reputational risk that the organization faces from its staff acting unprofessionally, unethically or illegally. It refers to risks attached to the way in which an organization and its staff conduct themselves - 'behavior' is the most important element of conduct risk. Due to its complexity, conduct risk is not easily managed only by rules, policies and procedures.

Conduct risk emanates from ethically compromised corporate culture and unethical behavior of employees – behavior that could cause malfunctioning of soundly architected controls. The ethics of the individual and the culture within the organization are both significant influencers of an individual's conduct.

Conduct risk is manifest in different forms. Conduct risk can occur in the way clients are served and how well the responsibilities of making profit for one's client and generating profit/result for the organization are balanced. Another form of conduct risk is when employees engage in financial misdemeanors by assisting clients in acquiring financial assets that do not comply with the law. Conflict of interest is another form of misconduct where personal interests of employees are not in line with the organizational or public interests. Market abuse, which entails incidents of market manipulation and insider trading, is another form of conduct risk.

While it is very important to have the right rules and regulations in place, their efficacy is compromised if behavioral elements do not complement these compliance directives. This is why conduct risk needs to managed with caution, and requires that organizations gauge their ethical culture, with the right management inculcating the ethical culture down the corporate echelons, stimulating compliance awareness and improving the commitment to compliance goals. Organizations, therefore, need to lay emphasis upon behavioral aspects and be able to measure them in order to proactively improve compliance.

The process for mitigating conduct risk is more complex and difficult to define than those of the more technical risks that the financial sector faces. The managements of organizations need to evaluate the company's values and objectives in order to frame 'customer outcomes' that they need to deliver. Once these outcomes are defined, the management should ensure alignment of corporate strategy with these fair customer outcomes. The next step requires ensuring that organizational/business processes are optimized to deliver fair outcomes to customers. This also means ensuring that a conducive culture is in place within the organization to facilitate employees to achieve the requisite results.

A 'right' corporate culture is one which puts customers and market integrity at the heart of the organization's business. This can be promoted by an ethically conscious management articulating its vision of ethical conduct into easily understood business practices, and implementing these within the organization. This should be followed by reinforcing desirable behaviors through performance management and rewards.

A management team that focuses upon organizational values while remaining committed to delivering fair value to customers can generate sustainable reputational benefits for the organization.

Sirajuddin Aziz
Editor-in-Chief

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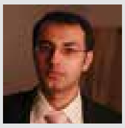

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MICRO, SMALL & MEDIUM ENTERPRISES:

an engine of growth & prosperity

By M. Ghalib Nishtar

Micro, Small and Medium Enterprises (MSME's) account for 99.7% of all enterprises in the world. MSME's have a significant role to play in boosting the economic growth, poverty reduction and social inclusion across the globe.

SMALL BUSINESS

MSME's are labor intensive, generating jobs, thereby increasing the "real income and standard of living of many people. In this way, they can increase the social and economic participation of women, youth and minorities". MSME's employ 78% of the labor force in low income countries and 66% of the labor force in high income countries. MSME's act as a 'useful bridge head between the informal economy of family enterprise and the formalized corporate sector'.

All over the world, half to two-third of all businesses are MSME's and in many regions this proportion is much higher. MSME's are capable of creating jobs with least amount of capital and in dispersed locations which makes MSME's attractive to policy makers. However, they remain as a heterogeneous group, in different organizational structure ranging from proprietorship to corporate, engages in factories to service organizational activities and with various definitions in different countries and in some countries they differ from industry to industry.

The heterogeneous nature and small size needs adequate support from organized intermediaries. These intermediaries exist in every country in different forms. International Finance Corporation (IFC) in 2010, revealed that an estimated 50-60% of MSME's on a global level are either under-served or completely un-served.

Financial institutions, globally, are considering MSME sector as an opportunity to capitalize and earn significant return on investment (ROI). Specifically, in the emerging markets the banks/financial institutions are looking to tap the un-served needs in this sector. Banks around the world are looking to emerging markets for new growth opportunities.

For example, in a recent publication "The State of Global Banking - In Search of Sustainable Model", according to Mckinsey estimated that 60% of global banking revenue growth from 2010 to 2020 will come from emerging markets. Within emerging markets, MSME is under served segment. The analysis shows that formal MSME's are more common in high –income economies, but in low and middle –income economies MSME density is rising at a faster pace. The opportunity for banks to serve MSME's in emerging markets is large. In 2010, banking revenue from MSME's in emerging markets totaled $150 billion, or one sixth of all emerging market banking revenues. By 2015, it is estimated this figure will grow by around 20 percent per annum to approximately $367 billion.

According to a World Bank study, MSME's in Pakistan account for 30% of GDP and contribute to 25% of export earnings.

According to a World Bank study, MSME's in Pakistan account for 30% of GDP and contribute to 25% of export earnings. According to Gallup survey in 2004, MSME in Pakistan employed 80% of the non-agriculture labor force. As the sector moves towards achieving growth and sustainability through greater market segmentation and product diversification, enterprise lending has become an increasingly important opportunity for microfinance providers (MFP's).

The MSME sector of Pakistan is heterogeneous, dispersed and mostly unorganized. It includes diverse types of production units ranging from traditional crafts to high–tech industries. MSME's in Pakistan account for 98% of all economic establishments. According to estimates, there are 3.8 million MSME's in Pakistan. These MSME's are concentrated in the trade, services and manufacturing sectors.

IFCs data shows that in Pakistan the micro-enterprises consist of 99% of total MSME's. Unlike SMEs which operates mostly in manufacturing and services sectors, micro-enterprises are involved primarily in trade-related business. With micro enterprises residing at pyramids base, microfinance providers are well placed to meet their funding needs.

While mainstreaming MSME's to operate at optimal levels will require developing a conducing eco-system but access to finance remains a key sector.

Since this segment of the market holds great promise for the country, United States Agency for International Development (USAID) Pakistan has inked an 8 year tenure U.S-Pakistan Partnership for Access to Credit Agreement with Khushhali Bank, to provide access to formal financing facilities for MSMEs and facilitate broad-based economic growth. The dominant aim is to encourage lending to small and medium enterprises (SMEs) in Pakistan. Of the $60 million, $12.1 million is reserved for the private education sector. This partnership will serve to stimulate targeted domestic, commercially viable investments, by mitigating some of the credit risk factors that prevent access to credit by small businesses across the country. The partnership will support inclusive growth and employment across all sectors.

why was JAPAN so unsuccessful in solving DEFLATION over the past two decades?

By Asif Ishaq

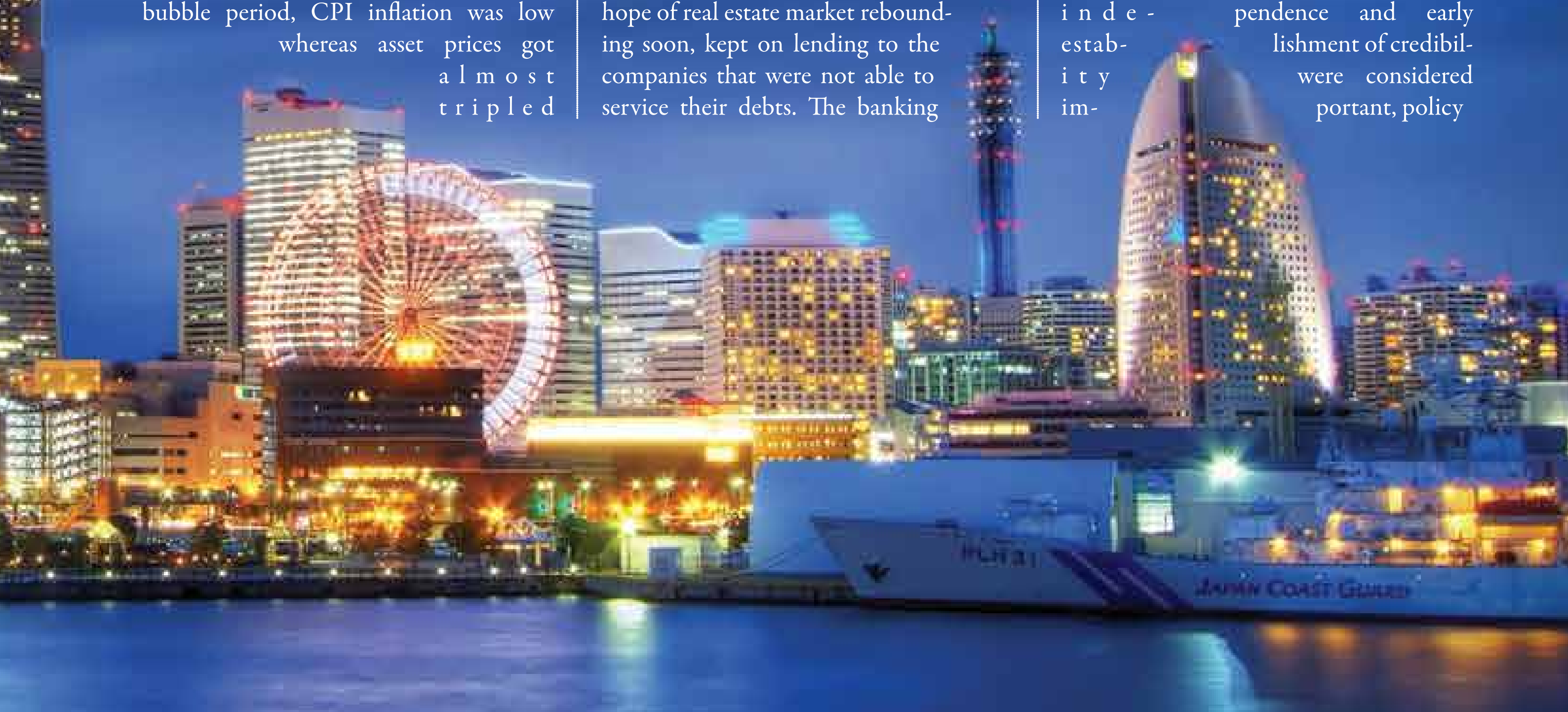
The term lost decade refers to the idle period of Japanese economy where the economic flow became stagnant for more than 10 years. From 1993 to 2003 , the average growth rate was recorded at just above 1% .The inflation rate, in terms of GDP deflator or Consumer Price Index (CPI), had been negative since 1998. Till the end of 2003, the CPI price level was brought down to 3 % by deflation, which is even below than that during the 1997 level, whereas in the same period, there was an increase of 12% in the United States CPI index. From 1997 to 2002, because of deflation along with virtually zero growth, the nominal GDP of Japan reduced by almost 4%, whereas during the same time period, United States witnessed an increase of 25 % in the nominal GDP. There were several problems that had been highlighted as contributing factors in explaining Japan's "lost decade".

The poor outcome in the early stage of Japanese stagflation has been linked with the problems that occurred due to the non-performing loans and the asset burst bubble. By the end of 2003, the stock index and the land prices dropped by one-third of their high prices that were recorded in 1989-1991.The banking crisis of 1997-1998 was a result of the non-performing loan problem and the slow policy responses. The increment in the consumption tax rate and the April 1997's withdrawal of income tax cut is cited as a mistake of the fiscal policy which has brought the economy in trouble.

From 1985 to 1990, it was quite clear that Japan's economy was experiencing a bubble. The land prices and stock prices index grew very sharply from 1983 to 1989. Nikkei 225 rose from ten thousand in 1983 to forty thousand in 1989. Growth rate of economy was reaching 5% compared to the average growth rate of 4% from 1975 to 1989. During this bubble period, CPI inflation was low whereas asset prices got almost tripled within few years. In 1989, the monetary policy was finally tightened. Discount rates increased from 2.5% to 3.25% in May 1989 and then further to 4.25% in December. In August 1990, it rose to 6%, representing a 350 basis point increase in 15 months. Regulatory tightening, along with this hike in the interest rates, was also applied for stopping the increasing land prices, limiting the bank landing to real estate projects along with increasing taxes on the capital gain from investing in land. In 1990, the stock prices started dropping from the very first trading day. Till the summer of 1992, the index had lost around 60% of its peak level. Land prices also started trembling in 1991. The bubble was finally busted.

From 1992 to 95, Non Performing Loans (NPLs) problem started getting worse. Construction and real estate companies were having problems in paying interest on loans as they were becoming bankrupt. The banks, in the hope of real estate market rebounding soon, kept on lending to the companies that were not able to service their debts. The banking problems worsened as no serious measures were taken to address this issue. The Japanese economy severely struck with balance sheet recession and was triggered by a collapse in land and stock prices, causing the Japanese firms to have negative equity (Companies assets were worth less than their liabilities). The authorities failed to deal with the actual causes for this downfall rather focused on tackling the symptoms.

In April 1998, when the newly independent bank of Japan started its operations, with new governor and board members, hopes were high for positive outcomes. However, after 5 years, the bank not only lost its credibility but also suffered loss of confidence. The economic conditions were misjudged by the policy board members, also the governor and fellow board members refused to co-operate with the government and took an independent view whereas cooperation was seriously required in these times of prevailing economic situations. Since independence and early establishment of credibility were considered important, policy



"From 1985 to 1990, it was quite clear that Japan's economy was experiencing a bubble" actions became conservative, tentative and lacked boldness and self confidence. The restructuring also failed.

In February 1999, the zero interest rate policy (ZIRP) got introduced; it was likely to continue as long as the "deflationary concern was dispelled." Unfortunately, in August 2000, the policy got lifted. However, in March 2001, it got introduced once again, and was to continue till "the inflation rate became stably above zero."

In October 2003, the conditions were elaborated even further, at this point the necessary condition in order to get out of ZIRP was that the rate of CPI inflation should either be zero or above for some time for a few months or so & there was no forecast which would show that the economy would fall back to deflation. Knowing the fact that at the time when ZIRP got terminated, economy was still suffering from deflation and that the ZIRP had to be re-instated, the interest rate hike of August 2000 was clearly a mistake. Also BOJ lowered the interest rates too little and too late (1991 to 1995).

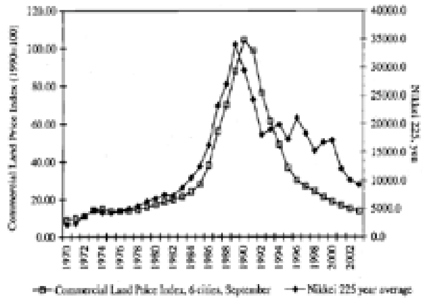
After the failure of Zero interest rate policy, Quantitative easing was introduced and from March 2001 to 2006 and it was expanded in several steps. "In August 2001 the amount of BOJ outright purchases of long-term government bonds was raised from 400 billion yen per month to 600 billion yen per month.

