

2. SOUTH ASIA'S FINANCIAL SECTOR

In South Asia, regional trends and averages can be misleading because India accounts for three-fourths of the region's population and about 80% of its GDP, and has the most highly developed capital and financial markets (Table 1). The region does share a legacy of direct state involvement in banking and other financial services, and all countries have undertaken a range of finance sector reforms in recent years.

Liberalization of capital markets in South Asia began in the early 1990s. In India, the 1991 balance of payments crisis facilitated capital market reforms that mainly targeted the development of India's equity market and the establishment of the Securities and Exchange Board of India in 1992. Other capital market reforms during the 1990s focused on improving corporate governance, securities disclosure, and pricing systems, and making listing requirements stringent. These reforms continued in the early 2000s with the ownership ceiling raised for foreign institutional investors, restrictions relaxed on use of forward contracts by foreign institutional investors, and the foreign institutional investor ownership ceiling increased for corporate and government bonds. Trading of derivative products started in 2000 on the National Stock Exchange, which now ranks among the largest futures and contracts markets in the world.

Pakistan's capital market reforms began in the early 1990s with the lifting of restrictions on purchases of shares of listed firms by foreigners and nonresidents. More recently, reforms have included the automation of the stock exchange trading system and efforts aimed at enhancing the government securities market in order to stimulate the development of the corporate bond market. Sri Lanka also initiated capital market reforms in the early 1990s by allowing foreign firms to buy listed securities on the Colombo Stock Exchange, subject to certain restrictions. Further improvements in the government securities market were instituted with the introduction of a real-time gross settlement system, a scripless security settlement system, and a central depository system for government securities. Additionally, foreign investors are now allowed to purchase treasury bonds up to a maximum of 5% of the total outstanding value of treasury bonds. Finally, since 1991, nonresidents of Bangladesh and foreigners have been permitted to buy listed securities and stocks.

Maldives is distinct from the rest of the region due to its small size, high dependence on tourism, relatively high per capita GDP, and small financial sector. Afghanistan stands apart because its recent reform have focused on rebuilding a financial sector devastated by decades of conflict. Bhutan is far smaller and relatively more prosperous than Nepal, and Nepal has a larger and much more diverse financial sector, but both countries display worrying signs of a credit bubble against a backdrop of still incomplete finance sector reforms.

Table 1: Selected Economic Indicators for South Asian Countries
(2007, percent of gross domestic product unless otherwise noted)

	South Asia	Afghanistan	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka
Population (million)	1,506.1	24.5	140.6	0.7	1,134.0	0.3	26.4	159.6	20.0
GDP (\$ billion)	1,437.4	9.6	68.4	1.1	1,170.7	1.1	10.3	143.9	32.3
Per Capita GDP (\$)	986.8	350.1	486.8	1,664.8	1,028.7	3,470.5	390.8	910.0	1,616.1
GDP Growth (percent, annual)	8.6	11.5	6.4	17.0	9.0	7.6	2.6	6.8	6.8
Inflation (percent, annual)	5.5	13.0	7.2	5.2	4.7	7.4	6.4	7.8	15.8
Fiscal Balance	(5.2)	(1.8)	(3.2)	(3.4)	(5.4)	(7.8)	(2.0)	(4.3)	(7.7)
Current Account Balance	(1.7)	0.9	1.4	10.5	(1.5)	(40.1)	(0.1)	(4.8)	(4.2)
Gross International Reserves (months of imports)	12.3	3.6	3.3	12.9	15.0	3.1	8.9	4.5	2.9
External Debt ^a	18.5	21.6	29.1	69.6	16.3	62.9	31.6	26.9	45.4
Debt Service ^b (percent of exports)	7.0	1.5	3.6	4.2	10.2	5.7	10.7	12.9	12.7
M2 (base money, currency in circulation, bank deposits)	-	21.6	45.3	59.5	85.2	73.8	54.4	50.6	39.2
Bank Deposits ^c	-	10.9	39.5	46.0	68.0	64.9	29.9	79.4	65.3
Credit to the Private Sector	-	-	37.7	21.2	47.4	100.0	37.7	29.4	34.0

- = data not available, () = negative, GDP = gross domestic product, M2 = cash and demand deposits.

^a Maldives, Sri Lanka, 2006.

^b India 2005, Sri Lanka 2006.

^c ADB Key Indicators for Asia and the Pacific 2008, most recent year available.

Sources: Statistical appendix (except notes a and b, previous *South Asia Economic Report* edition statistical appendix); and note c, ADB Key Indicators for Asia and the Pacific 2008, most recent year available.

Fifteen years ago, the bank-dominated financial sector in Bangladesh, India, Pakistan, and Sri Lanka displayed broad similarities. Capital and exchange controls limited financial market development, and the predominant state-owned banks were constrained by interest rate controls and noncommercial mandates including directed lending and support for inefficient state-owned enterprises. Direct government interventions resulted in a proliferation of

special-purpose financial institutions, many of which were authorized to raise deposits. Significant losses in many state-owned banks meant that the financial sector was constrained in their ability to intermediate to support growth, instead consuming deposits to cover ongoing credit and operating losses. High reserve requirements for banks essentially co-opted deposits to finance government deficits. All four countries have pursued financial sector reforms, with the nature and extent of progress varying.

Despite an early start with privatization of one of five state-owned banks in the 1980s and a program of financial reform since the 1990s, Bangladesh remains burdened with undercapitalized and poorly performing state-owned commercial and specialized banks. State bank reform and further privatization efforts have proceeded slowly. Private and foreign banks have grown in number and market share, now accounting for almost 60% of banking assets, but the inefficient state banks are a drag on the entire system. Some interest rate controls remain, and banks are still required to meet directed lending requirements to targeted sectors. Prudential standards have been strengthened, although loan-loss provisioning requirements remain weak—a common feature of the region (Box 1). Many banks, particularly state-owned banks, do not comply with key prudential requirements.

India's financial sector reform since the 1990s has focused on gradual liberalization and use of an activist supervisory authority, the Reserve Bank of India (RBI), to drive the restructuring of state-owned banks. Following recommendations from the 1991 Narasimham Committee report on the financial sector, several key steps were taken, including interest rate deregulation, reduction in cash reserve and statutory liquidity requirements, reduction in barriers to entry in banking, and gradual strengthening of prudential norms. The combination of exposure to increasing competition and strengthened prudential regulation was intended to improve the performance of state-owned banks while retaining majority government ownership and the banks' social role.

New banks quickly took advantage of the liberalized entry rules in India. Between January 1993 and March 1998, 24 new private banks—including 15 with foreign ownership—began operations. The impact of new prudential standards was immediately evident, with the state-owned banks recording large losses and impaired capital, leading to recapitalization of 19 state-owned banks in 1993 and 1994, with many banks receiving further government support in subsequent years. The capital injections were at least notionally dependent on time-bound remedial plans, but there were few consequences for not meeting the objectives established in memoranda of understanding with RBI. In the face of a state-owned bank's failure to meet prudential standards or reluctance on the part of government as a shareholder to recapitalize or support reforms, RBI had few options but to provide forbearance while continuing to push for needed restructuring. Over time, the performance and governance of state-owned banks have been

Box 1: Loan Classification and Provisioning Requirements

Despite recent improvements, the standards for loan classification and provisioning in South Asia have several weaknesses including:

- interest accrual when more than 90 days in arrears (Bangladesh);
- no minimum provision required for loans 90 days in arrears (Bangladesh, India, and Sri Lanka); and
- lengthy arrears required before classified as doubtful or a loss (Bhutan, India, Maldives, and Sri Lanka).

