

## **Structural Issues and Reforms in Financial (non-bank) Market in Pakistan**

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### **1. INTRODUCTION**

A large body of research now links financial sector development, including the depth of the banking system, liquidity in capital market, and financial liberalisation to long-run growth and poverty reduction. According to a recent World Bank report,<sup>1</sup> “As the dust settles from the great financial crises of 1997-98, the potentially disastrous consequences of weak financial markets are apparent”. The report further states that the importance of getting financial policy making right has become one of the most critical development issues in this century. In the past, there have been two extreme approaches concerning financial market regulation. One clearly supports the central role of state in the financial markets, whereas, the other sees state intervention more of a problem than as the solution. Of these two rather diverging ideologies, the International Financial Institutions (IFIs) advocate the development of market institutions, more liberalisation and lesser role of state. Pakistan has been following IFI advice in this regard. However, after the East Asian Crisis, a strong point of view has emerged that believes that in developing countries, ruling out state’s role from financial markets is unrealistic. But, the state has to play a developmental role. According to Stiglitz (1991), “governments have played a central role—whether good or ill may be debated—in the development of most of those countries which today belong among the more developed”.

The financial policy focus in developing countries is quite often donor directed and is tilted towards the provision of diversified financial services. Capital market development is an important element of this policy, as it is considered as a flexible alternative to bank financing and useful in diversifying ownership of assets. Whereas, the other point of view believes that developing countries should focus more on traditional bank based financial system as with the passage of time, economic development creates its own demand for particular types of financial

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<sup>1</sup>Finance for Growth, 2001, World Bank Policy Paper, Washington, D.C.

services. In this context, it is further argued that in weak institutional framework and macro-economic instability, capital markets cannot efficiently contribute towards their prime objective of capital formation. Evidence clearly suggests that advanced economies have sophisticated financial systems that ensure minimum risks and volatility, thus reducing their vulnerability against shocks. This proves a causal link between GDP of countries and development of financial markets. But, the question is that should policy makers in developing countries follow developed countries models for financial market development or look at feasible options in a country specific environment?

Keeping in mind the above arguments, this paper provides an overview of the wide spectrum of reforms in the financial (non-bank) market and the corporate sector implemented by the Securities and Exchange Commission of Pakistan (SEC). The Financial market in Pakistan is quite vulnerable to shocks and has several imperfections. While carefully evaluating the nature of financial sector reforms, the paper also looks at key policy challenges that provide essential support in successful implementation of financial reforms. Although, the country's macro-economic indicators have improved, the legal system still lacks the capacity to enforce contracts, poverty is on the rise and policy consistency is debatable. Under these circumstances, the paper reviews impact of reforms in relation to their fundamental objective of attracting long-term capital. The paper concludes that supporting structures are essential for capital market reforms to work in transition economies like Pakistan where policy consistency is lacking, banking system has a substantial non performing portfolio, the capital market needs more depth, and regulatory framework requires strengthening and political support. It is critical for developing countries to analyse the history of financial sector developments in the advanced economies and evaluate the supporting environment, without which, financial markets cannot prosper.

## **2. OVERVIEW OF FINANCIAL (NON-BANK) MARKET IN PAKISTAN**

### **2.1. Stock Market**

With over 740 listed securities, the capital market in Pakistan has an overall market capitalisation of Rs 600 billion (USD 10.0 billion). As compared to this rather small size of the market, the average turnover of shares in all three stock exchanges was 154 million shares a day in 2002. Commenting on this peculiar characteristic of the stock market in Pakistan, the *Economist* (August, 2001) termed it as a market with one of the highest turnover of shares in the world. For the past one year, the market has been characterised by a continuous bullish trend and the KSE-100 index has broken all records in nominal terms. On the other hand, the activity in the primary market remained dull and the market has not really managed

to perform its main function of capital formation as an economic agent. The only significant contribution towards capital formation has been through corporate debt instruments called Term Finance Certificates (TFCs) that raised approximately Rs 10.00 billion during 2002. Only four new equity issues raised Rs 6.3 billion. The foreign portfolio investment has also picked up and has reached at approximately USD 500 million from a dismal figure of USD 150 million in 2001. The major reason for this enhanced level of investor confidence in the stock market appears to be mainly due to structural reforms focused on governance, transparency and efficiency of the market. This has been supported by higher levels of liquidity, macro-economic stability and interest rate rationalisation.