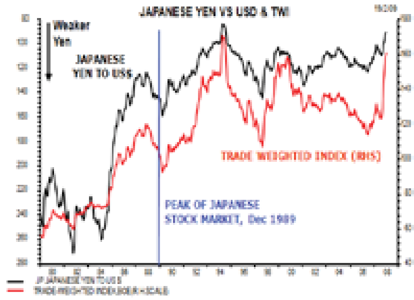
At the same time, the current account target was raised to 6 trillion yen (or about 2 trillion yen excess reserves), which was further increased to 800 billion yen in December 2001, 1 trillion in Feb 2002 and then to 1.2 Trillion in October 2002. The current account target was also raised to 10–15 trillion yen."

Although quantitative easing got expanded by these steps, where the amount for long-term bonds in October 2002 stood at 1.2 trillion from 400 billion yen per month in September 2001, deflation became worse, indicating that quantitative easing did not work and it failed as well. The main reason for its failure was that when the money supply was increased by the regulatory authorities, they were of the opinion that this act will be amplified by the banks and they will start extending loans to corporate and the other sectors of the economy but that did not happen. Instead of supporting the step taken by the regulatory authority, the banks maintained their conservative approach towards extending loans and advances.

In order to overcome deflation along with promoting an independent central bank, Inflation targeting was also proposed. However, the inflation targeting was opposed by Bank of Japan. The economists in the Bank argued that, "to get out of deflation there were no clear instruments, and a mere announcement without instruments would not convince market participants to change their inflation expectations." Others in the Bank, on the other hand, suggested that "the commitment to keep the zero interest rate policy until the inflation rate becomes stably above zero has similar effects to inflation targeting." The Policy Board members were cautious, had mainly followed the consensus, and were unwilling to adopt "unorthodox" methods, which points towards another reason why the Bank of Japan failed to overcome deflation. They made mistakes at a technical level regarding interest rates, money supply etc.

Furthermore, analyzing the period from 1997 to 2010, Japan's GDP growth turned negative, shrinking the economy itself. Japan's government hiked the consumption tax by two-thirds, from three percent to five percent in 1997, while slashing personal income taxes by another 32 percent, corporation taxes by another 38 and inheritance taxes by another 48 percent. In other words, from 1997 to 2010, the government slashed progressive and proportional income, corporation and inheritance taxes by nearly thirteen trillion yen while hiking consumption taxes by more than six trillion yen. What can you expect, other than for consumption to shrink further, when a government continues to slash taxes on richer citizens and larger corporations, who spend the smallest portion of their incomes and wealth on consumption and continue to hike taxes on poorer citizens and smaller businesses, who spend the largest portion of their incomes and wealth on consumption? What the government did was even





better! It curtailed consumption growth altogether, to zero percent, and with no annual growth in domestic consumption, suppliers cut their capital formation by three percent annually while shrinking their inventories by 48 percent annually. Since consumption, capital formation and inventory increase comprised 99 percent of Japan's economy during this period and the latter two are driven by consumption which was no longer growing, there was no way that Japan's economy could grow.

From 1992 to 1995, despite weak economy, the exchange rate kept on getting appreciated with no apparent macro-fundamental reasons for it. It moved to 80 yen per dollar during the spring of 1995 from 100 yen per dollar. At this stage, it was very much required for the exchange rates to be depreciated for controlling the declining situation of the economy, which was generally avoided.

This appreciation in the exchange rate as highlighted by the economists "dampened an expectation of early recovery and contributed to disinflation and then deflation."

Several debates have been carried out, focusing on what the Bank of Japan could have done for preventing deflation to occur and to get worse. In the studies at

"Federal Reserve Board", many academics and policy makers have argued that "the Bank's actions were too little & too late, at least in retrospect, in preventing deflation from emerging and fighting out of deflation."

LESSONS TO BE LEARNT FROM JAPAN'S LOST DECADE :

- In order to avoid a situation like that of Japan, monetary policy is an important measure. It is not just limited to money supply and interest rates but the disposal of failed banks as well as debtors.

- The Sooner, the better if you cannot avoid the failure. Japan's total bad debts were around 12 Trillion Yen in 1991. Since the Ministry of Finance did not dispose the loan, they became huge as the land price collapsed, around 100 trillion yen in 2003.

- After the crash, money should be eased promptly by the central bank. Because the Bank of Japan was unable to stop the bubble and when it burst in January 1990, the bank did not change the very monetary policy. When the policy got eased in July 1991, BOJ was too cautious due to the fear of another bubble. As a result, the prices of real estates and stocks fell to less than 1/5 of their peak.

- "Emergency fiscal stimulus" was repeated by the Japanese government, trying to rescue the economy, which resulted only as the vast amount of government deficit, 180% of GDP. Since many companies and banks were insolvent, the money supplied by the government was used to make up zombie banks and companies who looked alive but were dead in reality.

- For restructuring, money supply can help whereas interest rate is not very effective under deflation. In 1999, the interest was reduced to zero by BOJ and that did not improve the ongoing crisis as the real interest rates were high under deflation. BOJ began with the "quantitative easing" from 2001, policy that supplied large amount of money, which decreased the pain of the surgery by banks and companies to restructure themselves.

> "From 1992 to 1995, despite the weak economy, the exchange rate kept on getting appreciated with no apparent macro-fundamental reasons for it"

Japan's economy is not doing very well recently. Since the asset bubble burst of the early 1990s, the country is suffering a slow growth rate, even negative, along with the price deflation. Economic statistics remain distressed, and above all, the nation's mood, in terms of both producers as well as consumers has turned pessimistic. Some are still of the opinion that Japan is a high income country, whereas others say transition to a new economy is getting prepared under a recession and some companies are doing very well. We cannot ignore the fact that Japanese economic performance had been less than expected in the last decade or so. The Japanese monetary authorities have faced with two basic problems due to the recent history of Japanese monetary policy. First, Japan was left in a prolong deflationary environment due to the BOJ's policies where lowering the short-term interest rate remained no longer efficient and effective as the floor of zero was hit by the policy rate.

Second, Japanese monetary policy for the past, left the bank with severe credibility problems. The public as well as the markets were unconvinced that the country's monetary policy can be committed to future expansion, returning the economy to health again. Due to these two problems, Bank of Japan was presented with particular challenges for finding solution in order to get the economy out of deflation quickly. The Bank's decision of raising the discount rates in May 1989 was criticized as a step taken too late. The Bank's focus on limiting yen appreciation in the second half of the 1980s accommodated asset inflation and made it difficult to achieve a soft landing in 1989. The Bank was criticized for overly tight policy in the first half of the 1990s. Once policy shifted to ease after 1994, the Bank was criticized for not more aggressively increasing monetary growth and preventing a slow downward drift in prices over the decade.

The reasons why Japan has been unsuccessful in solving the problems of deflation for the past two decades can be summarized as follows:

- Lack of political/economic leadership.

- The policy board members were cautious and mainly followed the consensus and were unwilling to adopt "unorthodox" methods.

- They made mistakes at a technical level (regarding interest rates, money supply etc.).

- Japan was in a "balance sheet recession" and the authorities tackled the symptoms not the causes.

MONEY LAUNDERING & TERRORIST FINANCING:

Understanding the Trends & Typologies

By Subtain Raza

Over the last three decades phenomenal growth of financial services has been observed due to advancement in technology and globalization. This growth has led to increased cross-border activities to boost up global financial intermediation. But on the other side, this development has also promoted transnational organized crimes including Money Laundering and Terrorist Financing (ML/ TF) enacted by underground economies.

Money laundering (ML) is defined as the process whereby criminals attempt to obscure the illegal origin and/or illegitimate ownership of property and assets that are the results or proceeds of their criminal activities. In Financing of Terrorism (FT) both legitimate and illegitimate money is characterized by concealment of the origin or intended criminal use of funds. The term Terrorist refers to any person who commits, or attempts to commit; participates as an accomplice, organizes or directs others or contributes to terrorist acts directly or indirectly.

Money laundering and terrorist financing are making global threats to international peace and security which could destabilize world's development and progress.

The United Nations 2000 Convention Against Transnational Organized Crime, also known as the "Palermo Convention," defines money laundering as, "The conversion, transfer, concealing, disguising, acquisition or possession of property associated with illegal origins or intents/acts of criminals."

Financial Action Task Force (FATF) has designated the categories of offences e.g., terrorism, Illicit trafficking in narcotic drugs & arms, corruption and bribery, counterfeiting currency, smuggling, fraud, piracy, extortion and insider trading and market manipulation etc. which heavily contribute to Money Laundering & Terrorist Financing.

The Difference between Money Laundering and Terrorist Financing

The fundamental difference between terrorist financing and money laundering involves the origin of the funds. In Terrorist financing, the miscreant uses funds for illegal religious, political or specified purposes but the trail of money might not necessarily come from donations, governmental covert funds or aid from agencies. Terrorist financing may be supported both by legitimate and illegitimate proceeds. Money laundering always involves the proceeds of illegal activity. The rationale of laundering the money is to enable the money to be used with lawful rights. From a technical perception, frequent laundering processes used by terrorists and other criminal organizations are similar. Although it would seem commonsensical that funding from legitimate sources does not need to be laundered, there is a need for the terrorist group to obscure the link between it and its genuine funding sources.

Terrorists and money launderers use similar methodologies to rout their money through various channels to avoid detection, such as placement, structuring/layering and integration the payments to avoid reporting and underground banking, such as the ancient system of Hawala or Hundi.

Stages In Money Laundering & Terrorist Financing Process

Money laundering & Terrorist financing often involves a multifaceted series of transactions that are usually complicated to trail. Generally, three phases of Money laundering are involved in this process.

Placement:

The physical placement or disposal of cash or other assets derived from criminal activity. While using placement mode, the money launderer instills the illegal proceeds into the financial channels or financial system. The illegal proceeds may be placed in financial institutions, casinos, shops and other designated non-financial businesses, both national and international. In this stage the transactions may be processed such as: Breaking up large amounts of cash into unidentified sums and depositing them directly into various bank accounts. Channelizing cash across borders to deposit in foreign financial institutions or to buy high-value goods—such as artwork, antiques, and precious metals and stones— that can then be resold for payment by other instruments e.g. cheque or bank transfer.

Layering:

The severance or partitioning the illicit proceeds from their origin by layers of financial transactions with motives to conceal the source of the proceeds. This particular stage is intended to reshape the proceeds of the crime into another form and creating complex layers of financial transactions to avoid the audit trail, supply channel and ownership of funds.

This stage can involve processes such as: Frequently sending wire transfers, converting deposited cash into monetary instruments (e.g. traveler's cheques), reselling high-value goods and prepaid access/stored value products, investing in real estate and legitimate businesses, injecting money in investments such as stocks, bonds or life Insurance and maneuvering shell companies or other structures to obscure the ownership of assets.

Integration:

Production of apparent legitimacy to illicit proceeds through the re-entry of the funds into the economy by showing it to be normal business activities or personal transactions. This stage entails using laundered proceeds in seemingly normal transactions to create the perception of legitimacy. The parties involved in laundering may choose to input the funds in real estate, financial ventures or luxury assets. A successful integration transaction makes it difficult to distinguish between legal and illegal wealth. This stage provides a launderer the opportunity to increase his wealth with the proceeds of crime.

Typologies In Money Laundering & Terrorist Financing

Basically, Typologies involve the study of methodologies, techniques and trends of money laundering and terrorist financing. As a series of ML or TF arrangements are conducted repetitively in a similar manner or using the same methods, we notify them as a "typology". The FATF & APG undertake comprehensive typologies research to better understand the money laundering and terrorist financing environment. The following examples taken from APG research sheds light on few key money laundering and terrorist financing methods, techniques, schemes and instruments.

Money Exchanges / Converting Cash:

This typology is being used to aid the process of smuggling to another jurisdiction or to exploit low reporting requirements on currency exchange houses to minimize risk of detection.

Use of Couriers for Currency Smuggling:

Illegal movement of currency to avoid transaction / cash reporting measures.

Smurfing:

Using a novel technique involving frequent transactions (deposits, withdrawals, transfers) to avoid detection threshold reporting compulsions.

Use of Financial Instruments:

Use of credit cards, cheques, promissory notes, etc. to have funds held in a financial institution, often in another jurisdiction.

Purchase of High Value Commodities:

A method to purchase intensive high value products like gems, precious metals, etc. to mask the ownership or move value without detection and avoid financial sector AML/CFT measures – e.g. movement of diamonds to another jurisdiction (a detailed presentation in Hollywood Movie "The Blood Diamond").

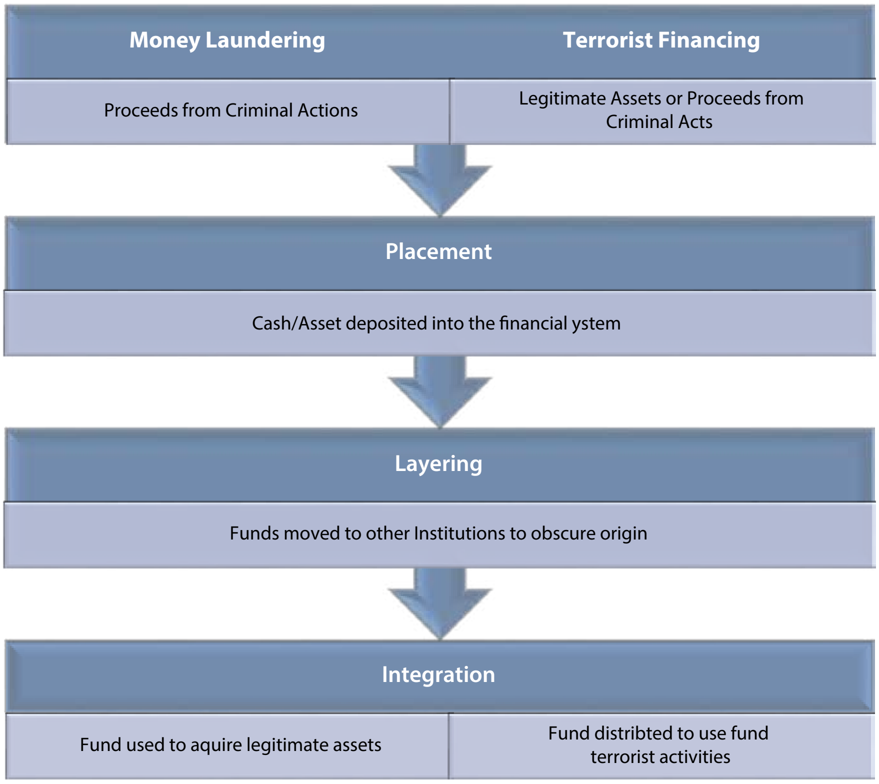
Investment in Real Estate, Race Horses and Vehicles:

Illicit proceeds are invested in high value negotiable goods to take advantage of reduced reporting requirements to make the source of proceeds of crime incomprehensible.