Country	Classification	Days in Arrears	Minimum Provision
Bangladesh	Substandard	180	20% of the balance, net of liquid security, and 50% of mortgages
	Doubtful	270	50% of the balance, net of liquid security, and 50% of mortgages
	Bad debt	360	100% of the balance, net of liquid security, and 50% of mortgages
Bhutan	Substandard	91	20%; 30% for the housing sector
	Doubtful	361	50%; 60% for the housing sector
	Loss	720	100%
India	Substandard	90	Nonaccrual status only, no minimum provision
	Doubtful	365	100% of unsecured portion plus 20% of secured portion if up to 2 years in arrears, 30% if up to 4 years, and 100% if more than 4 years in arrears
	Loss	Not specified	100%
Maldives	Especially mentioned	90	5%
	Substandard	180	10%–20%
	Doubtful	365	35%–50%
	Loss	730	100%
Pakistan	Substandard	90	25% of balance, net of liquid security, and 30% of forced sale value of mortgages
	Doubtful	180	50% of balance, net of liquid security, and 30% of forced sale value of mortgages
	Loss	365	100% of balance, net of liquid security, and 30% of forced sale value of mortgages (no value for mortgages more than 3 years in arrears)
Sri Lanka	Special mention	90	Nonaccrual status only, no minimum provision
	Substandard	180	25% of unsecured portion for credit cards; 20% of unsecured portion for other facilities
	Doubtful	360	50% of unsecured portion
	Loss	540	100% of unsecured portion

Sources: Country prudential standards.

improved, but the most recent committee reviewing India's financial sector has reiterated the need for further progress and privatization (Government of India, Planning Commission 2009).

The list of changes to India's legal framework for banking supervision as well as improvements to its practical implementation is impressively long. Prudential standards have been continually reviewed and updated. In particular, more stringent accounting and loan-loss provisioning requirements have been phased in, with nonperforming loans being recognized when 90 days in arrears, effective March 2004—a significant change from the previous standard of 180 days. A prompt corrective action framework has been introduced in an effort to ensure that capital deficiencies are addressed in a timely manner.

Banking reforms in Pakistan started in the 1990s with deregulation, consolidation, restructuring, and privatization of state-owned banks, as well as permitting the entry of new banks. Government-owned commercial banks lost their dominance to private commercial banks, as the former's share of total banking system assets declined sharply. Today, they amount to about 20%, the lowest level in the region.

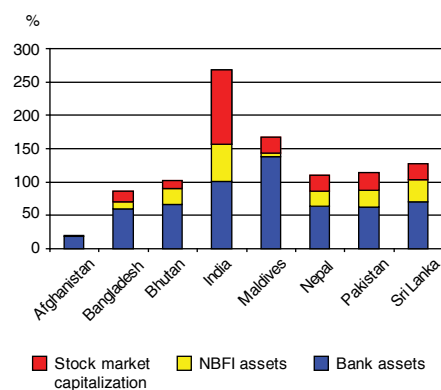
Improvements in corporate governance, information disclosure, and transparency of Pakistan's banks are a direct result of enhancements in prudential frameworks and the practice of bank supervision. The State Bank of Pakistan (SBP) underwent institutional reform, building the capacity of its personnel and introducing prudential regulations that, in most respects, conform to best practices and international standards. SBP has increased minimum capital requirements and imposed a moratorium on new bank licenses to promote consolidation, and these reforms have improved financial intermediation and supported growth in credit to the private sector. Despite the progress to date, SBP has identified a range of further reforms, including the need for a new banking act and new or revised prudential standards.

Sri Lanka's reforms since the 1990s have included interest rate deregulation, strengthening prudential requirements, and building the supervisory capacity of the Central Bank of Sri Lanka (CBSL). Efforts to reform underperforming state-owned banks have focused on operational restructuring rather than on privatization. While state-owned development banks were privatized in the early stages of finance sector reform in the 1990s, the government has taken steps to reverse this trend with the establishment of three new state-owned development banks between 2005 and 2007.

Structure, Performance, and Development

Banks currently dominate the financial system of most South Asian countries (Figure 2). All countries in the region except Afghanistan have established capital markets, with India's stock market capitalization ranking among the world's top 10. Development of nonbank institutions lags behind that of the banking sector, with most countries in the region lacking legal frameworks and supervisory structures to support growth of contractual savings vehicles such as life insurance and pensions.

Figure 2: South Asia's Financial Systems (percent of GDP)



GDP = gross domestic product, NBFI = nonbank financial institution.

Notes: End 2007 data, except Bhutan stock market capitalization, 2005; India data end-March 2008; Nepal data July 2007.

Sources: Country section tables.

Banks

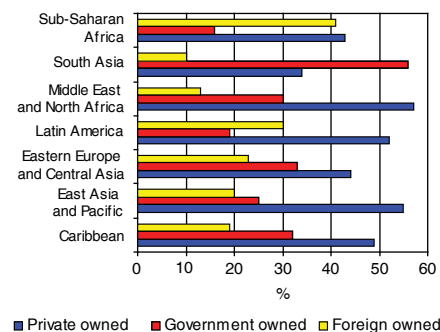
South Asian countries have a much higher proportion of government-owned banks than the rest of the world, ranging from 20% of total banking assets in Pakistan to 70% in India (Figure 3). Although state-owned bank dominance has been gradually decreasing across South Asia, progress over the last few years has been slow, resulting from more rapid growth of private sector banks than from significant privatizations.

State-owned banks throughout the region have tended to be less profitable and efficient than private and foreign-owned banks (Table 2). This is largely attributable to higher operating expenses—often from overstaffing—and higher loan-loss expenses, reflecting the generally poorer asset quality arising from directed or priority sector lending and politically influenced credit decisions. These contributions to poor asset quality, together with the delivery of subsidized credit programs, help explain the lower interest margins of state-owned banks. While there has been recent improvement in the performance of India's state-owned banks, they continue to demonstrate underperformance relative to its private sector banks.

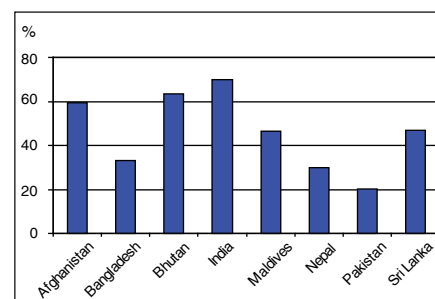
Continuing weaknesses in South Asia's state-owned banks have negative consequences for finance sector development and, more generally, private sector development. Inefficient state-owned banks require high margins to cover their operating expenses and loan losses. Thus, rates charged for loans, aside from subsidized and directed lending, need to be higher than would be required by better-performing banks. This phenomenon effectively shields private and foreign banks from the full effects of competition, as they only have to be slightly more efficient to gain the market share from state-owned banks and do not have to pass on to customers the full benefits of their superior efficiency. As a result, bank customers bear the burden of higher margins, and private and foreign banks are able to earn extraordinary profits because of the continued underperformance of the large state-owned banks.

Figure 3: State Ownership of Banks in South Asia

Bank Ownership Around the World, by Region (percent of total bank assets, median values 1995–2002)



State-Owned Bank Market Share (percent of total bank assets)



Sources: First panel, Micco, Panizza, and Yanez (2007); and second panel, country section tables.

Table 2: Bank Profitability, Efficiency, and Margins

	Return on Assets	Overhead Costs/ Total Assets	Interest Margin/ Total Assets
South Asia			
Government owned	0.54	2.64	2.69
Foreign owned	1.68	2.07	3.43
Private owned	1.04	2.44	3.08

Note: Data are median values covering the period 1995–2002.

Source: Micco, Panizza, and Yanez (2007).

The high reserve requirements prevalent across South Asia (Figure 4) limit the ability of the banking sector to intermediate to support private sector growth. Deposits are effectively co-opted to meet government financing requirements, as banks must invest significant funds in government securities to meet the reserve ratios. This can have the effect of crowding out lending to the private sector. High taxes are another concern, with effective rates in excess of 40% of pretax profit evident in banks' financial statements across the region. Retained earnings are essential for banks to build capital to support growth, so governments may need to reassess the taxation of financial institutions to achieve a better balance between fiscal requirements on and the importance of bank profits to support private sector growth.

