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Pakistan

Politicians, Regulations, and Banks Advocate Basel

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Introduction

In the 1950s and 60s, Pakistan was held up as the poster-child for late development and state-led industrialization, and considered on a par with South Korea. Since then, the two have followed markedly different development trajectories. Since the 1990s, Pakistan was among a set of developing countries that wholeheartedly implemented IFI sponsored liberalization reform, resulting in a dramatic transformation from a state-led 'developmentalist' model up until the 1970s, to a 'neoliberal' model based on Washington Consensus principles after the 2000s. As part of these reforms, Pakistan transformed its tightly controlled, highly segmented, public bank-dominated financial system into an almost fully privatized, deregulated, and liberalized one by the 2000s. One of the key tenets of Pakistan's new development model is the promotion of services exports, especially financial services, by encouraging the internationalization of the banking sector, making it an especially interesting case to observe the causal mechanisms of adoption of international financial standards. The Pakistani case also shows how liberalization pressures from international financial institutions in one period can create path dependencies, leading to policy-driven convergence over time. Pakistan is also one of the few cases where all three major actors (politicians, regulators, and banks) faced strong incentives to converge on international standards by the 2000s. This led to substantive compliance, compared to cases like Nigeria or Vietnam where one or more of the major actors had conflicting incentives, resulting instead in mock compliance (Table 4.1).

As part and parcel of banking sector internationalization, Pakistan is one of the highest adopters and implementers of Basel I, II, and III and the Basel Core Principles (BCPs), but with different actors driving adoption over time. Starting from a domestically oriented model, over the course of the 1980s to 2000s, Pakistan's politicians were the initial drivers for convergence. Subsequently, regulators pushed for Basel adoption, and finally, once the banks' interests became aligned with those of politicians and regulators, all three major actors pushed for a concerted convergence on Basel standards.

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Table 4.1 Pakistan: key indicators

Pakistan	
GDP per capita (current US$, 2017)	1,584
Bank assets (current US$)	120.1 bn
Bank assets (% of GDP)	43.1
Stock market capitalization (% of GDP)	28.1
Credit allocation to private sector (% of GDP)	16.5
Credit allocation to government (% of GDP)	28.6
Polity IV score (2017)	7

Note: All data is from 2016 unless otherwise indicated.

Source: FSI Database, IMF (2018); GDI Database, World Bank (2017); Polity IV (2014)

While Basel I and BCP adoption in Pakistan was a result of IMF and World Bank conditionality, over the course of the late 1980s and 2000s, Pakistani politicians, whether civilian or military, increasingly shifted away from prioritizing state-led industrial development, to embrace a more international orientation and championing financial services exports in particular. A liberalized, privatized, and internationalized banking sector was seen as vital to this development strategy, even though the specifics of Basel adoption fell under politicians' radar and were not as politically salient an issue as other reforms like bank privatization. The adoption of international banking standards was seen as important for internationalizing the banking sector, but regulators also made instrumental use of Basel standards to force bank consolidation.

As part of IFI conditionality and financial liberalization, the independence and regulatory power of the Pakistani central bank, the State Bank of Pakistan (SBP), was greatly strengthened. At the same time, internationally oriented politicians began to appoint former IFI bureaucrats to key posts at the SBP, generating strong peer incentives for officials to international standards. By 2000 the SBP took over from the IFIs in becoming the main actor driving through Basel I and then II adoption. Initially this was done against the wishes of the domestic banks, which viewed the adoption of international standards as a heavy burden, but were not politically powerful enough to oppose the SBP, either because they were still in the process of privatization, or were loss-making because of the financial crisis of the 1990s. During this period, foreign banks were the SBP's main partners in pushing forward adoption and helping local banks to implement. By 2007/8, however, the situation dramatically reversed, with the domestic banks taking the lead on adoption, while the SBP lost some of its steam after international financial standards were discredited in Pakistan for failing to stop the global financial crisis. By this point, not only had the highly internationalized domestic private banks incurred massive sunk costs by investing in costly Basel-related infrastructure, but they had emerged as a powerful interest group because of the transfer of ownership to domestic industrial conglomerates or foreign investors, as well as the

fact that the new development model's emphasis on financial services placed them at a privileged position in the economy, giving them leverage over the SBP. The banks now saw staying up to date with international standards as a vital signalling mechanism to preserve their global position. For its part, although the SBP was less zealous about Basel III than it had been about Basel II, in order to compensate for Pakistan's FATF blacklisting, it not only went ahead with Basel III adoption, but modified certain elements to make them even more stringent than the original standard. Therefore, in Pakistan after 2007, incentives for convergence were salient for all three sets of major actors, which explains the high degree of adoption and implementation.

The following analysis is based on central bank, IMF, World Bank, and other official documents, speeches of central bank governors, news articles from major local business newspapers, and twenty-seven semi-structured, off-record interviews. The interviews were conducted in Karachi between December 2016 and January 2017, with bank CEOs, CFOs, and risk managers, at large and medium domestic private banks, foreign banks, a domestic public bank, a microfinance institution, current and former senior officials at the central bank, consultancies which specialized in helping banks with Basel implementation, as well as with industry associations Pakistan Banking Association, Pakistan Business Council, and Karachi Chambers of Industry.