Mutual Commodity Exchanges:

Motive of this methodology is avoiding the use of money or financial instruments

The Processes of Money Laundering and Financing of Terrorism



"Underground banking systems are being used to remitt money. Various case studies revealed the features that most of money launderers and terrorist financers use this mode of money for remittance because it is the most confiden-tial method to move value without detection and to obscure the iden-tity of those controlling funds"

in value transactions to evade financial sector AML/CFT measures – e.g. a direct exchange of heroin for gold bullion.

Wire Transfers:

This typology is assisted by electronically transfers. The funds are routed between financial institutions and often to another jurisdiction to avoid exposure and confis-cation.

"Money Laundering and Terrorist Financing crimes are emerging abruptly impacting potential negative consequences on the economic, polit-ical and social pro-gress."

Alternative Remittance Channels:

Underground banking systems are being used to remitt money. Various case studies revealed the features that most of money launderers and terrorist financiers use this mode of money remittance because it is the most confidential method to move value without detection and to obscure the identity of those controlling funds. These channels are eye-catching to terrorist financiers. Al Qaeda successfully instigated its operations because of effective transfers of money by hawala/hundi/alternative remittances before September 11, 2001.

Trade-based manipulations:

To assist the agenda of money laundering and terrorist financing, the malpractices used by male factors are invoice manipula-tion, over/under invoicing and alterations in trade finance routes and commodities to avoid financial transparency laws and regulations.

Gambling & Gaming activities:

These activities involve buying tickets from legitimate players; using casino chips as currency for illicit transactions, using online gambling to obscure the source of funds. Most activities are performed in casinos, horse racing, internet gambling etc.

Exploitation of (NPOs) non-profit organizations:

Terrorist funds and other illegal proceeds may be legitimized by using the shield of (NPOs) non-profit organiza-tions.

Investment in Stock Exchanges or Capital markets:

There are motives to avoid exposure of proceeds of crime by purchasing negotia-ble instruments available in capital markets.

Intermingling of legal business with illegal activities:

To obscure the source of funds this is an instrumental step by money launderers to combine the proceeds of crime with legitimate business monies.

Use of Front/Shell Companies:

Presently, launderer and terrorists are using these bodies to avoid the identity of persons controlling funds and take advantage of relatively low reporting requirements.

Trust Company Service Providers:

These are persons and entities that professionally create, administrate or manage the corporate vehicles. These vehicles are used to obstruct the access to people controlling funds.

Use of Trusts:

The term trust expresses the legal relationship that is accorded by a person (the "settlor") where assets are handed over under the control of another person (the "trustee") for the benefit of one or more beneficiaries. This mode of involvement evades the identity of persons controlling illicit funds.

Use of "Gatekeepers" or Professional Services:

The involvement of lawyers, accountants, brokers etc. with intentions to hide and guard the beneficiaries and the source of illegitimate funds.

Alternative Delivery Channels:

Exploiting the new payment technologies for money laundering and terrorist financing is another typology with impending threats. Examples include computer, ATM cards and cell phone-based remittance and payment systems.

Money Laundering and Terrorist Financing crimes are emerging abruptly impacting potential negative consequences on the economic, political and social progress. There is a dire need for countries to have more strong anti-money laundering policies, regulations and independent authorities to cope with this concern. Internationally, effectual efforts e.g., contributions from FATF, IMF, WB, and UNO have been launched to fight against ML/TF and most of the countries have shown exceptional cooperation in connection to devise monitoring and surveillance systems for financial institutions, cross border money & drug smuggling, regulatory measures and international cooperation to prevent, detect and respond money laundering and terrorist financing.

As financial institutions have more diverse products like customer accounts, wire transfers, correspondent banking and foreign exchange services, etc. consequently there are more concerns regarding exploitations of these entities. Therefore, more dynamic efforts like strengthening the AML/CFT policies, reporting officer designation based on experience and qualification, co-operation with the supervisory authority, effective tools for customer due diligence, rapid monitoring and responding to suspicious transactions and AML/CFT employee training program can play their considerable role in combating money laundering and terrorist financing.

RISK MANAGEMENT & CASH-RELATED RISKS

GENERAL POINTS: AN ANALYTICAL MODEL

By Helena Tejero

The term risk (from the Italian word risico or rischio, which in turn comes from the Classical Arabic word rizq, means what providence holds in store) refers to any contingency that, if it were to materialise, would cause harm or loss. Risk is a fundamental concept in any management process today, given how closely it is tied to organisation's business activity. This is also true of a central bank's activities. Indeed, it could be said that no activity is free of risk. Realising this, since their inception central banks have developed various mechanisms to protect against such eventualities, gradually giving shape to a modern, proactive and systematic risk-management discipline. Risk management today comes under the umbrella of what is termed corporate governance, and it aims to formalise and consolidate the procedures of identifying, assessing, responding too and monitoring risks so as to minimise their impact on operations.

Although there is no universal consensus among central banks about the range of possible contingencies, two categories are often distinguished: financial risks (market, credit and liquidity risks) and operational risks. The former derive from possible financial events that may have a negative impact on the value of financial assets. By contrast, operational risks relate to harm caused by inadequate internal processes (or failures), people or systems, or as a result of external events.

All central bank's activities can be affected by operational factors, whether internal or external, and these may translate into a loss. One of a central bank's most significant tasks is cash management. This involves putting cash into circulation, and the withdrawal, exchange, safekeeping and recycling of legal tender banknotes and coins, while ensuring their quality and authenticity. It also entails supervising and monitoring the economic agents and entities participating in the cash cycle, and in cash processing and handling.

In 2005 the Banco de España set up a system to identify, evaluate and adopt the necessary measures to mitigate operational risks, and to prioritise resources, by establishing the most suitable policies, methodologies, procedures, tools and organisational structures. All the Bank's organisational areas apply this model, in particular the Cash and Issue Department, which is responsible for cash management.

i) Functions, processes and activities

The starting point for operational risk management systems is an inventory of the functions, processes, and activities that each organisational area undertakes, and which make up each unit's process map. This preliminary step is necessary in order to identify the risks to which the exercise of this responsibility is subject. An example of the main elements of a possible business process description is given below.

Cash management functions and processes

Cash management is a core activity of any central bank, and the members of the European System of Central Banks are no exception. The functions of the Bank is specifically entrusted within this context:

- Executing the country's issuance policy and decision-making, in coordination with the European Central Bank (ECB), on the quantity of banknotes to manufacture and who is responsible for producing them, and the general policy of putting banknotes into circulation and withdrawing them.
- Managing and controlling the putting into circulation of coinage on behalf of the State Treasury.
- Estimating future banknote and coin needs.
- Determining the general characteristics of automated banknote handling, verifying banknote authenticity, sorting banknotes by condition, destroying banknotes unfit to return to circulation, and checking the quality of the cash in circulation.
- Coordinating the application of the anti-counterfeiting strategy.
- Storing the banknotes in the logistic stock and the Eurosystem strategic stock, owned by the ECB, and manage international shipments.
- Conducting cash transactions with the public sector, financial institutions, and the public.

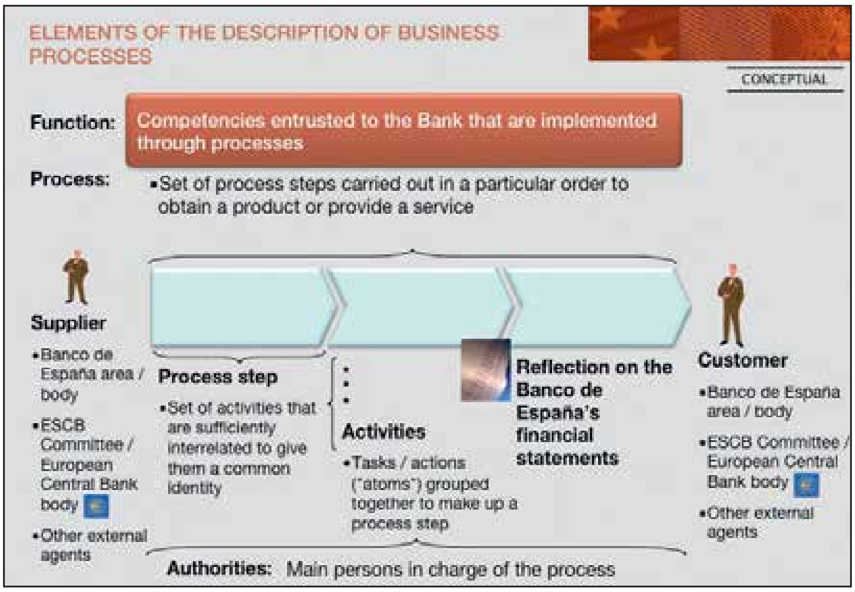
Within the huge range of possible organisational models, to fulfil its role, a Cash Department may be subdivided into the following areas or divisions:

- Issue Division, which implements the central bank's issuance policy;
- Custody Division, which manages daily operation of putting into circulation and withdrawal from circulation of banknotes and coins, with private individuals and the banking sector;
- Industry and Technology Support Division, which supports the divisions listed above and manages human resources, infrastructure, and the equipment entrusted to the department;
- External Relations Division, which coordinates and manages general aspects of the department's external activity and its relationships with cash professionals, and
- Risk, Internal Control and Security Division.

In order to control risks appropriately, each division implements a series of mitigating measures, which in turn, are backed up by the checks performed by the Department responsible for the Bank's internal controls.

A review of the activities performed makes it possible to identify the number

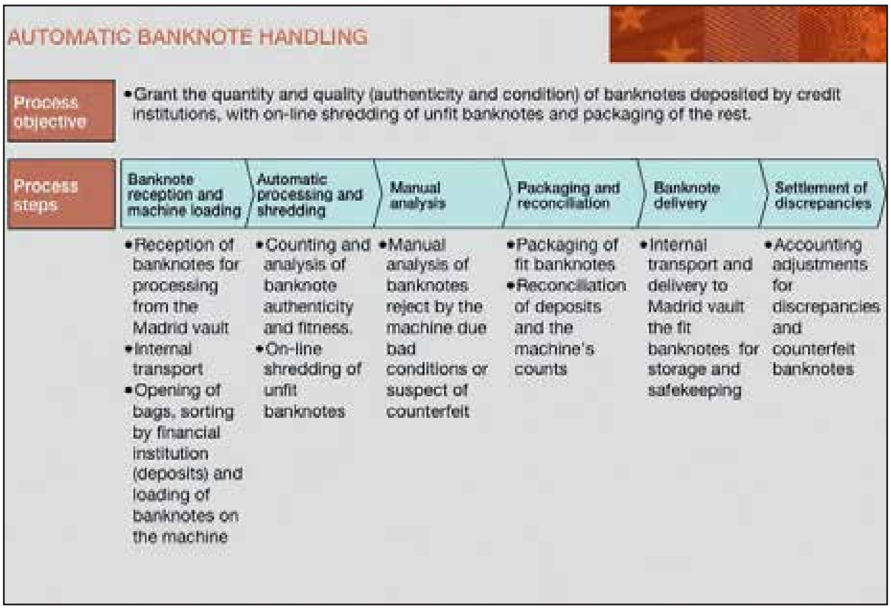
Processes description methodology



Source: Banco de España.

of processes (not usually less than 20 in a Cash Department) covering all the relevant workflows for the execution of the tasks entrusted to the department. By way of illustration, a description of one process-automatic banknote sorting-is described below.

Automatic banknote sorting process



Source: Banco de España.

ii) Identification of risks

The identification of the inherent risks of any activity is based on an analysis of the possible contingencies that may affect its functioning. This involves studying various scenarios by asking the question "what if...?" For example, what would happen if a business process failed or was inappropriate? What would the consequences be in economic terms, for the Bank's reputation, and/or its failure to meet its objectives? What is the likelihood of this happening?

In order to fully identify all the possible contingencies, the model classifies a number of scenarios. Thus, as well as considering the possibility that a process fail, it is assessed what would happen if there were faults in the systems or infrastructure, internal or external malicious acts, labour-related incidents, or more extreme events.

In the cash management area there is a wide range of possible events, such as under or overestimating the number of banknotes to produce, faults in banknote handling machines, misappropriation of banknotes, occupational accidents during coin handling, disasters befalling the reserve vault, or the robbery of a cash-in-transit van.

From the foregoing it may be deduced that the reasons why a risk materialises may be external, i.e. beyond the Bank's direct control, such as natural forces or acts or omissions by third parties. For instance, new regulations on banknote use may have a significant impact on future demand, which could result in the number of banknotes to produce being underestimated, or criminal organisations may emerge that pose a threat of largescale theft. Risks may also be internal, such as the acts or omissions of staff, shortcomings in the design or execution of processes, and systems malfunctions.