Since 1998, a comprehensive capital market reform programme is being implemented in Pakistan. With an overall aim to provide maximum protection to the investors, the reform programme has targeted on improving governance of the stock exchanges, setting-up of Securities and Exchange Commission as an independent regulator, and introduction of modern trading systems in conformity with international practices. The reform programme has met with strong resistance from various quarters, especially from the brokerage community, who argue too much power has been given to the securities regulator. Despite high level of resistance and low motivation on part of capital market actors, the Securities Commission has managed to implement significant number of reforms that have notably reduced the element of systemic risk and provided a voice to the small investors. Independent chief executives now manage the Stock Exchanges and rules have been made so as to minimise interference from those with vested interests. Modern trading and settlement systems are in place to avoid possible systemic risk in the market. In addition, the capacity of the securities regulator has been considerably enhanced through its operational and financial autonomy. The question remains that would the capital market in Pakistan manage to generate fresh capital as a result of these reforms or would it still remain crippled under pressure of geo-political and economic uncertainties?

## **2.2. Non-bank Financial Institutions**

The Securities Commission is also entrusted with the regulatory responsibilities for non-bank financial institutions and insurance companies. Over the past two decades, especially in the early nineties, a number of non-banking financial institutions emerged in Pakistan. These specialised financial institutions included state owned development finance institutions, mutual funds, leasing companies, investment advisors, investment banks, housing finance companies and micro-finance institutions. In addition to these, over fifty modaraba companies were floated to offer Islamic modes of financial services. The main source of capital for these institutions have been subsidised lines of credit from international financial institutions, borrowing from local banks, and resources mobilisation through the capital market.

Several steps have been taken in order to make non-banking financial institutions more viable and more effective. The direction of the reforms is towards shifting ownership to private sector, consolidation through mergers and takeovers, and fiscal incentives to encourage long term project financing.

### **3. FINANCIAL (NON-BANK) MARKET REFORMS**

During the past three years, the Securities Commission has successfully implemented a well thought out and comprehensive reform programme taking in to account interests of all stakeholders. The important initiatives in this regard are highlighted below.

#### **3.1. Risk Management Measures**

##### **3.1.1. T+3 Settlement System**

In addition to redefining net capital balance in line with international standards, the Commission fully implemented the T+3 system of settlement at the three stock exchanges. This replaced the old archaic system where settlement of trades could actually take up to thirteen days. With the implementation of T+3, possibilities of systemic and settlement risk have decreased. Tremendously.

##### **3.1.2. Capital Adequacy and Margin Requirements for Brokers**

For the first time, capital adequacy ratio has been introduced, where exposure of brokers not to exceed 25 times of their net capital balance. Similarly, margin requirements have also been strengthened (margin requirements raised and free exposure limit abolished).

##### **3.1.3. Regulations for Short-selling**

In an effort to regulate short selling in the ready market and to bring it in line with international best practice, the Commission approved the Regulations for Short Selling under Ready Market, 2002 in February 2002. The introduction of these Regulations is a significant step towards minimising market manipulation and ensuring a healthier and more transparent capital market.

##### **3.1.4. Improvements in COT Regulations**

In September 2001 and May 2002, the market witnessed abnormal price fluctuations, mainly due to the September 11 events and growing cross-border tension between India and Pakistan, respectively. On both occasions, the risk management measures, earlier introduced by the Commission, worked effectively. However, certain weaknesses were observed in the Carry Over Transactions (COT)

system. In this context, the stock exchanges were advised to make the following changes in the COT system:

- (a) COT transactions should be for a minimum period of 10 days albeit the finance would have the option to release it after one day;
- (b) COT should only be allowed in specified liquid shares;
- (c) Higher margins should be mandated for COT transactions; and
- (d) COT shares should be kept with the Central Depository Company (CDC) or with the clearinghouse of the stock exchange and should be pledged in the name of the financier, if the financier were a bank or a financial institution.

### **3.1.5. *Investor Protection and Clearing House Protection Funds to be Fully Funded***

The Investor Protection Fund (IPF) and Clearing House Protection Fund (CHPF) have been set up to ensure effective risk management in the secondary market and to protect investors' interest in case of default by members of the exchanges. The Commission observed that the funds were not fully funded by the exchanges and directed them to ensure that the IPF and CHPF are fully funded by June 30, 2007.

## **3.2. Improvements in Governance**

### **3.2.1. *Registration of Brokers and Agents***

The Commission promulgated the Brokers and Agents Registration Rules in May 2001 to establish a direct regulatory nexus with brokers and agents for protection of investors' interest.