Political economic context

Pakistan is a lower-middle-income country with a high degree of external vulnerability due to a periodic balance of payments crisis and a development model that prioritized attracting foreign investment. After the late 1980s, Pakistan's development model began changing wholescale from a 'developmentalist' state-led model based on import substitution industrialization, to a 'neoliberal' model based on 'Washington consensus' principles (Zaidi, 2015). While Pakistan is no longer a primarily agricultural economy, industrial growth has stagnated since the 80s, and the economy has become increasingly services based (Zaidi, 2015).

The financial system

Until the late 1980s, Pakistan had a typically 'repressed' financial system, with a high degree of policy directed lending through public development finance institutions (DFIs), a nationalized commercial banking system, and credit planning (Janjua, 2004, 2003).

Financial liberalization and deregulation began in 1988 under an IMF structural adjustment program (Janjua, 2003). DFIs and policy lending were phased out,

and four of the five nationalized commercial banks were privatized with only National Bank of Pakistan (NBP) left in the public sector, entry restrictions on foreign banks relaxed, and bank licensing liberalized (Naqvi, 2018). Significant changes in the regulatory framework were also made. Prior to the 1990s, regulatory functions were shared between the Ministry of Finance, Pakistan Banking Council (PBC), SBP, and the Corporate Law Authority (CLA). On the recommendation of the IMF, in 1997, the PBC was abolished in 1997, making the SBP sole regulator of the banking system (Janjua, 2004).

Post-liberalization financial structure

By the mid-2000s, the financial sector was highly liberalized and almost completely privately owned (Naqvi, 2018). The new 'outward-oriented' development strategy envisioned a financial sector that was highly profitable and internationally competitive in order to contribute to GDP, and in particular to increase financial services exports (Government of Pakistan, 2007; International Trade Centre with Government of Pakistan, 2007). The new strategy depended on attracting foreign investment into the domestic financial sector, as well as encouraging domestic banks to internationalize in order to profit from fees-based activities in their foreign branches. SBP governor Muhammad Yaqub captured this change in strategy in a 1993 speech in which he stated that he was determined to transform the banking industry '[in]to a service industry from a bureaucratic machinery' (Yaqub, 1993, cited in Janjua, 2003, p. 286).

By the 2000s, the post-liberalization Pakistani financial system was highly concentrated, consisting mainly of five large domestic commercial banks, MCB, UBL, HBL, ABL, and NBP, which together account for about 80 per cent of all profits in the banking sector, and 60 per cent of bank deposits (Munir and Naqvi, 2015). These five banks were internationally oriented: although domestic for regulatory purposes, they became partially foreign owned, with majority shareholdings of UBL and HBL being sold to foreign investors (Munir and Naqvi, 2015). These banks also had an extensive historic network of foreign branches in countries ranging from the UK, Europe, and the US, to Asia Pacific, the Middle East, and Africa (HBL UBL, MCB, ABL, NBP company accounts), which catered mainly to the Pakistani diaspora. After bank licensing was deregulated, a variable number of small private banks emerged, but these never managed to capture significant market share, since they could not compete with the extensive branch network of the five large commercial banks. Although the number of foreign banks increased (see Figure 4.1), their activities remained limited to investment banking, or in some cases consumer finance, as they could not compete with the large commercial banks in capturing deposits either. The large increase in foreign ownership of bank assets therefore reflects increased

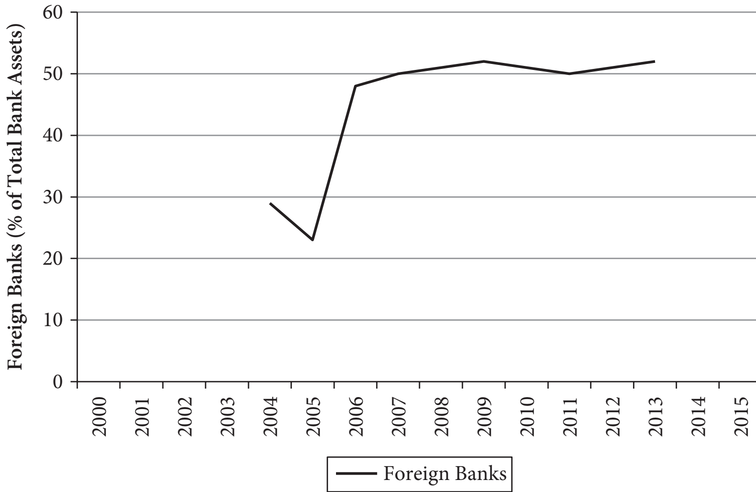

Figure 4.1 Pakistan: foreign ownership in the banking sector.
Source: Claessens and Horen (2014)

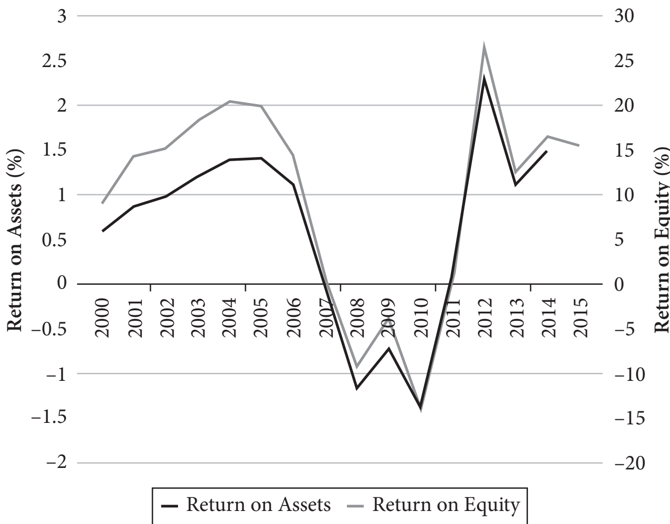

Figure 4.2 Pakistan: bank profitability.
Source: Bankscope and Orbis Bank Focus, Bureau van Dijk (2018)

foreign shareholding of the large five banks rather than the dominance of foreign bank subsidiaries.