While operational risks are inherent to any activity, i.e., they are always present, organisations have developed relatively effective systems to protect against them, by addressing their root causes. Therefore, one of the most important steps in risk management is the identification and implementation of controls, i.e. specific measures adopted with the purpose of mitigating risk: either to avoid an event's occurring (frequency), or to reduce the harm it would do if it did ultimately occur (impact), or to act on both aspects. For

> "In 2005 the Banco de España set up a system to identify, evaluate and adopt the necessary measures to mitigate operational risks, and to prioritise resources, by establishing the most suitable policies, methodologies, procedures, tools and organisational structures"

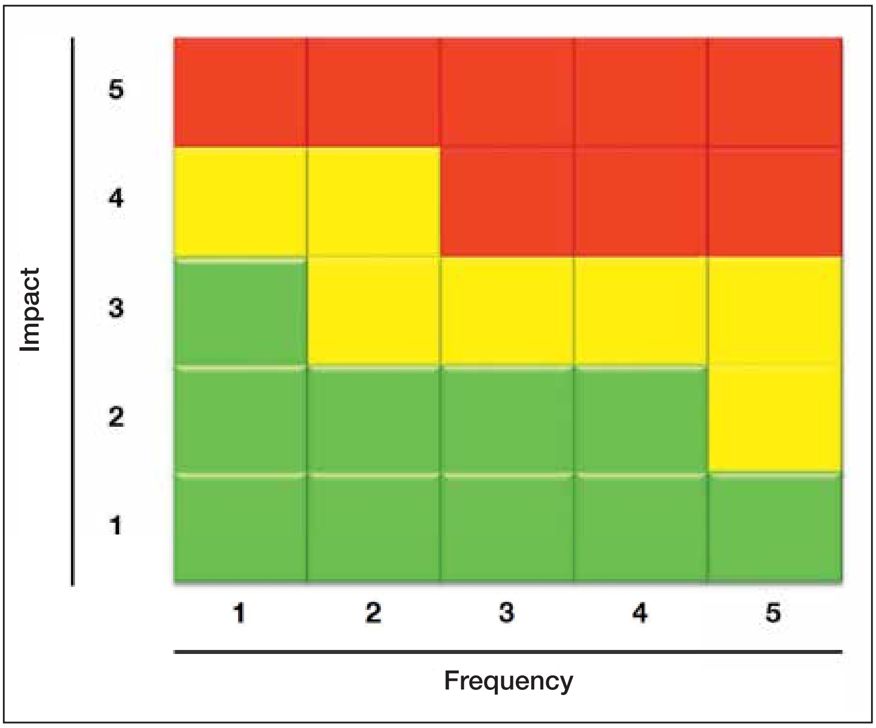
example, to reduce the possible impact of errors in cash deposits an "unprocessed banknotes" system may be implemented whereby financial institutions expressly, irrevocably and unconditionally waive the right to be present during counting and validation and wholly accept, without the possibility of any claims, the count performed by the central bank and the corresponding debits and/or credits to settle any differences that may potentially arise in counting. Alternatively, to reduce the frequency of possible shipment transport-related contingencies a system of auxiliary deposits could be set up by bringing together a number of credit institutions under the management of one entity that, using the services of an agent specialising in funds transport, storage and handling, receives a quantity of banknotes from the central bank in the form of a deposit sufficient to meet the needs of the financial centre in which it operates.

It should be noted that the effectiveness of the controls varies according to the moment they are applied, their level of automation, and their scope. Thus, the controls may be preventive (anticipating the risk event to avoid its occurrence or to minimise its impact, for example, the "four eyes" principle); corrective (put into operation once the event has materialised so as to minimise its impact, such as business continuity plans) or predictive (to predict the occurrence of events, such as the use of statistical models to predict the future demand for cash). Moreover, controls may be automatic (for example, banknote processing machines) or manual (presence of security personnel); or they may be applied to all operations (verification of the contents of all the bags of coins) or only to a sample (verification of the contents of a bag selected at random).

iii) Risk assessment

Not all risks are equally important and not all controls mitigate them in the same way. Moreover, unlike some other types of risks, such as financial risks, there is no link between operational risk and profitability. Therefore the "appetite" for operational risk is zero, although there may be a degree of tolerance or acceptance of it. Therefore, the management system incorporates uniform rating scales for the organisation as a whole and a tolerance policy in order to determine the relative importance of the risks and establish

Risk tolerance matrix



Source: Banco de España.

levels of action and thresholds at which risks are to be raised to the relevant decision-making bodies.

All the risks are evaluated based on 1) impact or damage they may cause –whether financial, reputational for the Bank and/ or affecting the achievement of its goals and 2) the frequency with which they may arise. Thus, for each event identified the following questions are asked: i) if the event occurs, what financial or reputational impact or failure to achieve goals may occur-measured qualitatively from 1 to 5, where 5 is the maximum-considering the effectiveness of the existing controls? and ii) how often could this risk materialise?, measured qualitatively from 1 to 5, where 5 is the most frequent.

Risks thus measured are plotted on a Risk Tolerance Matrix (see figure below). Operational risks in the green area are considered, exante, tolerable and do not require an action plan. However, business areas will inform the Bank's Risk Management Committee of risks in the yellow or red areas, and propose mitigation measures, so that the body can approve or accept the residual risks.

Bearing in mind the financial and reputational impact of many of the activities associated with cash management, it is logical that on an aggregate scale, the operational risk exposure is significant.

This is all so, in those cases where the control environment, while being extremely effective at reducing the probability of occurrence to levels close to zero, is unable to prevent significant damage being caused. Imagine, for example, that someone gained access to the security features incorporated in banknotes to allow their counterfeiting, or that a shipment van was attacked by terrorists or suffered a serious accident, or that the banknote vault were to flood or have a fire, or that human capital were lost without an effective succession plan. Although these situations all look highly unlikely given the control measures in place, their occurrence could cause very significant losses.

iv) Handling and monitoring of risks

However, not all risks are high impact or low probability or have a robust control environment. It is therefore important to analyse possible mitigation strategies and programmes to reduce the severity and frequency of the contingencies identified.

For example, a natural disaster that could render the site holding a portion of the bank's reserves inoperative. To address this possible eventuality, business continuity plans could be drawn up to allow the most critical operations to be resumed on an alternative sites, such as services to credit institutions, including both lodgements and withdrawals of banknotes and coins. We could also envisage more cash than recorded being delivered as a result of human error and that someone might steal the difference. In this case, automated banknote traceability systems could be used. The use of money bags marked with bar codes or similar means of identification would allow their location within the internal distribution system to be ascertained at all times. This could also bring other benefits, such as better control over incomings and outgoings of money bags.

However, despite the attention paid to risk mitigation, changes can occur in the environment and risks may materialise. If they do, it is important to register the loss events that occur and quantify their impact, as well as investigating their underlying causes so as to prevent a recurrence, where possible. It is also crucial to compare the information derived from these facts with the exante risk identification and assessment in order to adjust the impact and/or frequency of occurrence to the reality of the facts. Equally, it is possible to compare the goodness of the results of the internal self-assessment with the experience of other central bank working groups specialised in operational risk, such as the International Operational Risk Working Group, of which more than 50 central banks are members.

Thus, managing risk is not a one-off activity, but must be carried out proactively on an ongoing and systematic basis to avoid daily activities being affected by contingencies and enable immediate action to be taken when necessary.

Central banks in general and their cash management areas in particular are exposed to significant operational risks. The "appetite" for risk being extremely limited, good practice has been developed for efficient operational risk management. These practices need to cover at least the following five stages:

- understanding the functions entrusted to the organisation and the activities deriving from them;
- identification of possible eventualities affecting their operations;
- determining the relative importance of each;
- decision-making on the most effective mitigation strategies; and
- ongoing monitoring of both the environment in which they operate, the risks and controls, and incidents that occur, both internally and in cooperation with other central banks.

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ECONOMIC GROWTH

in Pakistan

By Salman Ahmed Shaikh

If we look at the history of economic development in Pakistan, the country witnessed its first major high economic growth phase in the 1960s. The country was able to create an industrial capitalist class, but later on, it was found that this growth only benefited a very specific minority class and created huge income inequality. After experimenting with nationalization in the 1970s, the high growth phase returned in the 1980s. The economy experienced high growth rates with foreign aid inflows, but this time, it was not backed by the same productivity growth as in the 1960s.

In the later part of the 1980s, Pakistan went to the International Monetary Fund (IMF) and The World Bank for Structural Adjustment Program (SAP). IMF recommended privatization, diminished role of government in running businesses, deregulation, and liberalization. The plan also pushed the country to remove quotas on international trade, lower tariffs, expand list of importable items, reduce subsidies and increase indirect taxes. These SAPs brought negative impact on growth, inflation, income distribution, the social sectors, and poverty in the 'lost' decade of 90s according to Akber Zaidi in his book "Issues in Pakistan Economy".

Dawn of the new millennium brought fresh investment, capital and huge inflow of remittances. However, the economic management during the first decade of the new millennium could not convert this third phase of high economic growth into a sustainable process by implementing structural reforms.

After World Trade Organization (WTO) regulations were put in place, the global trade is now increasingly replacing quota-based trade restrictions with tariffs. Trade policy cannot be made in a vacuum and using import substituting industrialization and maneuvering exchange rates cannot help to replicate similar growth levels of the past.

Apart from the structural change in production and employment, there also has been a change in the exports and imports mix and diversification in import sources and export destinations. Non-Discriminatory Market Access (NDMA) status to India, Generalized System of Preferences (GSP) Plus status extended to Pakistan and prospects of new trade ties with Central Asia especially in the energy sector present new prospects as well as challenges for Pakistan. On the other hand, the country needs to diversify its export markets especially if the economic crisis continues in Europe. But, amidst these opportunities, weak law and order situation and energy crisis has led to not only capital flight and brain drain, but a lot of established entrepreneurs have shifted their production facilities to countries like Bangladesh and Turkey.

1. Challenges for Pakistan's Exports

Energy Crisis

Energy crisis in Pakistan has worsened especially since 2005. It has led to loss of potential output, increased incidence of manufacturing sector unemployment, cost push inflation, capital flight, low manufacturing capacity utilization and loss of export markets. The contributing factors to the crisis include inefficient energy mix, price distortions and low investment in alternate energy. The short term measure by the government to absorb loss from price distortions created by an inefficient energy mix has resulted in the ballooning fiscal deficit.

For estimating the cost of energy on output in Pakistan, a study at Pakistan Institute of Development Economics (PIDE) estimated the cost of unserved energy using primary data from firms. According to their estimates, the overall industrial sector loss ranges between Rs 269 and Rs 819 billion. The figure roughly equals 1% to 3% of total GDP per year.

Furthermore, oil related imports of Pakistan now exceeds one third of total imports. Rising oil prices have resulted in higher imports, balance of payments deficit, decrease in value of rupee and soaring inflation.

It is now appreciated by almost all circles that at current consumer prices for electricity, the energy mix has to be modified. This modification in mix requires new projects and these projects require huge amount of financing. But, due to delay in tax reforms and administration, Government is already cash starved with mounting fiscal deficit and it cannot sustain the subsidies.

Since energy is a major component of cost of production and transportation, it leads to cost-push inflation spiral in the overall economy. Hence, the final export price of finished goods especially in the wake of free trade after WTO rules is now competitive with the rest of the world.

Law & Order Crisis & Weak Governance

Security of property rights has been one of the most important determinants of why some countries developed quickly than others. In Pakistan, return to democracy in 2008 after the military rule ended was hoped to change matters. But, political forces in capitalistic democracy contributed in maintaining the status quo by providing token benefits to their voters and by creating and encouraging an environment where the common public has no choice than to join hands and support them to safeguard their private property rights. One of the reasons behind capital flight, brain drain and lack of domestic and foreign investment is the inadequate provision of civil as well as private property rights in Pakistan.

2. Macroeconomic Imbalances

Low Savings and Investments Ratio

Economic growth literature highlights the importance of capital formation, complimentary investments and physical and social infrastructure. Pakistan is one of those countries that have very low savings rate. Pakistan has one of the lowest investments to GDP ratio in the world. One of the prime reasons of low investment to GDP ratio include the high cost of doing business which includes i) high taxes in the formal sector, ii) supply side bottlenecks, iii) weak law and order situation and iv) weak legal system and enforcement.

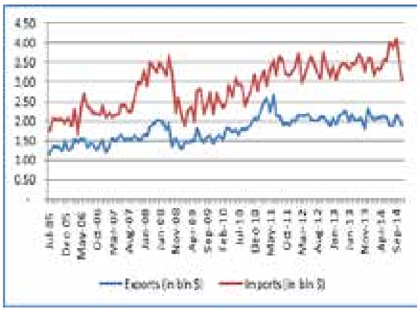
High Trade Deficit

Pakistan has achieved steady increase in exports in absolute terms, but the imports have surged steeply than the exports. **Figure 1 shows that the gap between exports and imports is increasing as represented by the vertical distance between the two curves.** The trade deficit has widened in 2005 and 2008 when the world oil prices swelled. However, with the continuation of energy and security crisis and rapid decline in foreign investment, the trade deficit has continued to rise. In recent quarters, the trade deficit is narrowing down as world oil prices continue to decline.

Rapid Rupee Depreciation

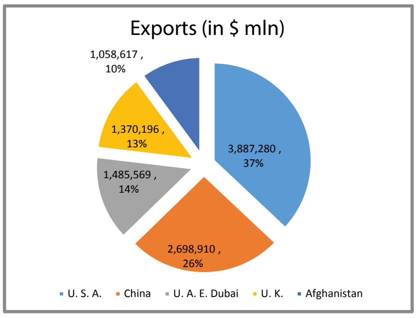
Rupee has witnessed a free fall during 2008-13 than in the almost twice as long Musharraf era before that. In FY08, PKR/USD exchange rate was hovering around PKR 60. But, in 2008 rapid depreciation of rupee began. The chief reasons

Figure 1: Imports and Exports (in bln $) During 2005-2014



Source: Pakistan Bureau of Statistics

Figure 2: Top Export Markets by Size of Exports for FY13



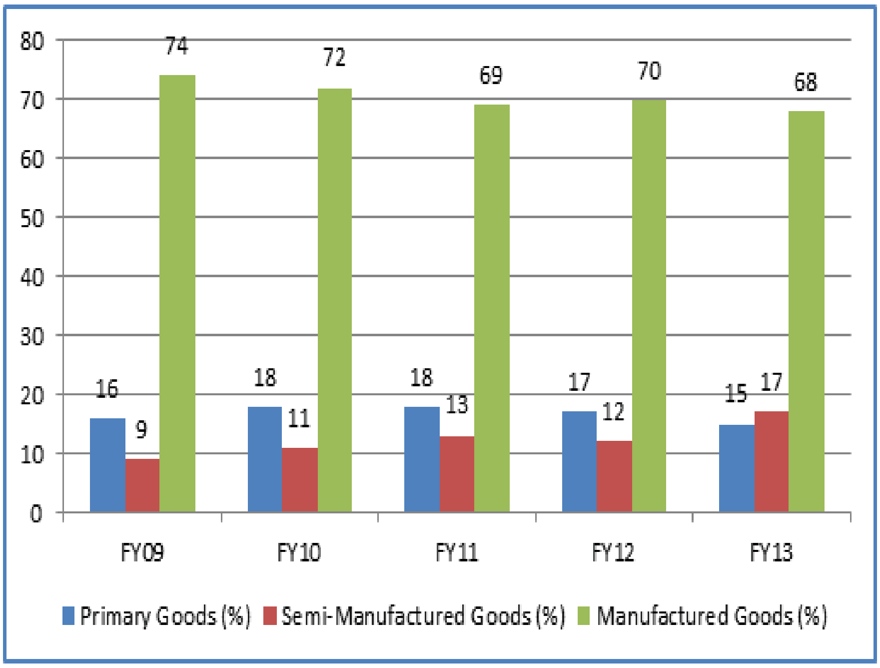
Source: State Bank of Pakistan

Figure 2 represents major export destinations for Pakistan's products. It can be seen that a lot of room exists for trade with SAARC countries, Central Asian countries, African countries and GCC countries. With Economic crisis in USA & Europe and geo-political crisis in Middle East, it is pertinent to seek further diversification in export markets.

ciation of rupee began. The chief reasons were decline in foreign investment, global economic crisis, oil price shocks, domestic instability and agitation and resumption in Pakistan's foreign commitments to the international lenders. Only in 2012 and 2013, rupee has depreciated by about 25% as shown in Figure 4.