### **3.2.2. *Regulations for Good Governance at the Stock Exchanges***

Recently, the Commission, under the Securities and Exchange Ordinance, 1969, has directed the stock exchanges to further improve governance and advised them to reconstitute their Board of directors as under:

- (a) Five directors to be elected from amongst the members by the general body of the exchange;
- (b) Four non-member directors to be nominated and appointed by the Commission;
- (c) The position of vice-chairman of the exchange to be abolished; and
- (d) The chairman to be elected by the Board from amongst the elected directors.

It is expected that the Boards thus reconstituted and streamlined will not only function better but will also be able to look after the interests of all stakeholders more effectively.

### **3.2.3. Revised Arbitration Procedure**

In order to ensure expeditious resolution of investors' complaints, the Commission has approved a two-tier arbitration procedure for the KSE. Under the new procedure, all claims and disputes of more than Rs 0.5 million, which are not amicably settled otherwise, should be referred to an Advisory and Arbitration Committee (AAC) for resolution or decision. The Committee consists of three members, namely, one member director, one non-member director and the Managing Director. A claim or dispute could be referred by the AAC to a panel of arbitrators. However, claims and disputes of up to Rs 0.5 million would be resolved or decided by the Managing Director of the exchange. It is expected that introduction of the new arbitration procedure will have a positive impact on engendering investor confidence.

## **3.3. Introduction of New Products/Systems**

### **3.3.1. Trading in Futures Contracts**

Derivative products give depth to the capital market, providing investors with basic hedging instruments and investment alternatives. The Commission approved the regulations governing futures contracts trading on June 9, 2001. Trading in futures contracts made its debut at the KSE on July 5, 2001. Currently, 13 scrips are being traded at both the KSE and the LSE. Stocks are selected for futures trading primarily on the basis of their liquidity.

### **3.3.2. OTC Market**

A quote-driven OTC market, essentially for small-cap stocks and debt securities, provides investors with an alternative, convenient and efficient avenue to make investments. Moreover, promoters can set up new projects or expand their operating activities by raising finance in a cost-effective manner in the OTC market where regulatory requirements are less stringent than in case of regular listing. In May 2002, the Commission approved, in principle, the concept of an OTC market and the necessary regulations.

### **3.3.3. Formation of National Commodities Exchange**

The Commission has approved the establishment of NCEL for trading in futures contracts in commodities. The NCEL will be the first demutualised exchange and will be sponsored by the Stock Exchanges and other premier institutions of the

country. It will be the first exchange of its kind in Pakistan and will consolidate commodity futures trading at the national level. The introduction of futures contracts in commodities will offer the investors basic hedging instruments, enabling them to lock-in costs, and will also provide necessary stimulus to boost investment.

#### **3.3.4. National Clearing and Settlement System**

The National Clearing and Settlement System (NCSS) commenced operations on December 24, 2001. Companies are being inducted in the NCSS in a phased manner. By September 30, 2002, the total number of companies inducted into the system was 150.

#### **3.4. Investor Education**

Various efforts are underway to educate investors about the significant aspects of investing in securities. The Commission has published a series of Investor Guides to educate existing and potential investors about the investment risks and rewards, the importance and significance of financial planning and, most importantly, the rights and responsibilities of investors and the recourse available to them. The preparation of the Investor Guide Series is a part of the Commission's investor awareness programme. Information asymmetries provide undue advantages to certain market participants in case of market failure. The Commission, therefore, aims to achieve maximum dissemination/ disclosure of information to all investors.

#### **3.5. Monitoring and Surveillance**

The Market Monitoring and Surveillance Wing (MSW) were set up within the Commission in October 2000 to facilitate initiatives in risk management. The MSW has two specific functions: (i) monitoring of systemic risk at the exchanges; and (ii) surveillance to detect general or specific instances of market abuse. The MSW monitors the market by using on-line data available on the websites of the exchanges. It identifies price and turnover aberrations that may need investigation to determine market malpractices, such as blank selling, insider trading, etc.

#### **3.6. Investor Complaints**

The Vigilance Cell dealing with investor complaints has emerged as an efficient and effective instrument for the protection of investors' interests, in particular, those of small investors. The Wing has successfully brought about quantitative as well as qualitative improvements in redressing investor grievances, which are partly reflected in the statistics presented below.