Following a period of crisis while they were being privatized, the commercial banks became extremely profitable, especially between 2004 and 2007, and again after the financial crisis (see Figure 4.2). Although real-economy lending had fallen,

the banks remained profitable through heavy investments in risk-free but high-yielding government bonds (Naqvi, 2018).

Political economy of governing elites, regulators, and banks

The two main political parties, the PPP and PML-N, which have shared power since the return to democracy in the 1990s, shared a similar 'outward-oriented' financial agenda under the strong influence of the World Bank and IMF. During the 2000s under the military dictatorship of Pervez Musharraf, banking regulation was delegated to the newly autonomous SBP, which carried the pace of financial reforms forward. Since the resumption of democracy under PPP in 2008 and then PML-N in 2013, financial sector policy has not shifted. In comparison to the dramatic changes that have taken place in the Pakistani financial system during the 1990s, especially bank privatization, Basel adoption remains a relatively uncontroversial de-politicized topic, with low visibility in electoral politics.

The domestic banks had little political influence the 1970s and 90s because they were under government ownership, or in the process of privatization. At the same time, institutional reforms under IMF programmes drastically increased the SBP's authority and autonomy, giving it the upper hand in enforcing bank regulation. However, once privatization was completed by the mid-2000s, the situation reversed dramatically.

The highly concentrated five large commercial banks articulated their interests to the SBP through the well-organized Pakistan Bankers Association (PBA). Although the PBA represents both domestic and foreign banks, it is dominated by the large privatized commercial banks. Not only were the banks politically well connected, but the government's strategy of promoting banks' foreign profits also ensured their privileged position in the economy, as did their high profitability from 2004 onwards, increasing their leverage over the SBP.

Pakistan's adoption and implementation of Basel I, II, and III, and the Basel Core Principles

Pre-Basel I financial regulation

Prior to the introduction of Basel I standards in the late 1990s, Pakistani regulators had in place a number of regulations for the purpose of maintaining financial system stability, including strict bank and branch licensing, bank-wise credit ceilings, minimum paid-up capital, and a liquidity requirement (Janjua, 2004, 2003). These regulations began to be phased out as they were replaced with the various Basel Accords, but minimum paid-up capital requirements were maintained and continued to be raised.

Basel I

Pakistan was a relatively late adopter of Basel I, waiting nine years after it was agreed internationally to introduce it into domestic regulation. In 1997, all commercial banks, NBFIs, and foreign banks were instructed to adopt the system of risk-weighted capital in line with the Basel accord through BPRD Circular #36 of 4 November 1997. After a significant delay following the BCBS's 1996 amendment to Basel I to include a capital charge for market risk, the SBP amended the capital adequacy framework, in order to 'align the regulatory capital requirement with the internationally accepted standards and institute a true risk-based capital adequacy framework' in August 2004 (State Bank of Pakistan, 2004).

Basel Core Principles

A few years after the Basel Core Principles were announced by the BCBS in 1997, the SBP made moves to incorporate these into the domestic regulatory framework (State Bank of Pakistan, 2005). In 2003 the SBP issued a 'Handbook for Corporate Governance', which was modelled directly on the Core Principles, as these were considered 'international best practise' at the time (Akhtar, 2006a). The new governance document provided guidelines for bank boards of directors, management, and auditors (see State Bank of Pakistan, 2003).

Basel II

Basel II adoption by Pakistan was extremely fast, showing the SBP's enthusiasm for the new regulations. The SBP issued a 'roadmap' for Basel II implementation in March 2005 via BSD Circular No. 3 2005, less than a year after the BCBS replaced Basel I with Basel II, followed by detailed instructions in June 2006 via BSD Circular #8 of 27 June 2006.

Aside from the speed of Basel II adoption, two other patterns are striking. Firstly, unlike many other peripheral countries, which were selective in their adoption, Pakistan adopted nine out of ten Basel II components, compared to an average of four for non-BCBS member countries (Jones and Zeitz, 2019). Pakistan was ambitious in its adoption, going quickly for the most complex components, including Internal Rating Based (IRB) approaches. In addition, the components were introduced by the SBP in a largely unmodified form, with the instruction document following the original Basel II documents (BCBS, 2004) almost word for word, even giving detailed instructions for the calculation of risk weights for financial instruments that barely existed in Pakistan, such as collateralized OTC derivatives. Basel II regulations in Pakistan were not modified for specialized banks, DFIs, or smaller banks.

Basel III

While Basel III adoption was still high compared to other non-BCBS countries, with Pakistan implementing four out of eight, compared to an average of just one out of eight components by 2015, the SBP took a more gradual approach compared to its speedy adoption of Basel II. Basel III began to be adopted with a three-year delay from when the BCBS issued the new accord in 2010, and the initial set of instructions contained only requirements to implement the core capital, leverage ratio, and capital conservations buffer, as the SBP wanted some time to consult with all the relevant stakeholders about the relevance of elements such as the countercyclical capital buffer, LCR, NSFR, and domestic systemically important financial institutions (D-SIFI). However, this gradual approach was combined with the SBP modifying certain elements of Basel III such as the CAR and capital conservation buffer to make them even stricter than the original requirements (FSI, 2015; State Bank of Pakistan, 2016) (Table 4.2).