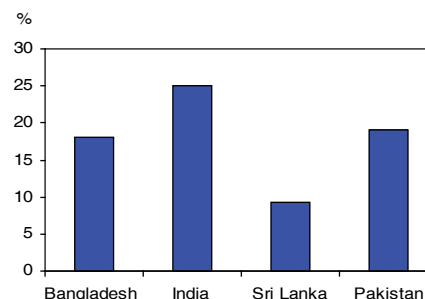
Nonbanks

Governments have a large presence in South Asia's nonbank financial sector. In addition to the state-owned insurance companies with significant market shares in most countries (Figure 5), government-run pension and provident funds are typically the only large institutional investor. All countries in South Asia also have state-owned specialized banks or financial institutions focusing on specific regions, sectors such as housing finance, or functions such as longer-term development finance.

South Asia's insurance industry is relatively less developed than its banking sectors. This reflects many factors, including dominance by state-owned companies that often lack technology, actuarial skills, and sound underwriting and investing practices. Growth in the insurance industry is linked to the growth of the middle class, so at early stages of development, the insurance sector is a lower priority than banking. However, as South Asia's economies continue to grow, authorities should place higher priority on reforming and privatizing state-owned insurance companies and establishing the required legal and supervisory frameworks. Most countries in the region have yet to adopt a modern insurance law and an approach to regulation embracing International Association of Insurance Supervisors principles. In most cases, insurance supervision is the responsibility of a government department rather than being housed in a fully resourced independent agency.

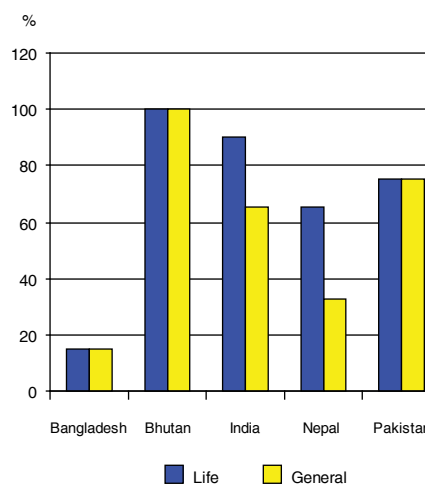
Many of South Asia's nonbank financial institutions rely on deposits for at least part of their funding. For example, finance institutions in Bangladesh and finance companies in India, Nepal, Pakistan, and Sri Lanka are restricted from accepting demand deposits and have lower minimum capital requirements than banks, but otherwise engage in the bank-like business of raising deposits and providing loans and leases. The policy intent of providing a bank-like charter is to encourage a range of competitors, with business restrictions intended to reduce risk to offset lower capital requirements. In practice, finance companies have proved a significant source of risk. Those truly relying on term deposits have been subject to liquidity pressures as wholesale markets have dried up. Others are engaging in regulatory

Figure 4: Statutory Reserve Ratios (%)



Sources: Bangladesh Bank, Central Bank of Sri Lanka, Reserve Bank of India, and State Bank of Pakistan.

Figure 5: State-Owned Insurance Companies' Market Share (%)



Sources: Bangladesh Bank, Insurance Regulatory and Development Authority, Nepal Rastra Bank, Royal Monetary Authority of Bhutan, and State Bank of Pakistan.

arbitrage, operating as banks in all but name while complying with lower capital requirements and typically less stringent internal control and governance requirements than those that apply to banks.

Capital Markets

Stock markets in South Asia have developed rapidly in recent years, as indicated by the increase since 2000 in the ratio of stock market capitalization to GDP (Figure 6). Equity listing and trading are the most advanced aspects of South Asian capital markets, but with the exception of India, still only provide access for a small number of companies, predominantly financial firms (Table 3).

Table 3: Number of Listed Companies

Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka
237	15	4,900	5	130	652	235

Note: Data for Bangladesh, India, and Sri Lanka, end-2007; Bhutan end-2005; Maldives end-2008; Nepal July 2008; Pakistan end-2008.

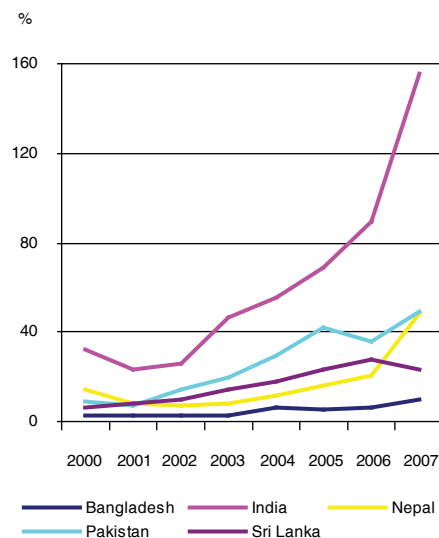
Source: Country stock exchanges.

The expansion of stock markets in South Asia implies buoyant trading activities. However, secondary markets are not yet active and remain very thin, due primarily to inadequate information available to investors. Bank financing, consequently, remains the main source of funds for productive investment in South Asia. Foreign access to local stock markets is limited due to several factors, such as macroeconomic weaknesses, inadequate transparency and accounting standards, foreign ownership limitations in listed companies, and cumbersome and opaque regulatory environments. Bond markets barely exist in South Asia except in India, where public bond market capitalization is around 30% of GDP (Table 4). Private bond markets do not exist or are small in South Asia compared to other developing Asian countries due to the preference for private placements by borrowers.

Despite ongoing development efforts in most countries across the region, the necessary infrastructure for broad, deep, and efficient capital markets is not yet fully in place. With the exception of Afghanistan where capital market development is very much a second-order issue, all countries in the region have ongoing reform programs to improve company and securities laws and the efficiency and effectiveness of capital market oversight. Except in India and Sri Lanka, South Asia still lacks robust clearing and settlement systems, in particular, real-time gross settlement and electronic fund transfer and settlement systems. Some countries, like Nepal, still issue debt instruments in paper form, while Bangladesh still uses a manual payment system for securities transactions.

There are both supply and demand constraints to capital market development in the region, including the lack of benchmark debt

Figure 6: Stock Market Capitalization
(percent of gross domestic product)



Source: World Bank (2008c).

Table 4: Bond Markets in Selected Asian Countries
(percent of gross domestic product)

	Corporate Bond Market Capitalization	Government Bonds Outstanding
Bangladesh	–	17.1
India	0.9	29.6
Nepal	–	14.1
Pakistan	–	27.5
Sri Lanka	–	31.6
Indonesia	2.4	18.0
People's Republic of China	10.6	23.5
Philippines	0.7	38.2
Thailand	13.5	27.8

– = data not available.

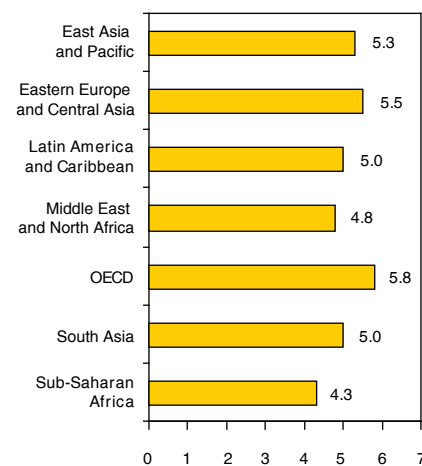
Note: Corporate bond market data is as of 2005. For East and Southeast Asian countries, government bond outstanding data is as of 2005.

Sources: Beck, Demirgüç-Kunt, and Levine (2000); and Sophastienphong and Kulathunga (2008).

securities, small institutional and retail investor bases, lack of an active and efficient secondary market, and poorly-designed tax policies. A supply side constraint in India is the preference by borrowers for private placements, which have less stringent regulatory requirements and low transaction costs. In Bangladesh, the supply of corporate debt is very limited as domestic borrowers prefer bank borrowings to avoid complying with disclosure and other governance-related requirements. Nepal's corporate bond market is also very small due in part to low investor confidence, high costs of bond issuance, weak corporate governance rules, lack of a credit rating system, little transparency in financial statements, and political instability. The main issue hampering the further development of Sri Lanka's stock market—aside from the impact of the civil war on investor confidence—is the lack of liquidity and a limited market size. In 2008, investor confidence in Pakistan's capital markets was shaken by the imposition of a price floor on listed securities in an ill-considered measure to check the sharp slide in prices. These country-specific issues are reflected in the regional ranking of investor protection, which falls short of the average for East Asia and the Pacific (Figure 7).