#### **3.7. Other Regulatory Measures**

Among several new rules, regulations and amendments to existing regulatory edicts as mentioned above, the SEC also issued Listed Companies (Prohibition on

Insider Trading) Guidelines 2001. Similarly, the Commission persuaded the government for issuance of a Takeover Law. Although, the government has issued Listed Companies (Substantial Acquisition of Shares and Take-Over) Ordinance, 2002, the final shape of this law does not really serve the purpose of facilitation of takeovers and mergers. The Commission has recommended major revamping of this legislation.

### **3.8. Transparency Measures**

The Commission has taken several important steps to improve the disclosure standard and the quality of financial reporting. Some of these measures include;

- SEC has adopted 38 out of 41 IAS.
- All listed companies are required to publish their quarterly accounts in an effort to improve transparency and disclosure by companies.
- Auditors found guilty of professional misconduct are barred from auditing listed companies for three years.
- In order to minimise conflict of interest, auditors of listed companies have been prohibited from performing other services for the same company.
- The Commission has also made it mandatory for listed companies to rotate their auditors after every five years.
- The State Bank provides the current position of foreign portfolio investment on weekly basis including flows thereof.

### **3.9. Regulation of Non-bank Finance Companies**

Several developmental steps have been taken to strengthen the non-bank financial institutions. Most important regulatory development in this regard is the transfer of regulation of all Non-Bank Financial Institutions (NBFIs) with the exception of DFIs to the Securities Commission. The restructuring plan of NBFIs—jointly undertaken by the State Bank of Pakistan and the (SEC)—envisaged the creation of a Non-Bank Finance Company (NBFC) whereby all existing NBFIs—with the exception of Modarabas and Development Finance Institutions (DFIs)—would be re-classified as NBFCs. The NBFCs would be treated as specialised companies and would come under the regulatory ambit of the SEC. Incorporated as a public limited company, the NBFC would be able to undertake all functions relating to financial services except commercial banking functions. These functions could include investment services, leasing, housing finance, venture capital investment, discounting services, asset management, investment advisory services, and any other non-banking financial service that may be so defined. Each proposed function of the NBFC shall require licensing from the SEC on the basis of prescribed eligibility criteria, and the NBFC shall maintain separate tiers of regulatory capital linked to each of its functions.

With the recent enactment of amendments in the Companies Ordinance, 1984—with respect to regulation of NBFCs, the SEC has been empowered with the requisite regulatory muscle to regulate the NBFCs under its purview in an effective and proactive manner. For this, the Commission has prepared a comprehensive set of rules for regulation and monitoring of NBFCs. These rules were finalised after soliciting public opinion and then sent to the Government for clearance prior to promulgation.

### **3.10. Insurance Reforms**

The new insurance law, namely, the Insurance Ordinance, 2000 was promulgated on August 19, 2000 and the old law (Insurance Act, 1938) was repealed. Extensive and radical changes were instituted in the Ordinance. It also replaced the administrative and compliance mandate from Ministry of Commerce to Securities and Exchange Commission of Pakistan. Consequently, the Insurance Division of the SECP started functioning from January 01, 2001.

The important provisions introduced through the new law are enhancement of paid up capital and solvency margin, reduction in management expenses, bifurcation of statutory and life funds held by life insurance companies, introduction of insurance brokerage system, the role and function of Insurance Ombudsman, provision of small disputes resolution committee and provisions relating to market conduct. The regulatory authority has been entrusted with necessary powers to further reform the industry as and when required. A separate code of corporate governance for insurance companies is being introduced which will further rationalise the insurance sector.

Although the new insurance law has not yet been implemented fully, its success is visible from the fact that 56 insurance companies were functioning till the beginning of 2001. 8 companies were refused registration under the new law due to their extremely low capital base as well as inadequate solvency level. 12 companies were advised to cease underwriting due to deficiency in their paid up capital as required under the new insurance law. Thus the number of companies has reduced to 36. It is presumed that after the enforcement of insurance rules already notified on December 12, 2002, more companies would be advised to cease underwriting due to shortfall in solvency requirements and hence the number of companies will be reduced further.