Enforcement

Available assessments from IMF FSAPs and Article IV Consultations, World Bank reports, SBP self-assessments, and the US Department of State's Investment Climate Statements, between 1998 and 2017, suggest that although compliance lagged during the initial phases of Basel I and II implementation during the late 1990s and early 2000s because of capacity constraints, especially among small banks, since the mid-2000s compliance with implemented Basel II and III standards has been largely substantive. Pakistan is also judged by the IMF to have achieved 'a degree of compliance with most of the Core Principles' (IMF, 2004, p. 28).

Table 4.2 Pakistan: adoption of Basel standards

Basel component	Adoption	Implementation
Basel I	BPRD Circular 36 of Nov 1997—Credit risk BSD Circular 12 of August 2004—Market risk	Credit risk—1998 Market risk—2004
Basel II	BSD Circular 3 of March 2005 (Roadmap document) and BSD Circular 8 of June 2006 (detailed instructions) (9/10 components)	Standardized approach—2008 Internal-ratings-based approach—2010
Basel III	BPRD Circular 6 of 2013 BPRD Circular 8 of 2016 (4/8 components)	CET-1, CCB, leverage ratio—2013–19 LCR and NSFR—2017–18

Source: Various SBP (State Bank of Pakistan) documents

This was broadly confirmed by interviews with regulators at the central bank, the SBP, and independent consultants. Punishment for non-compliance includes limiting of banking activities, and eventually revoking of banking licences, which suggests that adopted standards were enforced. By the time interviews were conducted in December 2016, both large and small banks were compliant with the Basel II and III provisions mandated by SBP regulations, but three large banks and one medium-size bank had already moved to the advanced approaches of Basel II, which were not mandatory. At the time of the interviews, four banks were compliant with the foundation internal-ratings-based approach, in terms of operational risk; all the large banks had moved to the standardized/alternative standardized approach; while two were trying to implement the advanced measurement approaches (various interviews with consultancies and domestic banks). No exemptions were made in Basel I, II, or III compliance for specialized banks, DFIs, or small banks.

Political economy of Basel adoption

Basel adoption in Pakistan can broadly be divided into three distinct phases, the first being IFI led, the second central bank led, and third private bank led. While Basel I was first introduced to Pakistan as part of a wider regulatory overhaul under various World Bank programmes, the newly strengthened SBP soon took the reins and became an ardent advocate of Basel II. This was despite the fact that banks were initially reluctant because of the high regulatory cost of adoption. The financial crisis proved to be a turning point in the SBP's attitude to international regulatory standards, with the perceived failure of Basel II in preventing the global financial crisis resulting in a much more cautious attitude to adoption. However, by this time, a new advocate for Basel II and then III had emerged; the large internationalized domestic commercial banks that had initially been reluctant adopters of Basel standards. These banks now saw keeping up to date with the most sophisticated international standards as vital to maintaining their global position.

IFI-led adoption of Basel I and BCP (1998–2000)

During this first phase, the World Bank and IMF were the main players in driving through Basel I adoption as part of structural adjustment conditionalities (Janjua, 2004). Following the end of military rule, two main political parties, the centre-left, formerly socialist, Pakistan People's Party (PPP), supported by industrial and rural workers, but also members of the landed elite, and the centre-right, fiscally and socially conservative Pakistan Muslim League-Nawaz (PML-N),

which draws its support from influential industrialists and agriculturalists of the most populous Punjab province, have alternated in power over the course of the 1990s. Despite their divergent political stances and constituencies, they have shared a remarkably similar financial agenda, centralized around liberalization and privatization. This was because these civilian governments, especially the PML-N government of 1997, were closely aligned with the IFIs in terms of international economic policy orientation (Zaidi, 2015). For example, full-time finance ministers were rarely appointed during this time, with civilian governments instead relying on advisors from the IMF and World Bank to ensure the implementation of conditionalities (Zaidi, 2015). Although the SBP was involved in the regulatory reform process, it did not have a very strong role in deciding the direction of reform because of its limited regulatory authority in the early 90s (World Bank, 1998). There is no available evidence to suggest that the then still nationalized banking system had an important role to play either. During this time, the main opposition to regulatory overhaul came from the Federation of Pakistan Chambers of Commerce and Industry, who feared that complex regulations would make access to credit more difficult (Janjua, 2004). However, in comparison to the controversial bank privatization programme, which saw many union protests (Munir and Naqvi, 2017), Basel I adoption remained a relatively de-politicized topic, with low visibility in electoral politics.

Adoption of Basel I and Core Principles occurred under the hard conditionalities of the 1997 World Bank Banking Sector Adjustment Loan (BSAL) (World Bank, 1998) and the October 1997 IMF Exchange Credit Fund and Exchange Facility Fund programmes. One of the main 'project objectives' of the World Bank BSAL I, on which release of funds for the next BSAL was conditional, included revising capital adequacy rules to bring them in line with the Basel I minimum CAR of 8 per cent by 31 December 1997 (World Bank, 1998). The IMF programmes included a similar performance criterion to make prudential regulations on capital adequacy consistent with international norms (Wilf, 2017). In the years following, all of the nationalized commercial banks became compliant, with only four of the small banks remaining non-compliant by 2002, while non-compliant DFIs were gradually phased out (Janjua, 2004).