Greater participation by institutional investors in South Asia's capital markets is crucial to provide more long-term investment opportunities and to meet the region's investment needs. Liberalization of remaining capital account restrictions will facilitate participation by foreign institutional investors. Development of domestic institutional investors in the region is especially important considering the

Figure 7: Investor Protection Index by Region, 2008



OECD = Organisation for Economic Co-operation and Development.

Note: The investor protection index ranges from 0 to 10, with higher values denoting better investor protection.

Source: World Bank (2008a).

expected demographic changes and economic development in South Asian countries. Pension funds and insurance companies should play important roles, so the necessary privatization and reform are crucial complementary activities to the development of more efficient capital markets in the region.

Financial Deepening

Financial sector development is an important contributor to economic growth and poverty reduction. Measures of financial deepening indicate the extent to which financial intermediaries channel savings into productive investments. A low level of financial deepening indicates that individuals are more reliant on barter and informal savings, and hold real assets or livestock as stores of wealth. Deeper financial systems are better able to meet the demand for investment, easing constraints in external financing.

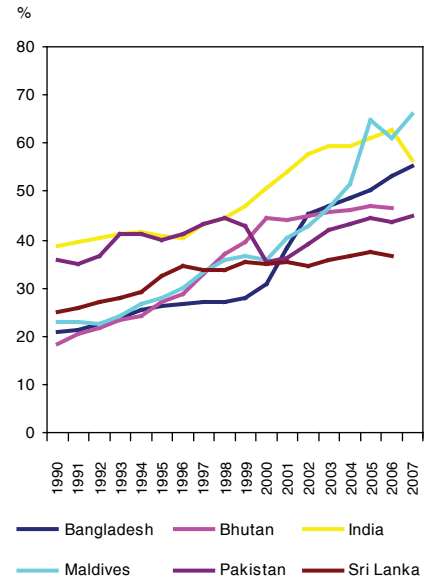
The ratio of cash and demand deposits (M2) to GDP is indicative of the level of monetization of savings and transactions. In countries where significant portions of the population do not have access to formal financial services or are reliant on barter, the M2-GDP ratio will be low. As more transactions become cash-based—and at a higher level of development are completed by check or electronic transfer—the level of the M2-GDP ratio increases. The upward trend throughout South Asia is indicative of the growing importance of the formal finance sector for transactions and savings, and reflects the varying degrees of progress in finance sector reform across the region (Figure 8).

Credit growth is another indication of deepening financial systems. Credit to the private sector is particularly important as it indicates the extent to which savings are channeled by the financial system into productive private sector investments rather than simply being used to meet government financing needs. Despite the steady upward trend in South Asia (Figure 9), credit to the private sector as a percent of GDP remains low by international standards. This reflects several factors, in addition to the still developing state of most banking sectors in the region, including the continuing role of directed lending and support for other state-owned institutions, co-opting of bank deposits for government financing through high reserve requirements, and the more general crowding-out effect of high government deficits.

Financial Stability

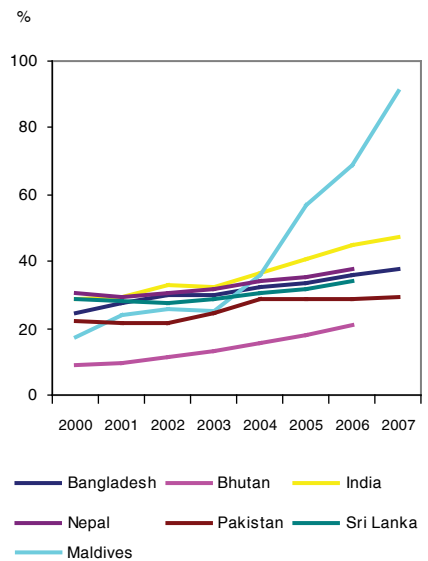
Assessing financial stability requires a review of macroprudential links, considering both the implications of the macroeconomic context and the prudential soundness of the financial sector. The degree of progress in financial sector reform is a key determinate of the resiliency of South Asia’s financial systems, as the regional economy is affected by adverse economic developments in the world’s major economies.

Figure 8: Selected South Asian Countries Ratio of Cash and Demand Deposits to Gross Domestic Product (percent)



Sources: Bangladesh Bank, Central Bank of Sri Lanka, Reserve Bank of India, Royal Monetary Authority of Bhutan, and State Bank of Pakistan.

Figure 9: Selected South Asian Countries Credit to the Private Sector (percent of gross domestic product)



Source: World Bank (2008c).

The central banks of Pakistan and Sri Lanka have begun to produce regular financial stability reports. RBI includes a chapter on financial stability in its annual *Report of Trends and Progress in Banking*, and the Bangladesh Bank publishes a half-yearly financial sector review. These efforts provide a range of data and analysis about the bank and nonbank finance sector, and endeavor to assess macroprudential links and risks to the finance sector. SBP's *Financial Stability Review* is particularly commendable for the scope of its coverage, depth of analysis, and acknowledgement of identified weaknesses.

Macroeconomic Context

South Asia's economies were not directly exposed to the proximate causes of the current global financial turmoil, but will be affected by the decline in demand for exports. The impact of global liquidity tightening is less significant because of the relatively low levels of external finance in South Asia (Table 5). However, even at these moderate levels, the difficulties in obtaining international financing has caused corporations to turn to domestic sources, increasing loan demand in the domestic banking system. This, in turn, has led to some liquidity squeezes and difficulties, particularly for nonbanks in India and Pakistan, in rolling over existing domestic short-term financing.

Table 5: External Financing: Total Bonds, Equities, and Loans in Selected Countries
(\$ million and as percent of GDP)

	2002	2003	2004	2005	2006	2007
Bangladesh	-	10.0	176.8	16.7	106.5	57.5
(% of GDP)	-	0.0	0.3	0.0	0.2	0.1
India	1,427.4	3,277.2	13,301.1	23,189.6	33,037.3	61,059.7
(% of GDP)	0.3	0.5	1.9	2.9	3.6	5.2
Pakistan	388.8	983.8	970	739.2	3,298.90	2,149.3
(% of GDP)	0.5	1.2	1.0	0.7	2.6	1.5
Sri Lanka	33.7	186.0	135.0	383.0	129.8	755.0
(% of GDP)	-	1.0	0.7	1.6	0.5	2.3
Indonesia	1,122.5	5,207.2	4,115.3	5,195.5	8,364.3	8,340.7
(% of GDP)	0.6	2.2	1.6	1.8	2.3	1.9
PRC	10,205.3	15,772.8	25,661.6	41,331.2	63,393.5	87,615.0
(% of GDP)	0.7	1.0	1.3	1.8	2.4	2.7
Philippines	6,345.5	6,405.4	6,358.3	6,194.8	7,172.5	6,648.4
(% of GDP)	8.3	8.1	7.3	6.3	6.1	4.6
Thailand	2,672.5	3,860.0	4,141.3	6,310.9	5,232.8	2,617.4
(% of GDP)	2.1	2.7	2.6	3.6	2.5	1.1
Viet Nam	392.5	397.0	114.0	968.8	457.4	2,641.6
(% of GDP)	1.1	1.0	0.3	1.8	0.8	3.7

- = data not available, GDP = gross domestic product, PRC = People's Republic of China.

Source: International Monetary Fund (2008b).

Despite the relatively low levels of external financing across the region, the current account deficits of some countries prior to the onset of the global financial turmoil—Maldives, Pakistan, and Sri Lanka in particular—highlight the potentially uneven impact of global developments (Table 6). The impact is already evident in Pakistan in sharply increased bank credit to the government, crowding out financing to the private sector, as well as the decision in 2008 to seek an International Monetary Fund (IMF) stand-by facility.