Reasons for the rapid depreciation of rupee include a) high import bill, ii) low Foreign Direct Investment (FDI) and iii) constancy in remittances Year-on-Year growth. The spurt in exchange rate in 2013 was also influenced by speculative run and uncertainty over Pak-US and Pak-IMF relations. Rise in import bill and slack growth in exports had led to a relatively more increase in demand than supply for USD. The Central Bank initially decided not to intervene and the market forces together with speculators let the rupee depreciate speedily. Late intervention by The Central Bank had stopped the damage for the time being, but the fundamental drivers for such rapid depreciation still need to be tackled with sound macroeconomic policy and long term economic planning.

Figure 3: Exports Composition during FY09-FY13



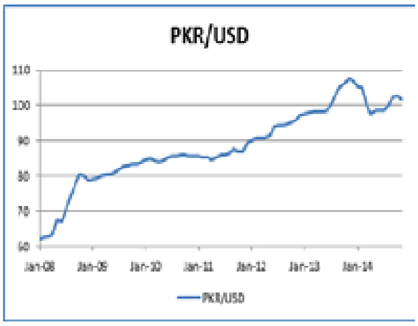
Source: Pakistan Bureau of Statistics

Figure 3 presents the export composition of Pakistan's exports by commodity groups. It can be seen that energy crisis and deteriorating law and order situation has taken a toll on competitiveness of Pakistan's manufactured exports. The ratio of Pakistan's manufactured exports has declined from 74% to 68% during 2008-13. It shows that value addition has become costly in Pakistan with the continuation of energy crisis, weak law and order situation and high cost of capital amidst tight monetary policy stance by the central bank until recently.

Fiscal Imbalances

Pakistan is classified as lower to middle income country by IMF and it is ironic that amongst those countries, Pakistan has lowest taxes to GDP ratio. In Pakistan, despite the spurt in economic growth since 2003, the tax to GDP ratio has consistently declined and now it is one of the lowest in the world. In Pakistan, the income tax collection is not as broad based as it should be and lack of documentation and 'un-documentation' due to stringent conditions for formal sector has resulted in slow progress in the expansion of tax base. Only, 2% of the population in Pakistan is registered taxpayers. The result of low tax collection is reflected in low investment in development and industrial infrastructure and lower scale of provision of key public goods which are essential for enabling the existing firms to remain competitive and to attract new private investment in the country.

Figure 4: Exchange Rate PKR/USD (2008-2014)



Source: State Bank of Pakistan

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NEED for Vast Spread ATMs in Pakistan

By Muhammad Arifeen

ATMs play a significant role for the banking sector and its customers in dealing with their service and cash requirements mainly in non-banking hours throughout commercial cities and metropolis of the country. The importance of ATMs could be determined with the value and volume of transacted amounts through the machines owned by different banks.

World Bank defines ATMs as computerized telecommunication devices that provide clients of a financial institution access to financial transactions in a public place. There are only 7 Automated Teller Machines for 1,00,000 adults in Pakistan, as banking happens to be one of the fastest growing and profitable industries. The official data reveals that as of June 30th 2014 there were 8,240 ATMs across Pakistan in a population of 200 million out of which 65 percent are adults. According to State Bank of Pakistan 1,00,000 of the country's total 12 percent banked population were reliant on cash machines for their financial transactions at public places.

In view of the acceptability of ATMs and 12 percent of the country's total banked population, the State Bank believes that there is a need to increase financial literacy and acceptability of electronic banking channels amongst people. The Deputy Governor of State Bank of Pakistan has voiced his concern over the growing demand for ATMs in the country and urged the banking sector to increase the number beyond the existing 9,000 ATMs deployed in the country.

Pakistan maintains a ratio of 6.49 ATMs per 1,000 individuals. This figure is considerably lower than the average present globally. India boasts of 13.27 ATMs per 1,000 individuals and is actively working towards increasing this figure. There are 290 machines in South Korea, 173 in US, 42.4 in Indonesia. Pakistani banks are aiming towards increasing the ATM machines count by 500-600 in 2015.

Commercial banks are seeing continuous expansion throughout the country. For meeting the increased cash transaction demand of customers, the Automated Teller Machines network of commercial banks increased to 9,018 by the end of December 2014.

The installation of 308 ATMs increased their total number to 6,757 which is 17.6 percent higher than the number of ATMs at the end of the last quarter of the fiscal year 2011-12. As many as 308 Automated Teller Machines (ATMs) were installed and 67 bank branches added to the online branch network in the country in the fourth quarter of fiscal year 2013.

In comparison with other plastic cards, ATM-only cards showed the highest growth rate of about 4.5 percent. The total number of ATM-only cards issued so far is 962,000, although debit cards have the highest percentage share (90 percent) in the overall plastic cards category.

In terms of the volume of overall e-banking transactions, ATM transactions have a major share of 63.7 percent and the average value per transaction stands at Rs 10, 007. In comparison with the number of transactions reported in the third quarter, the overall volume of ATM transactions increased 8 percent while the value also increased by 8 percent.

The number of ATMs in the country has reached 7,684 for the quarter which ended in December 2013, showing an increase of 10.2 percent from the previous quarter. As of December 31, 2013, for every 100,000 people, there are 4.2 ATMs in the country and during the same period, Rs 635 billion was transacted using this channel.

The State Bank of Pakistan has directed all the commercial banks to improve the poorly managed ATM services across the country. Through a circular, the SBP had instructed the banks to ensure round-the clock availability, consistent monitoring of ATMs and mobilisation of maximum resources to timely resolve issues like 'out of cash', hardware, software problems, power outages and connectivity glitches. The State Bank of Pakistan has asked commercial banks to deploy more Automated Teller Machines (ATMs) as the currently available network of 9,000 machines is insufficient to match the growing demand.

It has taken notice of poor performance of Automated Teller Machines and also asked the banks to immediately improve their functioning. SBP also deputed inspectors to monitor the ATMs across the country. During Ramazan and Eid-ul-Fitr holidays the SBP through a circular advises all banks to meticulously comply with its guidelines and instructions regarding management of ATMs operations in order to ensure continuous availability of ATM service.

The authority imposes heavy penalties under the relevant laws on those banks which fail to comply with the guidelines and instructions regarding management of ATM operations and monitoring of ATM cash/downtime during Ramazan and Eid holidays. The SBP has depute special inspection teams to carry out surprise inspections of ATMs throughout the country to ascertain the compliance level of its instructions and guidelines by banks. Banks are required to take all necessary steps to ensure continuous availability of ATM services.

Banks have already been advised by SBP to make adequate back-up arrangements to ensure availability of ATM services round-the-clock and put in place comprehensive operating procedures to timely resolve the cases of out-of-cash, breakdown of ATMs, systems and network. Usually the ATMs either do not work or are found out-of-cash while in Ramazan due to reduced banking hours and during that time more people rely on ATMs for cash withdrawal.

State Bank of Pakistan (SBP) penalizes commercial banks with recurring complaints of having dysfunctional and impaired Automated Teller Machines (ATMs) aimed at improving system of alternative deliver channel and banking system throughout the country. Sources said that the banking regulator has constituted a committee to investigate bank issues in operating ATMs as a large number of complaints have been received by the concerned department of The Central Bank.

SBP is trying to resolve the issues of banks particularly the availability of cash on urgent basis so they could serve the customers without any delays and hardships. The Central Bank decided to ascertain snags at ATMs including hardware faults to software issues, cash unavailability or link problem to give guidelines to banks for fixing problems in their respective ATMs. In case the banks fail to maintain their ATM functioning round-the-clock, The Central Bank will most likely impose fine on the banks.

Delays by banks in maintenance and cash feed in ATMs will be penalized to improve the alternative delivery channel of the banking system. The banking regulatory wants to address the issues of customers regarding ATMs to facilitate them and to gain their confidence on banking system with best qualitative services.

By Dr Sabir Ali Jaffery

Banking industry is considered to be the largest and a dominating facet of financial sector, not only with regard to turnover, profits and employment opportunities but also owing to its paramount impact on the country's economy as a whole. It was for these reasons that during the last few decades there has been a growing tendency to apply marketing tools and techniques to promote banking activities. However, as a part of banking activity marketing is of recent origin. Its advent can be traced to the American Banking Association Conference held in 1958. In Europe, however, it was not until 1970 that marketing entered into financial sector.

> "Marketing system of physical products has several middlemen such as, distributors, retailers, and commission agents. As against this, the marketing of banking services is a direct function between supplier and the end user"

Marketing has been defined by various men-in-profession as a "part of management activity that seeks to direct the flow of banking services profitably to selected customers".

The Rapid Results College (RRC), London maintains that marketing for banks involves:

- People and techniques committed to make best possible use of a bank's resources to generate profits by identifying and meeting the needs of its present and potential customers.
- An approach to business or a management attitude that makes a bank operate profitably by satisfying its customers' needs.

The Institute of Marketing, London has defined marketing as "...the management process responsible for identifying, anticipating, and satisfying customer requirements profitably."

In the wake of increasing competition among banks and non-banking financial institutions, marketing has become integral part of banking activities. Its rising importance is marked by three major factors such as technology advancement and diversification of customer's needs:

However, nature and scope of marketing in promoting banking services is sharply distinct from marketing of tangible goods.

Marketing in banks has to perform two different functions. It has to attract deposits as well as simultaneously persuade customers to utilize its services. This two-fold nature of banking functions makes its marketing operations more complex as compared to those that are normally faced by other commercial and manufacturing organizations.

Next, to perceive marketing vis-à-vis banking activities, it is of prime concern to identify the distinct nature of banking activities, which characterizes as under:

Intangibility:

Banks' services are intangible in nature as against goods and commodities. Hence, problems of packaging, storage, transportation, and inventory control are not relevant to it. Services of middlemen which are often utilized in marketing physical products have no role to play in marketing or selling bank services. Moreover, the bank marketer does not have to demonstrate or display the 'product' that he offers. It, therefore, seriously limits the alternatives available to him, which makes his job solely dependent upon his professional skill.

(ii) Inseparability:

It implies that availability and offer of bank services are simultaneous. The only thing in between is marketing activities to promote their sale.

(iii) Individualized Marketing:

Marketing system of physical products has several middlemen such as, distributors, retailers, and commission agents. As against this, the marketing of banking services is a direct function between supplier and the end user. This necessitates establishment of extensive branch network.

(iv) Lack of distinctiveness:

Services offered by different banks are almost identical. The emphasis is, therefore, shifted from product to promotional strategies which consist of branch location, marketing skill of the marketer, quality of service, introduction of new services, reputation and publicity campaign.

(v) Retaining:

Retaining of a customer is more important than attracting one. A disgruntled and dissatisfied customer may prove substantially harmful.

(vi) Diversified services:

Banks to remain in the competitive market have to offer a wide range of products and services to meet variety of business needs of different class of customers.

(vii) Widely dispersed branch network:

An intelligently developed branch network plays pivotal role in laying foundation of a bank's expansion on sound footing leading to a prosperous future.

(viii) Prudent Expansion:

Banks' main earning is from making advances. The well known maxim is "while selling loans, banks are buying risks". Hence, expansion, both intensive and extensive, should be well thought of and most articulately planned.

There are a few more specialities, as under, associated with financial services:

Fiduciary Responsibility

Bankers by persuading customers to put their funds under their (banks') care and custody incur much heavier responsibilities toward their customers than the sellers of consumer products have toward their buyers. Whilst it is inconvenient if the goods are substandard or not otherwise as per the sample, these may be replaced or repaired. In contrast, if a banker fails to meet his fiduciary responsibilities, the implications can have far-reaching and long-term effects.

Impact of Economic Policies

Banking operations are directly affected by the policy changes brought about by the monetary authorities of the country, such as, The Central Bank and The Ministry of Finance. For example, the recent 1% reduction in the interest rate announced by the State Bank of Pakistan has up surged the loan-giving activities of commercial banks.

Changes in the economic and monetary policies of the country require that the targeting, planning, executing, and monitoring of marketing activities needs to be flexible so as to absorb the implications of such changes without much upheaval.

Dual Function of Attracting Deposits and Lending

A customer of the bank is both the supplier and user of funds. This entails a two-fold marketing strategy to be pursued by the bank marketers.