Central bank-led adoption of Basel I and II (2000–7)

During the 2000s, although the IMF and World Bank remained important in influencing Pakistan's financial sector policies, the government, especially the newly independent central bank, took the reins of economic policymaking under the military dictatorship of Pervez Musharraf. Under Shaukat Aziz, a former international investment banker, who was appointed finance minister in 1999, and then prime minister in 2004, the international orientation of the financial

sector was consolidated. Aziz's vision revolved around globalizing the banking sector; both through attracting inward foreign investment and through outward internationalization of Pakistani banks. Since the resumption of democracy under the PPP in 2008 and then PML-N in 2013, financial sector policy has remained outward oriented.

During this period banking regulation was delegated to the newly autonomous SBP, which had started taking a much more proactive role in designing financial sector policy as its regulatory powers had been expanded, and autonomy increased under IFI structural adjustment. While the independent central bank had sole authority over financial regulation, its policies were in keeping with the general thrust of Aziz's vision for the financial sector, because SBP governors were appointed by the Federal Government. Basel II adoption was given impetus by the appointment of two SBP governors between 1999 and 2009, Ishrat Hussain and Shamshad Akhtar, who were ardent advocates of adopting Basel II, influenced by their IFI background. While the domestic banks were initially resistant to Basel II implementation because of the heavy costs it would entail, the foreign banks emerged as a key partner in Basel I and II implementation. The SBP had a great amount of leverage over domestic private banks during the early 2000s, as the large banks were still being privatized, and were at times loss-making, limiting their political influence and economic importance.

By the 2000s, the SBP's authority and independence was dramatically increased mainly as a result of IFI conditionalities during the 1990s. On the recommendation of the IMF, the SBP was made the sole regulator of the banking system in 1991, given formal independence from the Ministry of Finance in 1994 (Janjua, 2004). Furthermore, a number of measures were taken to strengthen the regulatory capacity of the SBP under the World Bank FSAL, between 1997 and 1999. An international consultant was hired in order to train the Banking Supervision Department in charge of prudential regulation and identify and recruit qualified supervision staff (World Bank, 1998).

Reflecting governing elites increasing outward orientation after the 1980s, the nature of SBP governors appointed by the Federal Government changed accordingly. Between 1947 and the late 1970s, the first six governors had domestic banking or civil service backgrounds, and the next five governors had only loose affiliations with the IFIs, for instance holdings consultancy assignments, or attending training courses. The appointment of career IMF bureaucrat Muhammad Yaqub in 1993 reflected the clear shift towards outward orientation by the civilian governments of the 1990s. The appointment of Ishrat Hussain in 1999 and then Shamshad Akhtar in 2006, who had previously made their careers in the World Bank and Asian Development Bank, respectively, by the Musharraf dictatorship, reflected the consolidation of the new financial sectors strategy under Shaukat Aziz. This was followed by the appointment of international investment bankers as governors from 2009 onwards (Munir and Naqvi, 2017).

Therefore, the nature and power of the SBP had changed dramatically by the early 2000s, from a nationally oriented developmentalist central bank, to one that was outward looking and deeply embedded in transnational regulatory networks. In particular, by 1999, the institutional reforms that gave it sufficient independence regulatory power had been completed, and coincided with the appointment of Ishrat Hussain who was an aggressive advocate for Basel I and II. At the same time, the commercial banks remained weak, while governing elites shared the SBP's outward orientation, giving the SBP leadership an unprecedented degree of power. This was reflected in the speed with which Basel II was adopted, and the fact that all elements were adopted without modification.

Basel I and II adoption were important for the SBP in the new regime for three complementary reasons. Firstly, and most importantly, with the change in development model and reorientation of financial sector strategy towards improving Pakistani banks global positioning (Dawn, 2007), Basel adoption came to be seen as a necessary signalling tool to attract foreign investors.

Secondly, liberalization of bank licensing in 1991 had led to the proliferation of a large number of small private banks (Zaidi, 2005). These were seen as lacking sufficient scale to become internationally competitive with cross-border banks post-liberalization. According to Hussain, 'The financial institutions [small banks] are neither conducive to positioning Pakistan in the global financial markets nor helpful for efficient intermediation within Pakistan' (Hussain, 2001a). The SBP therefore actively pursued a policy of encouraging consolidation in the banking sector through merger and acquisition during the first decade of the 2000s (Dawn, 2005). Basel I and II regulations proved a useful tool for this policy, as small banks found it much harder to meet the requirements, which then gave the SBP an excuse to revoke bank licenses, or force a merger. Between 2001 and 2006 alone, twenty-one financial institutions were merged or taken over (Akhtar, 2006b).

Finally, in part because of their socialization at the IFIs, top officials at the SBP, especially governors Ishrat Hussain and Shamshad Akhtar, believed that Basel I and then II were better tools for risk management because of their socialization at the IFIs. They thought Basel would become especially important in protecting against the risks of globally interconnected financial markets, as the traditionally closed Pakistani financial system liberalized externally. In line with the thinking of the time, which SBP officials were familiar with because of their strong links with transnational regulatory networks, and in reaction to the previous era of state intervention, the governor believed in the philosophy underlying Basel II, namely that light-touch regulation and market discipline would be more effective in promoting financial stability. For example, according to Ishrat Hussain in a 2001 speech, 'Economic theory and international experience all suggest that the Central Bank should encourage such transparent, disclosure-based and market-based regulation that the financial institutions themselves have the incentive to comply with the regulations for their own protection' (Hussain, 2001b).