Table 6: Current Account Balances in Selected Countries
(percent of gross domestic product)

Country	2006	2007	2008
Afghanistan	(4.9)	0.9	(1.3)
Bangladesh	1.3	1.4	0.9
Bhutan	(4.4)	11.0	3.9
India	(1.1)	(1.5)	(3.0)
Maldives	(33.0)	(39.1)	(50.6)
Nepal	2.2	(0.1)	2.6
Pakistan	(4.0)	(4.8)	(8.4)
Sri Lanka	(5.3)	(4.5)	(7.1)
PRC	9.5	11.0	10.1
Indonesia	2.9	2.4	0.1
Philippines	4.5	4.9	2.5
Thailand	1.1	5.7	(0.1)
Viet Nam	(0.3)	(9.9)	(9.3)

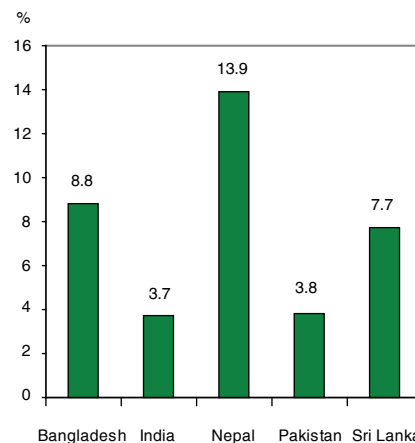
() = negative, PRC = People's Republic of China.

Source: ADB (2009).

A specific concern for most South Asian countries is the impact of a global slowdown on the flow of workers' remittances. These are a large contribution to economies across the region (Figure 10), and any negative trends would have implications for domestic demand and the balance of payments. Although anecdotal evidence suggests general cutbacks in the number of migrant and guest workers employed around the globe, this has not yet had a major impact, partially because returning workers will repatriate any savings still held abroad. However, as the economic downturn progresses, a slowdown in remittance growth is likely, if not an outright decline.

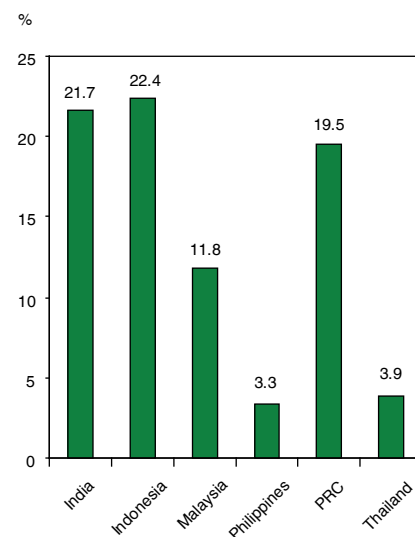
Homegrown credit bubbles in several South Asian countries appear to be the greatest risk to financial stability. In 2007, private credit growth in India was 21.7%, one of the highest levels in developing Asia (Figure 11). While partially attributable to robust economic expansion, declining inflation, financial deepening, more competition among banks, improvements in the quality of banks' assets, and financial innovation, much credit growth in 2007 and continuing into 2008 was from increased demand from corporations no longer able to

Figure 10: Workers' Remittances, 2007
(percent of gross domestic product)



Sources: Asian Development Bank (2008a) and Reserve Bank of India.

Figure 11: Private Sector Credit Growth in Selected Asian Countries, 2007
(percent annual change)



PRC = People's Republic of China.

Source: International Monetary Fund (2008a).

access international financing. This most recent development is not a classic credit bubble, characterized by rapid increases in credit, as it is essentially replacing foreign borrowing with domestic bank financing. However, to the extent that these corporations may not be able to service current debt levels, the banking system has assumed additional risk. More classic credit bubbles may be evident in Bhutan, Nepal, and Maldives, where rapid credit growth appears linked to rapid—and possibly unsustainable—increases in real estate prices.

Prudential Soundness

Across South Asia, the legal framework and practice of bank supervision are closer to international best practices than the regimes for insurance and capital markets. Most countries have taken or have in progress measures to increase their compliance with the Basel Committee on Banking Supervision's Core Principles for Effective Banking Supervision. Four countries have adopted elements of Basel II (Box 2). South Asia's banking sectors are generally more developed and, in most cases, are the primary sources of systemic risk. Thus, a greater focus on bank supervision has been warranted, although further progress in the nonbank sectors is clearly needed to support growth and development.

Box 2: Basel II in South Asia

Several South Asian countries are adopting the revised framework for *International Convergence of Capital Measurement and Capital Standards* (Basel II). Banks in the region are expected to follow the standardized approach for credit risk, which is similar to the Basel I risk-weighted approach, with the additional option of using external ratings to determine risk weightings. Key, but often overlooked, elements of Basel II include pillar 2 (the supervisory review process) and pillar 3 (disclosure and market discipline). An important aspect of pillar 2 is the ability to impose higher capital requirements on individual institutions based on their risk profile, a power not generally provided under the current legal framework in most South Asian countries. South Asian countries adopting Basel II have made commendable progress with disclosure and transparency, with a wide range of industry- and institution-specific data made public by the central banks in India, Nepal, and Pakistan. Sri Lanka's disclosure is not yet of the same standard; however, this weakness is somewhat mitigated by the requirement for all of Sri Lanka's banks to obtain coverage from a ratings agency.

India. From March 2008, India's larger banks with an international presence (including the entire State Bank of India group) adopted the standardized approach for credit risk and the basic indicator approach for operational risk. The net effect has been an 80 basis point decline in reported capital adequacy as the effect of lower risk weightings for some assets was more than offset by the operational risk capital charge.

Nepal. Effective July 2008, all commercial banks and larger financial institutions were required to adopt a framework based on the simplified Basel II standardized approach, together with the basic indicator approach to capital charges for operational risks and the standardized measurement approach to market risks.

Pakistan. Beginning in 2008, all commercial banks were required to adopt the standardized approach to credit risk and the basic indicator approach to operational risk. The net effect has been capital-neutral, with the charge for operational risk offsetting the lower risk-weights for some assets.

Sri Lanka. The standardized approach for credit risk and basic indicator approach for operational risk came into effect for Sri Lanka's banks in 2008. Capital requirements for market risk, based on the standardized measurement approach, had been introduced previously.

Table 7: Macprudential Indicators for Selected Countries

	Bank Regulatory Capital to Risk-Weighted Assets	Bank Nonperforming Loans to Total Loans	Bank Return on Assets	Bank Return on Equity
Bangladesh	10.0	13.2	0.9	13.8
India	12.6	2.8	1.0	12.7
Pakistan	13.6	8.4	3.0	30.1
Sri Lanka	13.3	5.7	1.8	15.4
Indonesia	20.5	8.5	2.7	19.2
Philippines	15.9	5.8	1.4	11.8
PRC	7.7	6.7	1.0	19.9
Thailand	14.8	7.9	0.1	7.3

PRC = People's Republic of China.

Note: Data for Bangladesh (except for Bank Nonperforming Loans to Total Loans), Pakistan, the Philippines, the PRC, and Thailand as of 2007; Sri Lanka as of 30 June 2007; and India's Bank Return on Equity as of 2006.

Sources: Central Bank of Sri Lanka and International Monetary Fund (2008b).

Reported capital adequacy varies across the region (Table 7). Capital adequacy for the system overall obscures the fact that in Bangladesh, Pakistan, and Sri Lanka, the capital adequacy of state-owned banks is much lower than for private banks. Since weaknesses were not addressed during the recent boom, the state-owned banks and banking systems as a whole are not well positioned to face an economic downturn. Private sector banks throughout the region and state-owned banks in India have increased capital adequacy over recent years in response to strengthened prudential requirements and enhanced supervision, building capacity to absorb the inevitable loan losses as economic growth decelerates.

Reported asset quality has improved overall in the region in recent years, with Bangladesh as a notable outlier (Table 7). As with capital adequacy, the banking system asset quality data obscure weaknesses in state-owned banks in most South Asian countries. A further concern is that weak loan classification and provisioning requirements prevalent in the region tend to overstate asset quality, profitability, and capital; and thus provide an exaggerated view of system resiliency. Profitability of South Asia's banking sectors has tended to lag behind other Asian countries, reflecting the impact of inefficient state-owned banks that have a larger market share in South Asia.