In view of the typical banking activities and commensurate marketing techniques,

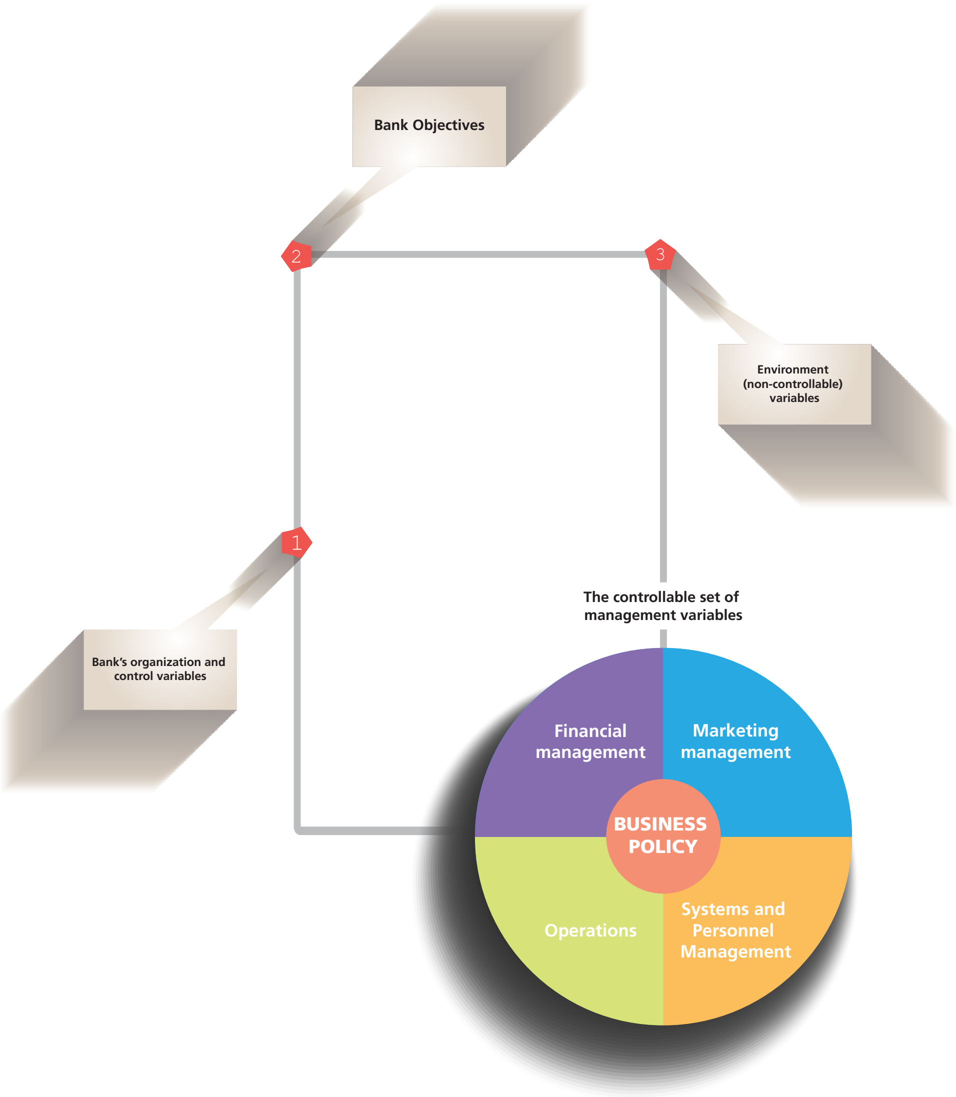


Figure 1: The Bank Management System

the bank marketing function evolves five subsets of management controllable variables, as shown in Figure-1 above taken from the 'Bank Marketing Management' by Arthur Meidan, Senior Lecturer, Sheffield University, published at Hong Kong by The Macmillan Studies in Marketing, p-5.

The Marketing Functions in Banks:

A bank's marketing functions focus on the following activities:

- Market segmentation.
- Customers' behaviour.
- Calculated dispersion of branch network.
- Diversification of services: A wide range of services offered is the nucleus of business promotion activity.
- Quality of service rendered: Marketing activity may procure a business but it can be retained only through quality service.
- Pricing of product: This should be competitive but profit generating.
- Continued market research.
- A watchful eye on competitors' strategies.
- Thorough grasp of economic and monetary policies of the country and prompt notice of changes in them.
- Bank marketers should have sound knowledge of the products of the bank and up-to-date information of laws, rules, and regulations issued from time to time by governments and regulatory authorities.

This treatise would be meaningfully concluded by reproducing what R. Brien and J. Stafford, famous marketing wizards, offered in their article, "The Myth of Marketing in Banking". While offering a two-fold role for marketing in bank management, they stipulated "one is at the level of formation of the marketing mix for the development of market segments which seem – according to market research --- to hold the best opportunities for profitable exploitation. While the second is of a philosophical nature --- that all bank activities should be so geared as to focus on the needs and wants of the customer --- which is a reiteration of the total marketing concept".

PRIVATE EQUITY INVESTMENTS

On the Horizon of Pakistan's Financial Landscape

By Zulfiqar Haider

Private Equity (PE) Investment is a slight new concept with respect to Pakistani Financial Market. Most of the times, the term private equity investment is mixed with the term public equity investments, which; are quoted on stock exchanges. Both investment platforms aim to provide capital to investee companies with an objective to earn higher returns on investments. However, it is unlikely to say that equity investments, PE investments may not be traded on stock exchange, hence considered as illiquid investments. These are long term and strategic investments and cannot be easily disposed-off. PE investors take a long term position for their investments and aim for higher returns as compared to other available mode of investments.

Private Equity Concept

Private Equity is an asset class, which aims to invest in companies with the objective to generate superior returns by executing a specific exit strategy. In PE investments, exit strategy is the way through which the investors pull back their investments at specified time with desirable returns. PE Investments are routed through participating in ownership stakes of investee companies by acquiring of an old stock, or by subscribing to the new issues either as a majority or minority shareholders.

The basic ideology of PE investment is to invest in those companies who are seeking funds to commence, construct, complete, or to enhance the performance of different ventures in order to generate revenues. Generally, PE investors invest their money at a time when there is a potential that Investee Company will make higher returns, because at this stage, the cost of acquiring or subscribing the ownership stake is comparatively much lesser than the cost of stock, once the venture starts giving the returns.

PE investments are for longer tenure, with the risk of loss of invested capital. This characteristic makes these investments as illiquid assets, because investor cannot readily sell these investments at desirable returns. So, a typical PE investment aims for the holding period of 3 to 10 years. But this feature of investment enables its investor to generate a 2-10 times multiple invested capital with an expected IRR of 20-50%.

One thing must be understood that PE investments are not similar to simple partnerships in ventures. Because partnerships are formed with an objective to run the business over a time, whereas PE investments are made with an aim to take advantage of dislocations in the market by making medium to long-term investments in areas, where there may be a unique situation driven by a mismatch for capital, resulting in superior returns.

Private Equity History and Initiatives in Pakistan

In history, if we search for the oldest PE transaction, J.P. Morgan stands out for executing a significant PE transaction where, in 1901 they executed the leveraged buyout transaction of Carnegie Steel Company for an amount of US$ 480 million. Later in 1946, some traditional PE firms were established. In the past decades, there were so many popular PE transactions with huge volumes of amount invested in these transactions.

In Pakistan, formalized private equity investment is a relatively new concept. PE Market is yet not established, and also there is no understanding for different rules and regulations governing directly to PE market / investments. At present, PE investments are governed through Assets Management Company Rules, issued by SECP, as mostly PE firms operate their investments through a PE Fund, which is managed by an Asset Management Company or Fund Management Company. Recently, SECP issued "Private Funds Regulations, 2015" aiming to regularize the formation and operations of Private Funds.

US-Pakistan Business Opportunities Conference held in 2013, was concluded with the launch of Pakistan Private Investment Initiative to mobilize at least US$ 150 million in PE Investment. U.S. Agency of International Development (USAID) announced the Pakistan Private Investment Initiative with Abraaj Group, and JS Private Equity Management. Through this initiative, two new PE funds with the sole focus on growth of SME sector in Pakistan will be established. USAID will provide a seed investment to capitalize the Funds, and other limited partners will match or exceed the fund capital. SECP has also proposed some tax benefits for the income of PE Investments.

So, we can say that the PE investments have great potential in the upcoming years as the economic indicators are favorable, because returns are more lucrative for commercial businesses, when there is declining interest rate scenario in economy.

Private Equity Risks & Attraction

PE investment is highly attractive to those investors, who can hold their funds for a longer period. As mentioned earlier, PE market is not yet formalized in Pakistan; hence there is no published comparison available which shows the returns of PE investments over other modes of investments. However, if we look around the world, PE Investors target their rate of return between 20-50% depending upon the nature of transaction. There is a difference for benchmarking the returns on PE funds and other funds, however; if we analyze the different research reports in different markets, it is evident that the returns on PE Funds are much more than the returns available in bond funds or traded equity funds.

The higher risk of PE is supplemented by higher returns. The biggest risk faced by PE investors is the loss of capital invested. As this is a long term investment and completely based on the performance of Investee Company, therefore there is a risk of not recovering the invested amount, or the underperformance of Investee Company may result in the lower or no dividends, which can extremely hamper the returns for PE investors. There are so many other risks associated with this type of investment, like market risk for underperformance of primary markets, exchange rate risk, if there is currency difference involves in investments, liquidity risk as these investments cannot be sold with readily recourse.

All risks are controlled through investment screening and monitoring criteria prepared, implemented and executed by a PE Firm which manages the PE Investments.

How Private Equity Investment Works?

There are many different options available for PE Investors, but a typically proven PE investment structure is one, where a PE Fund is established which; is managed by a Fund Management Company (FMC) who use the fund's capital to invest in different types of PE investments.

The PE fund is established under the governing laws and capitalized by PE investors who called the Limited Partners (LPs) in Fund. Once the fund is capitalized with the investment of Limited Partners, a FMC is appointed who will manage and operate the fund. Sometimes, a fund manager also invests some of his own money in the fund's capital with the purpose to become a stakeholder of the fund's performance. Fund Manager invests in the fund as a General Partner.

A FMC charges a certain percentage to the Fund Investors as a fund deployment fee. This fee typically ranges between

> "These are long term and strategic investments and cannot be easily disposed-off"

1-3% of deployed fund. Fund Investor's also agree to share a carried interest with FMC, if the actual return of fund exceeds the agreed targeted returns.

FMC deploys the funds in different types of PE investments through a comprehensive investment appraisal process with the approval of investment committee. Investment appraisal process contains the criteria where a fund manager selects its targeted sector, returns, mode of financing, tenure of financing with an exit strategy. The FMC may appoint different legal, financial, and technical advisors depending upon the type, nature and size of investment.

Types of Private Equity Investments

Private Equity Investments can be deployed in wide mix of investment types depending upon the industry, nature, time, and size of transactions. A mix of hybrid equity investments can also be made where an equity is mixed with a preferential debt/shares, but return on equity is greater than the returns on debt, therefore PE investor prefers to invest in purely equity trade. Following are the key types of investments available to PE Investors:

Venture Capital

is investments in a company which is in the early stages of development, usually with negative cash flows. Typical holding period for venture capital is 5-10 years with the targeted IRR of 30-50% on 5-10x cash multiple. Risk of capital loss is high; exit can be availed through strategic buyer or IPO.

Growth Capital

is investments in growing companies which need funds for capital expenditures, acquisition or to cover a gap between working capital. Hybrid equity/debt can be placed for this category. Typical holding period for growth capital is 3-7 years with the targeted IRR of 30-40% on 3-7x cash multiple. Risk of capital loss is moderate as company is already established; exit can be structured through a sponsor trade buyer, sale to a strategic buyer, or through Financial Buyer IPO.

Leveraged Buyout

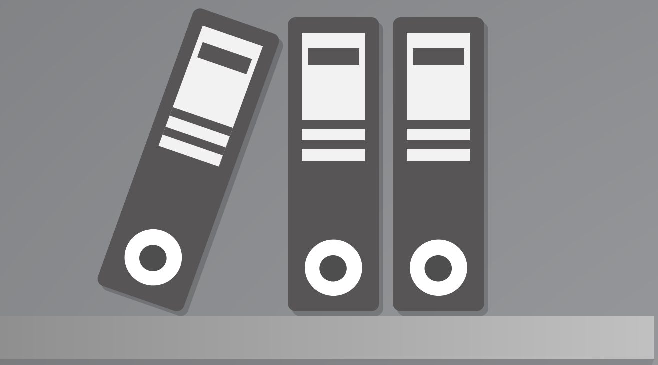
is an investment type where a PE firm acquires the target company with a significant amount of debt and equity. Once the company is acquired, the deleveraging process is initiated through cash flows of acquired company to reduce the debt burden as quickly as possible, enabling the increase in the value of company. Holding period of LBO is 2-5 years, with a targeted IRR of 25-35% on 2-5 times cash multiple. Risk of capital loss is low.

Some other types of investments are also available for PE Investor namely Mezzanine Financing, Pre-IPO placement, Distressed Buyout for corporate restructuring or turning around the businesses.

Challenges of Private Equity Investments in Pakistan

Mostly private equity investments are huge in size, and to locate a strategic limited partner is a very difficult task especially in the context of Pakistan, when the country is facing internal and external terrorism and political de-stability. Foreign investors are reluctant to invest their money in long term investments. If local commercial banks act as LP, then they need to manage their capital adequacy requirements, as Basel III accord introduced some higher percentages for risk weighted assets of unlisted stocks. Mostly PE firm works with no collaterals as direct participation in equity, but high NPL ratio, and a prolonged litigation process in country suggests the high risk of capital loss.

Despite the challenges, a Private Equity Platform can play a vital role in development of economy, as it operates through equity participation, which reduces the interest payment liability of performing company. High returns are lucrative for investors to invest their money in private equity. A high growth is anticipated for Private Equity Market in Pakistan.



COMMERCIAL BANKING
Problems and Solutions

By Dr. Sabir Ali Jaffery

Q.1 The articles of association of a company requires that the company shall have minimum four directors and that the account of the company shall be operated jointly by the executive director along with one director. The company for the time being has only three directors. The executive director of the company approaches you to open company's account. He maintains that the person nominated as the fourth director is out of the country at present who is expected to be back within the next fortnight when he will sign the relative documents. In the meantime, the account may be opened with the existing three directors with the mandate as aforesaid. Will you open the account? Substantiate your answer.

Ans. The company must have the minimum number of directors as required under the articles of association, failing which it will not be recognized as a properly constituted entity. The position may be explained to the executive director who being a professional himself, should appreciate your plea. The request of the executor director should however, be politely declined.

Q.2 One of the joint signatories authorized to operate upon a company's account relinquishes his office. Consequently, another person is appointed against the vacancy. What fresh mandate will be required to accept him as an authorized person to operate on the account in terms of the original mandate?

Ans. Assuming that the outgoing person was an employee of the company, a letter signed by the chairman, the managing director, or the secretary to the board containing the duly constituted authority in favour of the new incumbent to operate on the company's account along with his signature appended thereon and attested by the signatory of the letter shall be deemed sufficient authority.