This top-down pressure for implementation by SBP governors was complemented by 'peer pressure' on more junior officers in the Banking Policy Review department responsible for Basel implementation from transnational regulatory networks. In particular, SBP officials noted that they had experienced peer pressure from other central banks they interacted with often, including those in Malaysia, Singapore, the Philippines, and Bangladesh, for example through meetings of the FSB Regional Consultative Group for Asia, for which Pakistan has acted as co-chair, or meetings of SAARCFinance, a network of central bank governors of the SAARC region[1] (Financial Stability Board, 2016).

When the Basel II regime replaced Basel I in 2004, the SBP was already well connected to transnational regulatory networks, and keeping abreast of current international developments and 'best practice'. According to an interview with an SBP official responsible for Basel implementation, 'we have constantly been observing international developments. There has been an accepted notion in SBP that all international standards should be complied with until it is seen that there is some kind of negative'.[2] Following international regulators, Ishrat Hussain thought that Basel I had some 'inherent rigidities' that undermined its effectiveness, which were remedied by Basel II (Hussain, 2005).

Meanwhile, the domestic banks, although not opposed to Basel II in principle, were reluctant to adopt the new standards too quickly because of the heavy costs this would entail. A survey conducted by the SBP in 2003 found that the majority of banks (49 per cent) thought that Basel II should not be implemented until 2008, and that the Standardized Approach as opposed to the IRB would be sufficient (State Bank of Pakistan, 2005). Not only did domestic banks initially lack the computerized systems and reliable data that adoption would have required, they also often had to hire expensive foreign consultancies and invest in expensive software infrastructure in order to ensure compliance (interviews with various domestic banks and consultants). In 2004, Ishrat Hussain chastised the domestic banks for lagging behind in implementation: 'I have very little doubt that the foreign banks operating in Pakistan will have any serious problems in making the transition successfully but I remain very much worried about our domestic banks…I see that our large banks have not yet woken up to attract the human resource of the right kind, set up the internal rating systems and the supporting technology' (Hussain, 2004). According to interviewees, the SBP pushed ahead with Basel II adoption despite the banks' complaints: 'Ishrat's response to bank complaints was that if you cannot do this [implement Basel II] then you have no business running a bank and I will find a buyer for you'.[3] Falling behind on adoption also carried severe penalties that included the imposition of heavy fines, limiting of banking activities, and eventually revocation of banking licenses

[1] SBP Official, Karachi, 6 January 2017. [2] SBP Official, Karachi, 6 January 2017.
[3] CEO, Consultancy, Karachi, 27 December 2016.

(Iqbal, 2005). According to interviewees, whereas before the 2000s banks never faced penalties for non-compliance with SBP regulation, under Hussain these penalties were rigorously enforced. During this period, the domestic banks were still in the process of privatization, or were loss-making because of the financial crisis of the 1990s, and so were not politically powerful enough to oppose the SBP.

Initially, therefore, the foreign banks were the SBP's main partner in pushing the Basel agenda through, since they were required by their headquarters to become compliant. The foreign banks wanted domestic banks to implement Basel II both because they were engaged in correspondent banking relationships with the domestic banks, and they found Basel II compliance reassuring in this regard, but also because they did not want to be at a competitive disadvantage to domestic banks.[4] Another important channel through which foreign banks aided Basel II implementation was through the transfer of personnel from early adopting foreign banks such as Citibank, American Express, and Bank of America to domestic banks. After the SBP made Basel II compliance mandatory, many domestic banks poached foreign bank-trained personnel because of the lack of local expertise on Basel II, in order to rush ahead with compliance.[5]

Under Shamshad Akhtar, the drive for Basel II implementation was strengthened. Akhtar was a strong advocate for Basel II, and described it as nothing short of a 'revolution' in risk management (Dawn, 2006). The Pakistan Banks Association (PBA) had to argue with her from time to time to tone down her approach. According to a foreign banker, 'the SBP under Shamshad was so over-ambitious that the PBA's Basel committee had to work with local and foreign banks to help convince her to slow down. The local banks were having a lot of trouble in implementation'.[6]

In particular, while the large banks were more easily able to bear the costs associated with Basel adoption, and could afford to hold the required amount of capital, the small banks felt especially penalized.[7] This was not a concern for the SBP as the policy of banking sector consolidation continued under Akhtar. According to an SBP employee who had worked closely with Akhtar, 'It [Basel II and increases in minimum capital requirements] was a political move—we felt that some people wanted to get banking licenses and we didn't want them to get it, and we thought it would be good if some of the smaller banks that were facing solvency and liquidity problems merged. They protested but we implemented it anyway'.[8]

While Basel II implementation was not a part of IFI conditionality, the IMF praised these developments, arguing that the SBP's establishment of a roadmap for Basel II implementation had contributed to strengthening the regulatory

[4] CEO, foreign bank, Karachi, 22 December 2016.
[5] CEO, consultancy, Karachi, 27 December 2016.
[6] CEO, foreign bank, Karachi, 22 December 2016.
[7] Consultancy, Karachi, 20 December 2016.
[8] SBP Official, Karachi, 6 January 2017.

framework and been looked upon favourably by 'the market', citing a narrowing of Pakistan's EMBI spreads relative to its peers as evidence (IMF, 2005).

Bank-led implementation of Basel II and III (2008–present)

The 2008 global financial crisis was another turning point for Basel implementation in Pakistan. Although the SBP's implementation drive lost some steam because Basel II's failure in preventing the global financial crisis discredited the regulations, they were pressured to continue with Basel III implementation, and even over-comply with some components, in order to compensate for the negative reputational shock caused by Pakistan's FATF blacklisting in 2008 and 2010.