One strength of South Asia's banking systems is that—with the exception of Maldives and some specific banks in other countries—the banks tend to be liquid with loan-deposit ratios comfortably under 85% (Table 8) and well-developed retail deposit bases. While the high reserve ratios prevalent in the region have had a dampening effect on growth and profitability of the banking sector, ensuring that banks hold high volumes of government securities has one benefit.

Table 8: South Asia's Banking System Loan–Deposit Ratios
(percent)

	2001	2002	2003	2004	2005	2006	2007
Bangladesh	-	-	-	-	82.8	82.3	82.2
India	49.4	53.2	54.1	54.4	62.3	69.6	73.0
Maldives	62.4	58.3	54.1	63.6	87.7	107.3	124.4
Nepal	60.1	61.1	60.2	59.8	64.9	60.7	68.7
Pakistan	-	65.3	65.2	73.6	76.8	80.3	71.9
Sri Lanka	72.9	67.0	66.4	66.7	71.1	78.6	78.9

- = data not available.

Note: Bangladesh data covers all banks while Pakistan data covers all scheduled banks.

Sources: Bangladesh Bank, Central Bank of Sri Lanka, Maldives Monetary Authority, Nepal Rastra Bank, Reserve Bank of India, and State Bank of Pakistan.

In the event of a crisis, these securities can be used for repurchase transactions with the central bank, providing banks with additional liquidity.

Response to the Global Financial Turmoil

To date, the most notable impact of the global financial turmoil on South Asia's financial systems is the bringing to light of underlying weaknesses. Credit booms in Bhutan, Maldives, and Nepal developed locally without any influence from structured finance products or credit default swaps. Weaknesses in state-owned banks in Bangladesh, Pakistan, and Sri Lanka are the result of long-term underperformance of basic banking—i.e., gathering deposits and making loans—rather than ventures into exotic new markets. Continued operation of insolvent and money-losing banks in Bangladesh and Nepal is attributable to domestic inability to take decisive supervisory action. The liquidity pressures on finance companies are a reflection of the fundamental riskiness of a business model using short-term wholesale funds to finance longer-term assets. The higher risk of loss from bank-like deposit taking by nonbank entities that are subject to less stringent capital and other prudential requirements existed long before mid-2007.

In common with their counterparts around the world, the central banks in India, Pakistan, and Sri Lanka have injected liquidity into the financial system, including making extraordinary refinancing available to nonbank finance companies. RBI has provided some countercyclical capital relief to banks through relaxation of provisioning requirements on restructured loans. This is broadly consistent with the concept of through-the-cycle or countercyclical approaches to capital adequacy, which involve building buffers of excess capital (or provisions) during good times, which are then drawn down when conditions deteriorate. The RBI approach has the disadvantage of not being transparent, as the banks will report better-than-actual asset quality.

Banks in South Asia are likely to be exposed to increasing loan losses as the global financial turmoil continues to unfold. The primary reason will be deterioration of the ability of domestic borrowers to repay—largely due to moderating domestic demand arising in part from declines (or at least slackening growth) in remittances, reduced exports, and to a lesser extent the generally limited reliance of South Asia on foreign funding and the global tightening of liquidity. The magnitude of losses will be most severe in countries recently experiencing credit booms and/or property price bubbles. Stress testing and scenario analyses can provide indications of likely losses, but are not themselves mitigating measures. Building strong capital buffers during good economic times is the best protection for the stability of the finance sector. Unfortunately, it is too late now to wish that different policies had been previously adopted. As the condition of poorly capitalized banks, particularly state-owned institutions, worsens, governments will be challenged in their policy response.

Financial support—without addressing banks' preexisting weaknesses—merely defers the recognition of losses and risks, creating an open-ended liability for governments. The fiscal position of countries with already weak state-owned banks—Bangladesh, Pakistan, and Sri Lanka—will make it difficult for governments to give the kind of capital support and guarantees provided to the financial sector in Europe and the United States. Considering these factors against the backdrop of long-standing difficulties in reforming state-owned banks and addressing identified weaknesses throughout the region, the most likely policy response is continued forbearance and deferring loss recognition. The downside is that the drag of the already weak banks on the finance sector and economy as a whole will increase. The clear lesson for policy makers is the urgency of addressing financial sector weaknesses as the global financial turmoil begins to abate, to position South Asia's finance sector better in anticipation of the inevitable next downturn.

Infrastructure for Financial Services

The absence of some basic government infrastructure for financial services and commercial transactions has hampered the development and performance of South Asia's financial sector. The lack of macroeconomic stability; costs of doing business; and issues concerning rule of law, transparency, and governance are all factors that negatively affect private sector development overall and the financial sector specifically.

Time, expense, and uncertainty in land registration are major obstacles to private sector and financial sector development because of the implications for taking and enforcing mortgage security. Of all regions in the world, South Asia has the second-highest number of procedures legally needed to acquire property, which on average takes more than 3 months and costs almost 6% of property value (Table 9).

A lack of good bankruptcy and collateral laws that adequately protect borrowers and lenders is common throughout the region. With an average score of 4.8, South Asia ranks below East Asia and the Pacific and only slightly above Sub-Saharan Africa in the legal rights index—a measure of how well-designed are bankruptcy and collateral laws. Legal rights vary across the region, with Bangladesh and India scoring well at 8 (out of 10), while other countries face a more extensive reform agenda to introduce modern collateral and bankruptcy laws (Table 10).

Table 9: Registering Property by Region

	Procedures (number)	Duration (days)	Registration Cost (% of property value)
East Asia and the Pacific	5.0	99.0	4.1
Eastern Europe and Central Asia	6.0	72.1	1.9
Latin America and the Caribbean	6.8	71.4	6.0
Middle East and North Africa	6.4	37.4	5.9
OECD	4.7	30.3	4.5
South Asia	6.4	106.0	5.9
Sub-Saharan Africa	6.8	95.6	10.5

OECD = Organisation for Economic Co-operation and Development.

Source: World Bank (2008a).

Table 10: Legal Rights and Credit Information in Selected Countries

	Legal Rights Index	Credit Information Index	Public Credit Registry (% of adults)	Private Credit Bureau (% of adults)
Afghanistan	1.0	0.0	0.0	0.0
Bangladesh	8.0	2.0	0.9	0.0
Bhutan	2.0	0.0	0.0	0.0
India	8.0	4.0	0.0	10.5
Maldives	4.0	0.0	0.0	0.0
Nepal	5.0	2.0	0.0	0.2
Pakistan	6.0	4.0	4.9	1.5
Sri Lanka	4.0	5.0	0.0	8.7
Indonesia	3.0	4.0	26.1	0.0
PRC	6.0	4.0	58.8	0.0
Philippines	3.0	3.0	0.0	5.4
Thailand	4.0	5.0	0.0	31.8
Viet Nam	7.0	4.0	13.4	0.0

PRC = People's Republic of China.

Note: The legal rights index ranges from 0 to 10, with higher scores indicating better-designed bankruptcy and collateral laws. The credit information index ranges from 0 to 6, with higher scores depicting more credit information available from either a public registry or a private bureau. Public credit registry coverage shows the number of individuals and firms listed in the registry with 5-year information on repayment history, credit outstanding, or unpaid debts. Private credit bureau coverage indicates the number of individuals and firms listed by the bureau with 5-year information on repayment history, credit information, and unpaid debts.

Source: World Bank (2008a).

Another common obstacle to financial sector development is the lack of information about borrowers' credit history. South Asia has the lowest penetration of public and private credit bureaus of any region in the world, with an average of less than 1.0% of the population registered with a public credit bureau and 2.6% with a private credit bureau. Only one half of South Asian countries have a credit bureau, and penetration in these countries is much lower than in some other Asian jurisdictions (Table 10).

Perceptions of weak governance and institutions continue to beleaguer South Asian countries, which on average receive poor rankings in terms of political stability, voice and accountability, control of corruption, government effectiveness, and regulatory quality. There is significant variation among the region's countries (Table 11). These findings emphasize the importance of broader-based reforms to provide the underpinnings for finance sector development.