Q.3 A private limited company is planning to be a public limited company. It has completed all the requisite formalities and now proposes to issue its shares to the public. It wants to appoint you as banker to the issue. Moreover, it desires that a running finance facility be extended to it against the security of the share money thus received. What should be your answer to the proposition?

Ans. Assuming that nothing adverse as to the credibility of the private limited company is in your knowledge, there is no harm in accepting the offer regarding your appointment as its banker to the issue.

However, any advance against the share subscription is not advisable for the following reasons:

(i) The company cannot lay hands on this money until certificate of commencement of business has been issued to it.

(ii) The company cannot withdraw this money unless shares have been allotted to the applicants.

(iii) Advance against the company's own shares is tantamount to reduction in share capital which cannot be made by the company without undergoing its cumbersome procedure.

Q.4 X secretary and Y director of a company sign a cheque as under:

X — Secretary
Y — Director

of XYZ & Co. Ltd.

Will the bank be within its right to debit company's account with the amount of this cheque? If the payment is made, will it meet the requirements of payment in due course as prescribed under Negotiable Instruments Act, 1881?

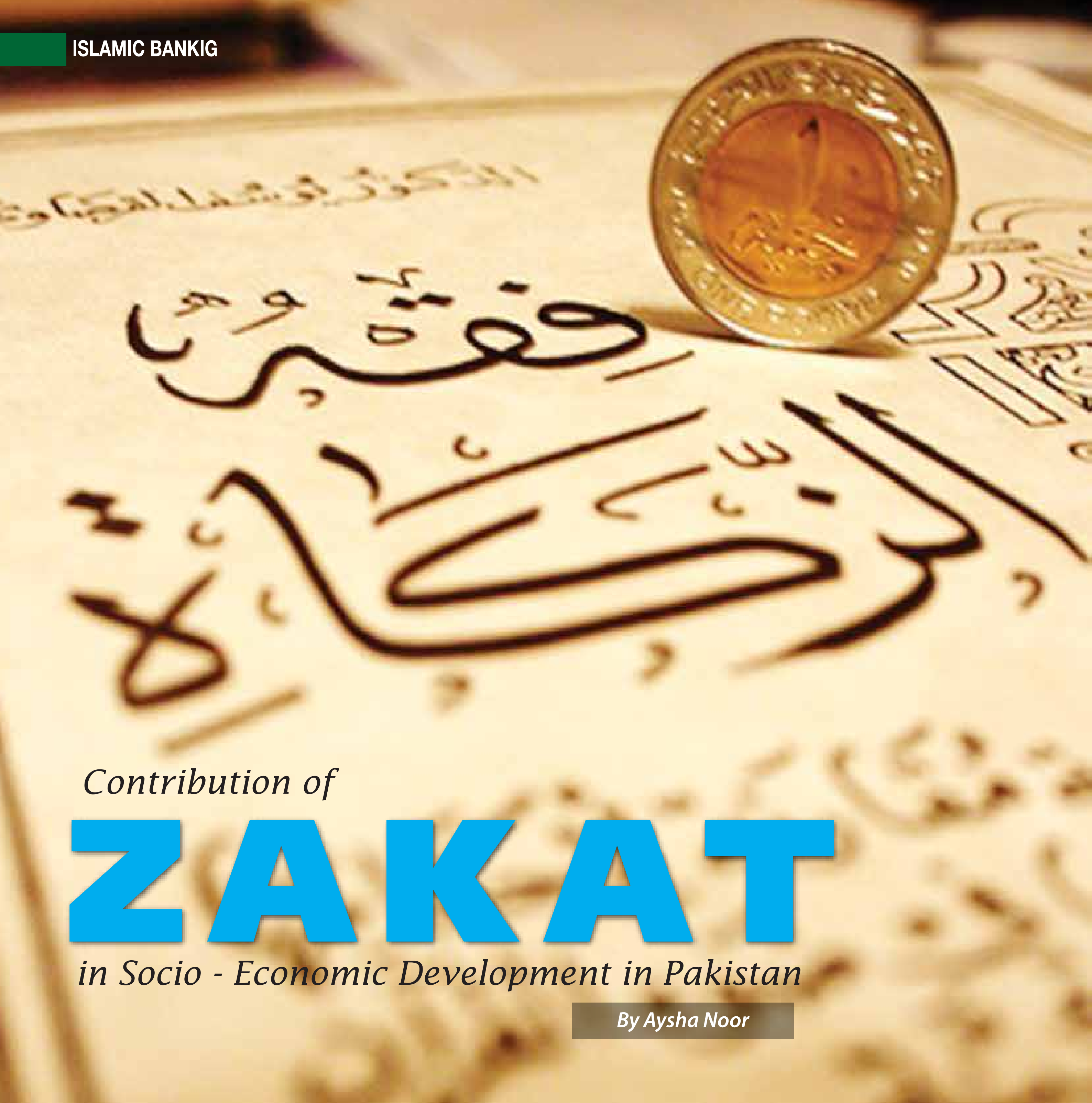
Ans. Prima facie, the cheque is not signed in the representative capacity so as to bind the company on it. Hence, its payment to the debit of the company's account may be tantamount to conversion. Moreover, the signatories may be held personally liable to the beneficiaries of the cheque as there is no indication that it was signed on behalf of the company.

The payment if made will not be "according to the apparent tenor of the instrument", as is required under Sec.10 of the Negotiable Instrument Act. Hence, the bank will not get protection should the payment be challenged.

Q.5 The mandate to operate on a company's account is "by the secretary with two directors". Mr. Abdul Hayee is secretary as well as a director. He along with another director signs a cheque both as secretary and as second director, as under. Will this cheque be paid?

For Electronic Entrepreneur Ltd.
Abdus Sami - Director
Abdul Hayee - Director
Abdul Hayee - Secretary

Ans. What is required under the mandate is that the secretary shall sign along with two directors. It means that in all three, different officials will jointly operate on the account. Since this condition is not fulfilled when one and the same official signs twice, although in different positions. Hence, the cheque is irregularly drawn and will not be paid.



Contribution of ZAKAT in Socio - Economic Development in Pakistan

By Aysha Noor

The research is conducted to comprehensively describe the evaluation of zakat system in Pakistan. This descriptive investigation leads to establish a relationship between the zakat, social and economic development. The zakat system creates economic balance in the economy by contributing negative impact on the concentration of wealth and contributing positive impact on the circulation of funds. This Islamic mechanism provides positive impacts on the poor segment of the society on the basis of the assumption that zakat is an anti-poverty instrument introduced by Islam.

The financial obligation that is mandatory in Islam on every Muslim subject Sahib - e - Nisab (as prescribed by the Shariah) is **Zakat**. The Quranic injunctions (9:60; 9-103) provides the system for collection of zakat and its distribution. The insight of practical implications of zakat collection and distribution is in the early Islamic history. The objective behind collection and distribution of zakat is to minimize the concentration and accumulation of wealth in few hands and allow its circulation in all parts of the economy. Its benefit goes to the poor and deprived class of the society. The economic system of Islam guarantees that each and every individual in the society can atleast fulfil all its basic needs through zakat. The second form of charity of Islamic economic system is sadaqat but it is voluntarily not mandatory as the system of zakat in Islam. The zakat system of Islam equip the poor segment of the society so they can actively participate in the economic activity of the society.

The first objective of Zakat system in Islam is to purify the activities as the Prophet (PBUH) mentioned that zakat purifies the wealth. Secondly, it does not allow concentration of wealth in few hands but allows circulation of wealth from rich to poor segment of the society. Thirdly, the zakat system of Islam is run through an organized institute in the early history of Islam and therefore provides salaries to institute workers. Fourthly, the zakat system induces the economic justices by collecting zakat from rich and distributing among poor. Although it is a thought provoking truth that there are moral hazards involved in the collection and distribution of zakat in Pakistan but it is still very effective and active in many parts of the Muslim world. Despite these moral hazards there are millions of rupees distributed across the country in the name of zakat in Pakistan. The number of people below poverty line in Pakistan increase every year despite the number of social and charity programmes of government and private NGO's.

This research is conducted with the aim to comprehensively provide the description and evaluation of zakat in Pakistan and is significant from the zakat policy makers' point of view that how the zakat system can be better implemented to achieve the socio-economic development. It is also an addition towards the existing literature as it provides the insight for new researchers on the relationship between zakat and economic development.

Theoretical Background of Study

Nisab and its Contribution in Economic Development

The practical implication of zakat in early Islamic history suggests that zakat is deductible on valuables like gold, silver, livestock, treasure trove, mines, merchandise and agriculture produce. The current Islamic methodology of deduction of zakat from holdings of currency in various forms of financial assets such as bank deposits, shares and securities is the outcome of the **Ijtihad** known as **qiyas**. The goods in personal use are not subject to deduction of zakat such as the house use as the residence of the owner and his/her dependents, household items, animals and any means of transportation for personal use although there is a difference of opinion on it. The agriculture land, plant and machinery are not subject to deduction of zakat. Zakat is deductible on the annual savings of the individual. The Prophet Muhammad (PBUH) has prescribed the nisab on different items and **ijma** (consensus of jurists) suggests that there is no variation from the instruction of the Prophet (PBUH), permissible. The declared nisab for gold is 20 dinars or 85 grams of gold and 200 dirhams or 595 grams of silver. The nisab for the holding of cash and other financial assets are similar to that of the gold and silver. However, with the passage of time the value of silver reduced relative to gold therefore there is a difference of opinion regarding the declaration of nisab on the basis of gold or silver. The declaration of nisab in Pakistan is on the basis of gold. The nisab for agriculture produce is 5 wasq or 950 kg in case the agriculture produced measured in terms of capacity and equivalent value of staple in other cases. The type of animal determine the nisab for the livestock. For example if camels are 5 in number than nisab is applicable, 30 in case of bovine animals and 40 in case of goat and sheep. The early Islamic history is silent regarding determination of nisab in case of the minerals. The percentage of zakat declared by Prophet Muhammad (PBUH) is 2.5% for gold, silver and other financial assets and merchandise. The agriculture produce on the land irrigated through rainfall is of 10% and irrigated through artificial mean is 5%. The detailed schedule laid down by Prophet Muhammad (PBUH) is applicable on various categories of animals. The rate of zakat on treasure trove is 20%. The Islamic history is silent regarding the rate of zakat on minerals however some consider that it is 2.5% in case of minerals while others say that it is subject to khums of 20%. The zakat is applicable on all the assets above or equal to nisab and is accumulated/saved by the individual for the whole year. Zakat is deductible once in the whole year while the usrh on the agriculture produce is applicable in harvesting of crop, the general consensus suggests that nisab determines the minimum level of holding required for the payment of zakat. Zakat is the source of poverty alleviation in the Islamic economic system. It is collected from the rich and distributed among the poor and neglected part of the society.

Methods Of Zakat Collection And Distribution In Islam

The literature provides insight for the role of zakat and charities in the modern muslim states. However, there is still room for further research in the area of zakat as an Islamic tool for social and economic development. There are number of questions which arise in this aspect such as:

- The emergency of Islamic system of zakat.
- The contribution of zakat in the economic development of Muslim societies in past.
- The role of zakat in present Muslim society.
- Is the institutional system of zakat useful in non-Muslim societies?

The best management of zakat is the institutionalization of the Islamic zakat system in the early Islamic history where the zakat workers are involved in collection of zakat from one segment of the muslim society and its distribution among the other segment of the society. It is needed to realize the importance of zakat as the role of any intermediary service which bring together the buyer and seller of any product or services. Hazart Abu Bakr Siddiq (R.A) waged war against those who denied zakat as the pillar of Islam. Therefore, there are still believers that zakat needs to be controlled through government intervention. Zakat needs to be clearly separate from other government revenue generating sources such as taxation, custom duty and excise etc., due to following reasons:

- Zakat is particularly to be distributed among the poor and deprive segment of the society instead of any fiscal project no matter how beneficial it is.
- The zakat rates are determined by the Prophet Muhammad (PBUH) and are not as adjustable to the requirement of Government as the tax rates are (Faridi; 1983).
- The zakat system is efficient if it is readily cleared by collecting it from one segment and readily distributing to the poor segment of society but this is not true in case of tax.

The zakat house needs to be properly managed so that trust can be built up between the zakat payer and zakat house. Otherwise, the zakat payers prefer to pay zakat to their poor relatives instead of zakat house. It must perform the primary function of poverty alleviation instead of investing zakat fund in the Government projects. Abbadi demonstrated various jurists' opinions regarding authorizing people to pay their zakat themselves instead of paying it through the zakat house. Various school of thoughts like Al-Shafi's, Al-Shabi, Al-Awzai and Al-Jafari suggest that the individual himself should pay zakat instead of zakat house if the zakat house is not trustworthy.

The Socio-Economic Infrastructure of Islamic Society

The faith in Allah is the root of any Muslim society. Allah has determined the five pillars of Islam and the zakat is the fifth pillar of Islam. Islamic society needs to be based on "Islamic Brotherhood" which is not possible unless the gap between the poor and rich needs to be reduced. This gap can only be reduced by following the Islamic way of mandatory charity that is payment of zakat from one segment (nisab) of society and then payment to poor segment. The Islamic economy provides three factors of production; capital, land and labour. Zakat is required to be paid to those who cannot participate in any factor of production. The concept of "Islamic Brotherhood" is not limited to its meaning it's not possible that one person does not even have enough to feed himself and his family and the other is spending a lavish life. The rich must take care of poor through payment of zakat as it alleviates poverty and does not facilitate the accumulation of wealth in few hands. In the Islamic society, the distribution process of zakat is such a strong network that no poor could sleep without eating.

Discussion

The desired level of Islamic socio-economic system is achieved by taking corrective measures in our current zakat and ushr system. The measures can be taken by the use of new framework of zakat. The following are the preceding discussions that could be used as tools to build up the precise socio-economic infrastructure of Islamic Society in Pakistan.