Furthermore, by this point the large domestic privatized banks, now owned by domestic conglomerates or foreign investors, had emerged as a key player and had gained leverage over the SBP, both because of political connections and their important position in the economy, given the new development strategy. Since 2004, the profitability of the largest five banks had been very high, strengthening their bargaining position. The five large domestic commercial banks now emerged as the leading advocates for Basel II and III adoption, with some banks even going above and beyond SBP mandated requirements. This was because the large five banks were highly internationalized, and saw keeping up to date with international standards as vital to maintaining and expanding their global position. This was not because they believed it helped them with risk management, but because they saw it as a vital signalling mechanism to reassure international investors and regulators. During this phase, the banks would actively lobby the SBP to offer more advanced approaches, while the SBP preferred a more gradual pace of adoption.

Ironically, at exactly the same time that large banks began to support Basel II adoption, Basel II itself became discredited in the eyes of both Pakistani regulators and banks. This was mainly because they had prevented neither the 2008 global financial crisis nor the 2008 domestic financial crisis experienced in Pakistan at the same time. Basel II was now perceived both as too complex and costly for the 'vanilla' Pakistani banking system. Furthermore, it was also perceived as ignoring some of the most important risks in the Pakistani financial system; excessive concentration of bank portfolios in government securities, which made the whole system very vulnerable to government default, and excess concentration of lending in very few industrial conglomerates (interviews).

After the financial crisis, the SBP's strong drive to implement Basel II lost some of its prior zeal, although by this point most banks were already compliant. A new SBP governor, Salim Raza, was appointed in 2009. Despite his international banking background, he was not as ardent an advocate of the Basel regulations as Hussain and Akhtar had been. In a speech shortly after his appointment, he

criticized Basel II regulations for ignoring systemic risk, and for an excessively 'light-touch' approach that was 'in vogue in advanced economies' (Raza, 2009). The banks, on the other hand, suggested that the SBP was no longer keen on moving ahead with the adoption of Basel standards because they themselves did not feel able to regulate the more advanced approaches.[9]

In a reversal from the previous phase of adoption, the main actors driving adoption of Basel II and later III now became the five large privatized domestic commercial banks. While the PBA had previously worked to convince Akhtar to slow the pace of Basel II adoption, it now took an active role in Basel II and III adoption; for example, in 2013, private banks approached the SBP to ask for the adoption of the Alternative Standardized Approach for operational risk, even though the SBP had not offered it in the Basel II instructions (State Bank of Pakistan, 2013), and continued to lobby the SBP to offer more advanced approaches at the time interviews were conducted.[10] This was not due to any belief in the regulatory superiority of the Basel Accords, but due to the market pressures inherent in a globalized and competitive financial environment. The large five banks wanted to maintain their historic network of foreign branches. In addition, Pakistani banks wanted to continue to internationalize by attracting foreign investment and making alliances with foreign banks (interviews with various domestic banks). The large banks believed compliance with the most advanced approaches would signal their relative sophistication to foreign investors and regulators, and set them apart from both their domestic as well as regional rivals in order to improve their international standing: 'SBP pressure is equal across banks but we are trying to go further in order to get recognition from our international partners. We take Basel as an opportunity to up our game'.[11]

Pakistani banks' preferences regarding Basel II shifted significantly after 2007, when Basel Committee members were required to be compliant with Basel II. The large domestic banks came to realize that now that Basel II had become 'best practice' in the developed world, compliance was vital for internationalization in multiple ways (interviews). This continued to be the case after Basel III was introduced in BCBS member countries in 2013. A former SBP governor described the Basel regulations as 'a necessity for Pakistani banks to internationalise'.[12] In addition, most of the substantial work in acquiring appropriate platforms, hiring skilled personnel, and expensive consultancies for Basel II implementation had already occurred between 2004/5 and 2008 under pressure from the SBP.[13] This meant the banks had already incurred huge sunk costs in putting the

[9] Risk management, medium domestic commercial bank, 13 January 2017.
[10] CEO medium domestic commercial bank, Karachi, 9 January 2017; Chief risk officer, large domestic commercial bank, Karachi, 28 December 2016.
[11] CEO, medium domestic commercial bank, Karachi, 9 January 2017.
[12] Former SBP Governor, Karachi, 21 December 2016.
[13] Consultancy, Karachi, 27 December 2016.

relevant infrastructures in place, and their incentives for further Basel II and III implementation changed accordingly.

Domestic banks found that compliance was important for their correspondent banking relationships, especially in major trading partner countries. According to one banker, 'Any changes that happen in the west, especially the US, filter to the Pakistani banking sector because of our corresponded banking relationships'. This was because the Basel standards provide a 'common standard that international partners can recognise' which reassured their partners that appropriate risk management systems were in place.[14] Another important reason was the maintenance or expansion of foreign bank branches. In this case, the pressure to become compliant comes from foreign regulators, who required compliance in order to continue operating in their jurisdiction. Banks even reported that some foreign regulators were pressuring them to report components of Basel III such as the LCR and NSFR, before the SBP had even mandated them.[15] However, this only applied to those banks that had branches in jurisdictions that were already Basel III compliant. Those banks that had branches mainly in regions where regulators were not concerned with Basel adoption, such as the Middle East, stated that the maintenance of foreign branches was not a relevant pressure for Basel II and III adoption.[16] Some banks also found compliance helpful when making international alliances with foreign banks. For example, one domestic bank made an alliance with a US bank, whereby the Pakistani bank issued the US banks' credit cards in Pakistan. According to the CEO of this bank, Basel II and III compliance helped them to get the deal, as the US bank had their own due diligence requirements for choosing foreign partners, and 'Basel compliance helps'.[17]

For its part, the SBP was not as eager to implement Basel III as it had been Basel II. In a 2012 speech to the Islamic Financial Services Board in Istanbul, the SBP governor Yaseen Anwar was sceptical about the effectiveness of Basel III and noted that the new complex international regulations were not well suited to the Pakistani financial system because they did not have a high degree of exposure to the complex financial products that were responsible for the 2008 crisis in the first place. He also noted the importance of 'keeping in view our own local legal, regulatory and economic environment' when implementing international standards (Anwar, 2012).