Table 11: Indicators of Governance, South Asia, 2007

	Voice and Accountability	Political Stability	Government Effectiveness	Regulatory Quality	Rule of Law	Control of Corruption
Afghanistan	-1.17	-2.37	-1.33	-1.75	-2.00	-1.53
Bangladesh	-0.63	-1.44	-0.81	-0.86	-0.81	-1.05
Bhutan	-0.88	+0.67	+0.01	-0.68	+0.49	+0.92
India	+0.38	-1.01	+0.03	-0.22	+0.10	-0.39
Maldives	-0.91	+0.11	-0.19	-0.04	+0.02	-0.78
Nepal	-0.89	-2.13	-0.81	-0.65	-0.64	-0.66
Pakistan	-1.05	-2.44	-0.62	-0.56	-0.93	-0.83
Sri Lanka	-0.39	-1.96	-0.29	-0.11	+0.06	-0.13

Note: Governance scores range from -2.5 to +2.5, with higher (lower) values denoting better (poor) governance.

Source: Kaufmann, Kraay, and Mastruzzi (2008).

Outreach

The outreach of the formal financial sector varies across South Asia (Table 12). The number of bank branches per capita is much higher in Bangladesh, India, Pakistan, and Sri Lanka than might be expected given per capita incomes, in part because of state-owned banks' mandates to serve all areas of the country. This outreach comes at a cost in terms of state-owned bank inefficiency, and the cross-subsidization of unprofitable state-owned bank branches discourages entry on commercial terms by private sector financial firms. The banking sectors in Bangladesh, India, Pakistan, and Sri Lanka all appear to encourage financial inclusion with low minimum deposit and loan amounts, and low fees for consumer loans, mortgages, and small or medium-sized enterprise (SME) loans. The major barriers to access are the time needed to process applications and the number of documents required (Box 3).

Despite these positive signs, South Asian countries remain among the lower ranked in financial inclusion (Table 13) due to interest rate ceilings or controls and government-subsidized credit. For example, interest rate controls in India can make priority sector lending unprofitable because permissible interest rates do not cover the high credit risk and fixed costs of the loan (Government of India, Planning Commission 2008a). Furthermore, these ceilings force banks to charge additional fees or even be susceptible to bribes, making bank lending to the poor an arduous task. Similarly, well-intentioned subsidized credit programs have the adverse effect of crowding out lending on market terms and conditions. Clearly, market-determined interest rates are crucial if outreach programs are to be sustainable.

Another main reason for the low level of financial inclusion in South Asia is the generally low penetration of microfinance, aside from Bangladesh (Figure 12). One challenge has been the lack of a suitable regulatory framework for microfinance in most countries, although Bangladesh introduced legislation and established the Microfinance Regulatory Authority in 2006. Initiatives are underway to expand microfinance in India and Pakistan, but striking a balance between consumer protection and self-sustaining microfinance providers is difficult. Particularly in India, there has been reluctance to permit deposit mobilization, reflecting concerns about the weaknesses and unsatisfactory supervision of many existing small financial institutions—urban, rural, and regional banks. Sri Lanka has experienced a unique set of challenges, with donor financial support provided following the 2004 tsunami, overwhelming the microfinance sector's capacity to disburse prudently and to administer properly.

Table 12: Indicators of Financial Sector Outreach

	Number of Bank Branches (per 1,000 people)	Number of ATMs (per 1,000 people)	Number of Loans (per 1,000 people)	Number of Deposit Accounts (per 1,000 people)
Bangladesh	4.7	0.3	61.1	255.2
India	6.4	1.9	78.0	442.9
Nepal	1.7	0.3	10.8	110.4
Pakistan	5.0	1.3	31.8	171.1
Sri Lanka	7.7	5.7	364.2	1,117.8
PRC	1.3	3.8	-	-
Indonesia	8.4	4.8	-	-
Philippines	7.8	5.3	-	302.1
Thailand	7.2	17.0	247.9	1,423.1

- = data not available, ATMs = automated teller machines, PRC = People's Republic of China.

Note: PRC, Indonesia, Philippines, and Thailand data are based on 2003/2004 survey data.

Sources: Beck, Demirgüç-Kunt, and Martinez Peria (2007); and Sophastienphong and Kulathunga (2008).

Box 3: Accessing Formal Financial Services in South Asia

		Physical access				Affordability				Eligibility					
		Loan Market Share		Locations to Submit Loan Application		Fees of Business Loan		Minimum Amount of Business Loan		Fees of SME Loan		Days to Process Business Loan		Days to Process SME Loan Application	
Number of Sample Banks	(bank % share out of total system)	in 2004	(out of 5)	Submit Loan Application	(% of GDPPC)	minimum loan amount)	(% of GDPPC)	Amount of Business Loan	(% of GDPPC)	minimum loan amount)	(% of GDPPC)	Application	Application	Application	Application
Bangladesh	56.51	2.12	55.28	6.46	174.40	2.62	34.55	43.26							
India	37.75	2.44	57.77	0.93	145.17	0.84	19.98	10.75							
Nepal	42.40	2.00	19,407.57	18.57	2,970.18	16.86	9.53	10.94							
Pakistan	44.02	3.09	1,526.04	0.12	234.25	0.19	31.98	33.63							
Sri Lanka	51.10	2.90	20.56	2.29	20.56	2.09	15.57	10.04							
		Fees of Consumer Loan		Fees of Mortgage Loan		Fees of Consumer Loan		Fees of Mortgage Loan		Fees of Consumer Loan		Fees of Mortgage Loan		Fees of Consumer Loan	
		Minimum Amount of Consumer Loan (% of GDPPC)	Minimum Amount of Mortgage Loan (% of GDPPC)	Minimum Amount of Consumer Loan (% of GDPPC)	Minimum Amount of Mortgage Loan (% of GDPPC)	Minimum Amount of Consumer Loan (% of GDPPC)	Minimum Amount of Mortgage Loan (% of GDPPC)	Minimum Amount of Consumer Loan (% of GDPPC)	Minimum Amount of Mortgage Loan (% of GDPPC)	Minimum Amount of Consumer Loan (% of GDPPC)	Minimum Amount of Mortgage Loan (% of GDPPC)	Application	Application	Application	Application
Bangladesh		25.70	1,412.52	0.23	145.17	0.18	9.44	33.48							
India		28.79	2,147.93	1.19	954.59	0.74	4.17	9.45							
Nepal		1,153.17	51.64	0.94	51.64	1.00	3.71	9.50							
Pakistan		146.71		0.14		0.08	20.71	28.44							
Sri Lanka		36.10		0.34		1.83	7.34	20.61							
		Annual Fees of Saving Account (% of GDPPC)		Annual Fees of Checking Account (% of GDPPC)		Annual Fees of Saving Account (% of GDPPC)		Annual Fees of Checking Account (% of GDPPC)		Annual Fees of Saving Account (% of GDPPC)		Annual Fees of Checking Account (% of GDPPC)		Annual Fees of Saving Account (% of GDPPC)	
		Minimum Amount to Open Checking Account (% of GDPPC)	Minimum Amount to Open Saving Account (% of GDPPC)	Minimum Amount to Open Checking Account (% of GDPPC)	Minimum Amount to Open Saving Account (% of GDPPC)	Minimum Amount to Open Checking Account (% of GDPPC)	Minimum Amount to Open Saving Account (% of GDPPC)	Minimum Amount to Open Checking Account (% of GDPPC)	Minimum Amount to Open Saving Account (% of GDPPC)	Minimum Amount to Open Checking Account (% of GDPPC)	Minimum Amount to Open Saving Account (% of GDPPC)	Documents to Open Checking Account (out of 5)	Documents to Open Saving Account (out of 5)	Documents to Open Checking Account (out of 5)	Documents to Open Saving Account (out of 5)
Bangladesh		2.28	0.89	0.00	0.00	0.00	4.57	4.57							
India		8.85	5.02	0.00	0.00	0.17	2.69	2.55							
Nepal		90.66	63.39	8.28	4.97	4.11	4.11	3.92							
Pakistan		1.59	1.59	0.00	0.00	2.64	2.64	2.43							
Sri Lanka		15.76	3.54	0.73	0.00	2.62	2.62	1.00							

GDPPC = gross domestic product per capita, SME = small or medium-sized enterprise.