Five Year Plan for Zakat Treasury (Baitul-Mal)

The Zakat collection and distribution is done on the basis of five year plan of which execution is distributed on annual basis. The accounting procedures need to be properly formulated regarding the collection of zakat and its distribution. The Hadith of Prophet Muhammad (PBUH) has clearly indicated the nisab and all the jurists have agreed upon that there is no excuse to change the rate of zakat. There is the room to formulate the guidelines regarding the distribution of zakat. The definition of poor and needy needs to be formulated, the distribution of zakat to the people comes in this bracket, the proper guidelines regarding the desire level of zakat use so that their living standard can be uplifted making them an effective part of the economy. The proper accountability of zakat distribution, training of Baitul-Mal staff regarding the proper distribution of zakat and to reduce moral hazards in its distribution. These broad objectives could be achieved by:

- The education of children of people living below poverty line along with distributing one time meal to them.
- Zakat is paid to establish a self-small business and its professional training needs to provided by Baitul-Mal.
- The supply of basic tools to people too make handicrafts.
- Training of handicapped to turn them into productive individuals of the society.
- The educational expenditure of small farmers' children.
- Facilitate the establishment of small cottage industries, simple agriculture and cottage industry.
- Financing of health-care and medical treatment for poor people.
- The supply of food to people living below poverty line.
- Expenditure on those whose hearts are made to incline to truth.

In the words of Abu Ya'la those whose hearts are inclined to truth, Muslims or non-Muslims could have a share in zakat and also:

- Whose hearts are inclined to help the Muslims.
- Whose hearts are inclined to defend the Muslims.
- Who can be persuaded to embrace Islam.
- Who can be persuaded to attract their tribes and clans to Islam.

Islamic Approach to Financing Socio-Economic Infrastructure from Zakat Fund

The zakat fund could be paid to those who are completely disabled or unable to work or gain their living. The socio-economic infrastructure could be built by providing the payment of zakat through kind of like production tools and production commodities. The partnership could be established between numbers of zakat takers through the zakat foundation. The **mudarabah** type of partnership could be established between the poor and the Baitul-mal to uplift the living standard of the poor skilled worker. The interest free lending repayable in easy installments could be encouraged through educational loans to poor talented students, skilled poor worker (to establish self-business), production tools for readymade garments to the widows and to those who are under debt.

Zakat Management System

The zakat management system needs to be revised and should address all the loop holes in the system that causes moral hazards in the distribution of zakat. The double accounting system needs to be implemented in the collection and distribution of zakat which has an inbuilt process to check moral hazards. The targets need to be established for five years divided into one year plans. The actual performance needs to be compared with targeted performance. There is a need to devise a system that could establish the causes of non-achievement of targets. The corrective action plan needs to be established and the system of zakat needs to be pro-active instead of re-active.

Contribution of Zakat Towards Socio-Economic Development

The benefits of all the methods of distribution of zakat will go to the poor segment of the society. The above devised system of zakat will reduce the people living below poverty line. The dependency of zakat fund will reduce due to self-owned businesses, the education level of country will increase and the poor will become the productive part of the socio-economic system of the country. The development of the country is not possible at the cost of increase in people below poverty line. The zakat system plays a vital role in the empowerment of poor in the Islamic country but it is the way of utilizing these funds for the benefit of the poor. The proper distribution of zakat could reduce poverty, reduce street crimes, enhance productivity, enhance the living standards of the poor segment of society, enhance circulation of wealth and a cure against accumulation of wealth in few hands.

Milestones Achieved in Pakistan through Zakat since October 1999

The following milestones are achieved through zakat system:

- 67% increase in guzara allowance (from Rs. 300 to Rs. 500).
- 100% increase in marriage allowance (from Rs. 5000 to Rs. 10000).
- 59% increase in educational stipend.
- Launching of permanent rehabilitation I & II.
- Launching of 18 hospitals as NHIS (from 58 to 76).
- Formulation of new zakat council.
- Emergency relief of Rs. 63 million to drought/famine victims in Baluchistan and Northern Areas.
- Emergency relief of Rs. 10 million to flood victims of Rawalpindi.
- Zakat grant to northern areas doubled from Rs. 20million to Rs. 40 million.
- Emergency relief of Rs. 50 million to flood victims of Badin, Sindh.
- 100% increase in the ceiling of outdoor/indoor patients of NHIS.

Improvement in Zakat and Ushr System of Pakistan

In December 1999, the Government of Pakistan under the directive of Chief Executive of Pakistan Committe Chairman Dr. Abdul Malik Kasi and the Minister of zakat and ushr were assigned to review the existing structure of zakat and ushr and improvement through short and long term measures. Dr. Mehmood Ahmed Ghazi, National Security Council and Former Minister of Religious Affairs, zakat and ushr committee deliberated various issues and recommendations to revitalize the system through appropriate amendment. President of Pakistan approved the following amendments:

- Section (9) of the zakat and ushr ordinance (XVII of 1981) relating accounts and transfer of funds through cross cheques.
- Section (16) amendment is that the chairman and members of district committee shall be the person of moral character and are not commonly known as persons who violate Islamic and financial integrity and do not involve in political activities.
- Section 29 –A is new insertion in the ordinance
    - o Dissolution and reconstitution of committee: All existing district committee, tehsil zakat and ushr committee and local zakat and ushr committee dissolved and cease to function with immediate effect and new constitution under section 16, 17 & 18 within a period of three months.
    - o Consequently, upon the promulgation of local government ordinance 2001 the composition of zakat committee will effect operational management through zakat and ushr (amendment) Ordinance No. XXXV of 2000 (30th July 2002).
    - o Consequently upon decision by the cabinet to supplement district zakat committee funds to meet administrative expenditure up to the limit of two percent amender been made through zakat and ushr (amendment), Ordinance No. XXXVIII of 2002.

Conclusion

The early Islamic history provides a thought provoking proof for the current Muslim world where there is no one ready to take zakat but there were numerous zakat payers. The concentration of wealth in few hands reduces the economic activity, enhances the poverty, enhances the number of people who consider themselves as deprived of capitalism, enhances street crimes and slows down the growth process of the economy. The only way for a Muslim society to come out of the problem of income inequality is through proper implementation of zakat system. Zakat must be collected from the rich segment (nisab) of society and distributed amongst the poor to eradicate inequality.

Zakat is the pace of economic development as it provides the source of financing for the neglected part of the population. The proper collection of zakat and its distribution plays a vital role in the poverty alleviation and socio-economic development. It is achieved through the proper formulation of zakat distribution plan as suggested earlier. The zakat distribution needs not to be limited to those people who are disable or can earn enough to survive. Its pace needs to enhance the education of children of poor farmers, poor labour working in the brick factories. The nourishment of children of people living below poverty line is necessary for the long term socio-economic growth. The **modarabah** type of financing for the poor skilled workers, availability of interest free loan to the children of poor segment of society, basic tools for the agriculture based industries, loans to widows working in the garment factories for self-business etc. There is need of reforms in the zakat and ushr system of Pakistan especially through introduction of double accounting system. The training of staff can play a crucial role in the collection and distribution of zakat. The alleviation of poverty is the need of the day as the street crimes are increasing day-by-day in Pakistan. The only way of enhancing the pace of development of Pakistan is via uplifting the vulnerable living standards of the poor.

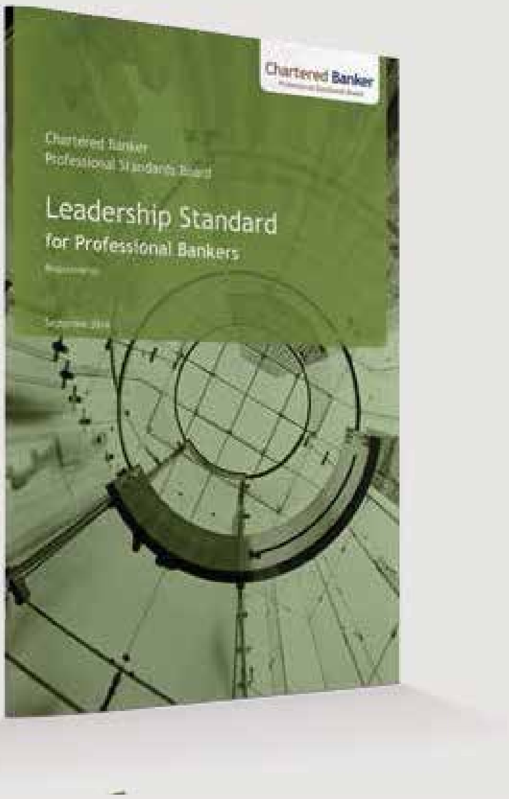
Standard BEARER

Maintaining momentum and strengthening professionalism – the CB:PSB publishes its Leadership Standard for Professional Bankers.

On 30 September, the CB:PSB launched the second in its suite of professional standards. **The Leadership Standard for Professional Bankers** is aimed at all bankers who are responsible for shaping culture, strategy and policy. The standard applies not only to Chief Executives and senior management but to leaders and managers throughout CB:PSB member firms. As Simon Thompson, Chief Executive of the Chartered Banker Institute and Chairman of the CB:PSB Professional Standards Committee explains: "There is no doubt that 'tone from the top' is important, but the CB:PSB believes that 'tone in the middle' is equally important. In shaping the Leadership Standard, we wanted to be clear that the conduct and expertise of leaders at every level contributes to the customer-focused ethical professionalism that the CB:PSB expects".

The Leadership Standard sets out requirements for the professional conduct (values, attitudes and behaviours) and professional expertise (knowledge and skills) of banking leaders. The CB:PSB has prioritized conduct requirements, such as developing and embedding a professional and customer-focused approach and culture consistent with the Chartered Banker Code of Professional Conduct. The CB:PSB believes that, while professional expertise is vital, banking leaders must also exhibit ethical, customer focused professionalism in their conduct, and take active steps to encourage their colleagues to do the same. The Leadership Standard begins, therefore, with the "how" rather than the "what". For exam-

> *"The Leadership Standard sets out requirements for the professional conduct and professional expertise of banking leaders."*



"The Advisory Panel was keen to ensure that the Leadership Standard would be accessible to a wide audience."

ple, it describes how leaders' knowledge and skills are shared, communicated and put into practice; how ethical decisions are reached; and how leaders challenge and shape the conduct and behavior of their colleagues.

THE DEVELOPMENT PROCESS

The Leadership Standard is the product of a detailed and rigorous development process including a public consultation which was carried out early in 2014. The consultation asked if the CB:PSB's expectations of banking leaders, as set out in the draft standard, were appropriate, who should be in scope and if implementation of the Leadership Standard would help build, over time, greater public confidence and trust in individuals, institutions and the banking industry overall.

Respondents, who were drawn from the banking industry, academia and training indicated strong support for the draft Leadership Standard but suggested additional focus on customer outcomes and risk management. These were agreed by the CB:PSB and incorporated into the final standard.

The CB:PSB's independent Advisory Panel has representatives from academia, consumer bodies, trade associations, consumer champions and acts as a hub for the views of a wide group of stakeholders. It also offered critical advice at each step of the Standard's development. The Advisory Panel was keen to ensure that the Leadership Standard would be accessible to a wide audience – not just those in banking or learning and development but to banks' customers and stakeholders. Their advice saw the Leadership Standard refined and streamlined as well as key elements of the Code clearly articulated.

While the Leadership Standard was being developed, the regulatory landscape and the banks' own initiative to raise standards – the Banking Standards Review Council (BSRC) – were evolving. The CB:PSB has a clear focus on ensuring that its standards complement and, where appropriate, build on these and other initiatives. The CB:PSB has, therefore, kept a close eye on proposals emerging from regulators, including the recent PRA and FCA consultation "Strengthening Accountability in Banking" (see page 40) and developments from the emerging BSRC.

PUTTING THE LEADERSHIP STANDARD INTO PRACTICE

With the standard published, the attention of the CB:PSB has turned to implementation. Member firms will begin to implement the standard in January 2015 but not from a standing start – as the standard has developed throughout 2014, member firms have used the themes of the standard to help shape and inform the internal leadership programmes which will be used to support its implementation. Susan Rice, Chairman of the CB:PSB, comments that "We do not underestimate the challenge we face. Just as it should be, the Leadership Standard is comprehensive and exacting. It is both a statement of intent and a detailed pathway to rebuilding confidence and trust in banking." The CB:PSB anticipates that it will take a minimum of one year to implement the Leadership Standard in full, with the first implementation progress review scheduled for 2016. For more information, visit www.cbpsb.org

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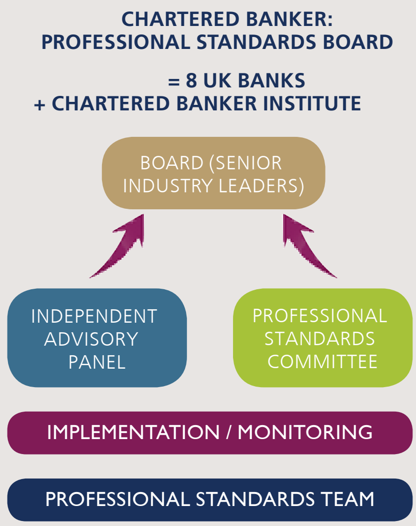
WHAT IS THE CB:PSB?



"We do not underestimate the challenge we face. Just as it should be, the Leadership Standard is comprehensive and exacting. It is both a statement of intent and a detailed pathway to rebuilding confidence and trust in banking."

ABOUT THE CB:PSB

The Chartered Banker Professional Standards Board (CB:PSB) was launched in October 2011. It aims to enhance and sustain a strong culture of ethical and professional development across the UK banking industry by developing a serious of professional standards at Foundation, Intermediate and Leadership (Advanced) levels. The CB:PSB intends to help build, over time, greater public confidence and trust in individuals, institutions and the banking industry overall, and enhance pride in the banking profession.

Jokes

What's the difference between a tragedy and a catastrophe?
A tragedy is a ship full of bankers going down in a storm; a catastrophe is when they can all swim.

A lady was newly appointed as a clerk in a bank. The manager of that branch was fond of Literature and books. He asked the clerk:

- "Do you know William Shakespeare?"

The clerk Replied:

- "No. In which branch is he working?"

View on Banker

"A banker is a fellow who lends his umbrella when the sun is shining and wants it back the minute it begins to rain."
Mark Twain

"Everyday is a bank account, and time is our currency. No one is rich, no one is poor, we've got 24 hours each."
Christopher Rice

"If you want to change the way your banking system is regulated, if you want to learn the mistakes of what's gone wrong, then you have to change your government." *George Osborne*

Interesting Quotes

The will to win, the desire to succeed, the urge to reach your full potential... these are the keys that will unlock the door to personal excellence. - Confucius

Expect problems and eat them for breakfast. - Alfred A. Montapert

There is only one corner of the universe you can be certain of improving, and that's your own self. - Aldous Huxley

Do the difficult things while they are easy and do the great things while they are small. A journey of a thousand miles must begin with a single step. - Lao Tzu