However, because of the international market pressures inherent in an 'outward-oriented' approach to the financial sector, the SBP had to continue keeping up to date with Basel III adoption, and even over-comply with certain components. In particular, the SBP was worried about the negative stigma associated with

[14] CRO, large domestic commercial bank, Karachi, 28 December 2016.
[15] Chief financial officer, large domestic commercial bank, Karachi, 21 December 2016.
[16] Risk management, medium domestic commercial bank, Karachi, 13 January 2017.
[17] CEO, medium domestic commercial bank, Karachi, 9 January 2017.

Pakistani banks in the post-9/11 environment, as banks came under scrutiny for terrorism financing, but especially since Pakistan was blacklisted by the FATF between 2008 and 2010 and again from 2012 to 2014. The SBP combined a gradual approach to Basel III adoption with over-compliance since keeping up to date with the latest international standards was seen as an important counterweight to the blacklisting. According to an SBP official, 'with 9/11 the financial sector has been under a lot of scrutiny so Basel helps developing countries establish internationally recognized financial systems. SBP ratios are even higher than Basel requirements. Frankly speaking, it is to demonstrate to the outside world that Pakistani banks are safe and sound because we have a lot of other challenges like the FATF'.[18] It was also expected that it would not be much of a problem for most banks to meet the Basel III requirements, since SBP regulations had already been very stringent, and the capital adequacy ratio for the banking system was already at 14 per cent (State Bank of Pakistan, 2011).

Although the IFIs were no longer the driving factor behind Basel II and III adoption, they continued to support implementation. In 2013 the IMF even asked the SBP to raise the CAR (among other reforms) in exchange for a USD 5bn Extended Fund Facility (InpaperMagazine, 2013). In addition, the IFC now took on a more direct role, because of its direct investments in domestic banks. According to an interviewee at one such bank, 'in 2014 we talked to IFC to invest in us and to give them comfort we wanted to be Basel compliant. Basel was one of the tick boxes for the IFC'.[19] According to interviewees at commercial banks, pressure to implement Basel II and III also comes from the ADB, which now provides much of its financing in Pakistan through private banks rather than through the government. Basel compliance affects the allocations private banks receive from the ADB, since before entering into an agreement the ADB evaluates domestic banks' risk management. If they feel risk management is weak, they will not enter into an agreement with that bank, and being Basel compliant is an important way of allaying these fears.[20]

Conclusion

Pakistan moved from being domestically oriented country during the pre-1980 era, to a 'policy-driven' pathway to Basel adoption due to the shift towards an internationally oriented development strategy by political elites between the late 1980s and early 2000s, in conjunction with IMF and World Bank structural adjustment programmes. However, Basel I and BCP fell under the radar of domestic

[18] SBP Official, Karachi, 6 January 2017.
[19] CEO, medium domestic commercial bank, Karachi, 9 January 2017.
[20] Risk management, medium domestic commercial bank, Karachi, 13 January 2017.

politicians, and the initial push for changes in financial regulation came from the IFIs. This was reflected in the slow pace of Basel I adoption, and a lag in bank implementation, especially by smaller and public banks.

As Pakistan's domestic political economy transformed because of the policy-driven financial liberalization reforms initiated during the late 1980s, Pakistan gradually embraced international standards. Politicians championed initial convergence and, in line with the argument in the analytical framework, this policy-driven convergence generated incentives for the regulator and the banking sector to become more internationally oriented over time. By the early 2000s, the newly independent and powerful internationally oriented SBP took the reins for Basel I and II adoption despite difficulties in implementation for small banks. This was reflected in the sudden and wholescale adoption of Basel II, even in the face of initial pushback from the banks.

Finally, by 2007/8, the third major actor, the large private domestic banks, had completed their transformation from nationalized developmental institutions to privately owned, internationally competitive banks. These internationally oriented banks, which saw adoption of the most advanced approaches of Basel II and III as vital to maintaining their internationalized business model, took over as the main driver of convergence. This was in order to maintain their extensive foreign branch network, and to facilitate entry into new markets, to maintain credibility among international investors and partners, as well as to maintain correspondent banking relationships. The 2007/8 crisis discredited Basel II and later III among Pakistani regulators, and threatened to shift Pakistan onto a merely market-driven pathway to convergence, with domestic banks going above and beyond SBP mandated standards. However, the private banks successfully lobbied the SBP to continue keeping up to date with Basel adoption, as did the external shock of FATF blacklisting. Therefore after 2007/8, despite the SBP's more cautious approach, Pakistan continued on its policy-driven pathway to convergence, which was reflected in ambitious Basel standard implementation and voluntary enforcement by banks. As at January 2019, Pakistan had the highest level of convergence on Basel standards among our case study countries and regions.

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