Note: Indicators are weighted country-specific averages based from a 2003/2004 survey of banks. Locations to open deposit account take the value 1 if an account can be opened at headquarters or a branch; and 2 if at headquarters or a branch; and 3 if at headquarters, branches, or nonbranch outlets.

Source: Beck, Demirgüç-Kunt, and Martinez Peria (2007).

Many reasons for the limited outreach of the formal finance sector relate to broadly applicable barriers to private sector development. For example, bank credit growth to India's SME sector was found to be weak because of (i) high levels of nonperforming SME loans in state-owned banks, (ii) a large number of SMEs yet to be registered, and (iii) the high costs of registering property as collateral and enforcing contracts (ADB 2004). In Sri Lanka, high real interest rates and weak enforcement of collateral laws are the main causes of banks' reluctance to provide credit to SMEs (ADB 2005), and SME financing is considered by Bangladesh's financial institutions to entail high administrative costs (Ahmed 2006). In Pakistan, a lack of good financial records by SMEs, brought about by their paucity in skills and resources, partially explains banks' reluctance to provide SME financing (State Bank of Pakistan 2008b).

Table 13: Index of Financial Inclusion

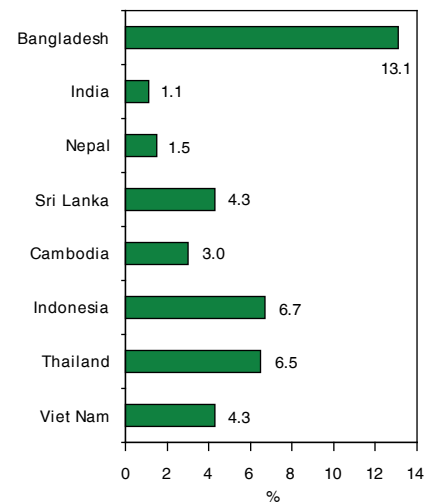
	IFI	IFI Rank
Bangladesh	0.118	69
India	0.170	50
Nepal	0.089	76
Pakistan	0.120	67
Sri Lanka	0.134	63
People's Republic of China	0.297	32
Indonesia	0.141	60
Philippines	0.163	53
Thailand	0.303	30

IFI = Index of Financial Inclusion.

Source: Sarma (2008).

There are also structural issues within the financial sector that inhibit outreach. The lack of computerization, particularly in state-owned banks, hinders communication between branches and regional and head offices, exacerbating long processing times. For example, in India, out of more than 6,000 bank branches managing government-related activities, only 16 have been computerized (RBI 2007). Adoption of new technologies is limited among nationalized and privatized commercial banks in Bangladesh (Rahman 2007), and in Pakistan, only a few banks provide mobile banking services (State Bank of Pakistan 2008a). One effort being made to improve efficiency in India is to convert all government payments and receipts into electronic form (RBI 2005). Mobile and internet banking, together with automated teller machines, are also seen as tools that can potentially lower the cost of financial intermediation.

Figure 12: Microfinance Penetration
(clients/population, percent)



Source: Honohan (2004).

Reform Agenda

South Asian countries need to continue—and in many cases to enhance—already identified reforms to increase the resilience and capacity of the financial sector to support economic growth and private sector development. Most issues and needed reforms have already been identified, and the key will be to make progress in some of the more difficult issues that remain outstanding, in some instances after many years of reform efforts. The most important issues across the region include

- creating prudent fiscal policies to avoid crowding out private sector credit growth by the need to finance government deficits;
- strengthening the legal foundation and government infrastructure for commercial transactions, including company and bankruptcy law, land title registration, and registration and enforcement of security interests in real and personal property (chattels);
- lifting nonprudential restrictions on financial institutions, such as directed and priority lending requirements;
- reforming and privatizing state-owned financial institutions;
- removing remaining capital account restrictions;
- improving the quality and application of accounting standards;
- bringing the legal framework and prudential standards for the financial sector fully in line with international best practices;
- building policy development and supervisory capacity, particularly in nonbank sectors such as insurance and pensions;
- establishing an appropriate legal framework for microfinance; and
- supporting credit bureau development.

Countries across South Asia have improved banking regulation and supervision in recent years, although a significant reform agenda remains. Key legal reforms are outstanding in several countries, but in many cases, the biggest challenges relate to the enforcement of prudential requirements and taking decisive actions to resolve identified problems in institutions. The passage of laws and regulations can be the easiest part of moving toward international standards. Enforcement, however, can be challenging, especially in the case of state-owned banks as illustrated by the long difficulties in addressing insolvent or undercapitalized banks in Bangladesh, Pakistan, and Sri Lanka. A related issue is the lack of supervisory capacity, particularly in rapidly growing banking systems such as Nepal's, or in supervising large numbers of previously unregulated or undersupervised institutions such as Bangladesh's microfinance sector or India's small banks and bank-like institutions that are not wholly under the remit of RBI.

To date, South Asian countries have made less progress with reforms to the nonbank sector and capital markets development. The two are linked, as institutional investors such as life insurance companies and pension funds play prominent roles in capital market development. In addition to legal reforms, there is a pressing need in most countries for policy development and supervisory expertise

in the insurance and pension fields. Reform and privatization of the state-owned insurance companies that dominate the market will be an integral part of developing nonbank institutions. Improving investor protection through strengthening legal frameworks, transparency and disclosure, and corporate governance will be important to further capital market development in South Asia.

A specific challenge is to rationalize the approach to regulation of deposit-taking institutions. The pressures from the ongoing global financial turmoil are highlighting the flaws in the philosophy of allowing small and thinly capitalized institutions to engage in bank-like activities, albeit with some business restrictions, in an effort to promote competition and to serve specific sectors or regions. These institutions are facing liquidity pressures and are often seen as systemically important because of their role as providers of business credit, leading to official support action that is out of proportion to their size and importance relative to banks. Countries should be moving to a harmonized regulatory regime with uniformly high capital requirements for bank-like activities, complemented by an appropriate regime for microfinance.

Several countries across the region have yet to establish appropriate legal frameworks for sustainable microfinance. Laws should provide for a graduated approach to regulation and supervision, ranging from a light regime of registration and periodic reporting for institutions wholly reliant on their own capital and grants, to a more bank-like regime for institutions that mobilize deposits. This approach matches the level of oversight to the risks, balancing the need for oversight to provide confidence to depositors and potential investors with the dampening effect of regulatory burden on sector development. Putting this enabling framework in place will be important in moving microfinance penetration in South Asia to the levels existing in Bangladesh.

The commonality of issues across South Asia, despite the disparities in size and levels of finance sector development, highlights the potential benefits from regional cooperation. The Network of Central Bank Governors and Finance Secretaries of the South Asian Association for Regional Cooperation (SAARCFINANCE), established in 2002, provides a platform that could support multicountry efforts such as moving to a common and more stringent loan-loss provisioning standard, and more broader-based projects (regional training and technical assistance) to build capacity in policy development and supervision of the nonbank sector. The South Asian Federation of Exchanges may be a useful forum to pursue enhancements in transparency, disclosure, and governance.

Experience with global developments since 2007 has highlighted the need for regional coordination in dealing with financial sector turmoil. Although South Asian financial sector is not yet highly integrated, some financial institutions in the region have significant cross-border activities. Supervisory authorities in India, Maldives, Nepal, Pakistan, or Sri Lanka may have to deal with home-host issues in the resolution

of a weak bank or insurance company with operations in more than one South Asian country. One early lesson from the experience with intervention in Europe's banks is the need to improve international cooperation and coordination, particularly with respect to resolution of troubled institutions. SAARCFINANCE provides a forum that could be used to build the necessary supervisory relationships for coordination of ongoing supervision and crisis management.