## **4. CORPORATE GOVERNANCE**

Corporate governance was a key area of reform during past three years. In March 2002, the Commission finalised and introduced the first Code of Corporate Governance for Pakistan, which was subsequently included as part of the listing regulations of the stock exchanges. The Code has been issued by the Commission after an extensive consultative process and is the result of joint efforts of the Commission

and ICAP. The initiative to develop a sound framework of good governance, which addresses the objective circumstances in Pakistan, was taken in December 1998 at the Fifth All Pakistan Chartered Accountants' Conference. A Committee comprising representatives of ICAP, ICMAP, stock exchanges and the Commission developed the draft Code. Seminars were held in Karachi, Lahore and Islamabad to elicit opinion on the provisions of the Code. In addition, the draft Code was placed on the websites of ICAP and the Commission. Based on the recommendations received from various quarters, the Code was finalised and made a part of the listing regulations of the three stock exchanges. It is now applicable to all public listed companies.

The Code primarily aims to establish a system whereby a company is directed and controlled by its directors in compliance with best practices so as to safeguard the interests of a diverse range of stakeholders. It proposes to restructure the composition of board of directors to pave way for representation of minority shareholders. The Code emphasises openness and transparency in corporate dealings and decision-making process. It also requires directors to discharge their fiduciary responsibilities in the larger interest of all stakeholders in a transparent, informed, diligent, and timely manner. The salient features of the Code are as follows:

- (i) The Code encourages representation of independent non-executive directors and those representing minority interests on the boards of directors of listed companies.
- (ii) It lays down the qualification and eligibility criteria for directors of listed companies.
- (iii) While reinforcing the powers, responsibilities and functions of the board of directors, the Code formalises the corporate decision-making process and requires adequate documentation of policies and decisions of directors.
- (iv) It seeks to strengthen corporate working, internal control system and external audit requirements of listed companies.
- (v) Corporate and financial reporting framework has been re-defined to foster better disclosure.
- (vi) Audit Committees and internal audit functions are required to be established by all listed companies.
- (vii) A statement of compliance with the Code is required to be published by companies to set out the extent of compliance with the Code. The statutory auditors of listed companies have been made responsible for reviewing and certifying this statement.

## **5. MINIMISING BARRIERS TO ENTRY**

The Commission has taken several steps to facilitate development of the corporate sector. The company registration process has been revamped. Companies

can now get their registration certificates in less than three days as compared to several weeks, as was the norm a few years ago. Also, now the name search facility is available through web search. As a matter of fact, the NOC culture is totally non-existent and the company registration offices are now moving towards online registration. The newly approved Digital Transactions Ordinance 2002 is going to further facilitate this process. Similarly, system of filing of statutory returns as well as mortgage registration has been simplified and made user friendly.

## **6. DEVELOPMENT PROJECTS**

In 2002, Commission set-up a Policy and Communication Division that focuses on research, development projects, and external communication. Presently, the Commission has undertaken the following three development projects.

### **6.1. Financial (non-bank) Markets Governance Programme (ADB)**

Subsequent to the successful completion of the Capital Market Programme Loan from the Asian Development Bank (ADB), the government has agreed to work with ADB on the second phase of reforms under Financial (non-bank) Markets Governance Programme Loan. Under this Programme, the policy reforms focus on financial sector development through integrated package to improve access to and availability of medium-to-long term finance for sustainable saving and investment. The key objectives of this programme are;

- Improve governance, transparency and risk management.
- Increase market instruments, participants and competition.
- Improve operational efficiency.

These reforms will largely be undertaken on three levels: (i) macro/policy level (including fiscal); (ii) meso-level: governance, regulation and institutions; (iii) micro-level: instruments and operations (including technical infrastructure). The Programme will also cover four market sub-segments: (i) equity; (ii) debt (including money market); (iii) contractual savings and institutional investment; (iv) non-bank financial services and institutions.

In addition, the ADB is considering possible guarantee support for the following;

- Foreign portfolio investment.
- Credit enhancement development of financial instruments.
- Insurance access and stabilisation.

### **6.2. Corporate Governance Project (UNDP)**

Pursuant to implementation of the Code, the Commission has designed a programme to promote good governance practices in the corporate sector in

collaboration with the United Nations Development Programme (UNDP). Under this programme, the Commission will focus on seeking the participation of various stakeholders and professionals in the effective enforcement of the Code and broadening the understanding of stakeholders on different aspects of corporate governance. The programme will also be instrumental in building the regulatory capacity of the Commission for efficient enforcement of good corporate governance practices and keeping pace with international developments on the topic as well as participating in an interchange of views on priority areas.

### **6.3. Anti-Money Laundering Initiative (World Bank)**

Money laundering is an issue that has gained increasing importance following the events of 9/11. Governments are particularly keen on keeping a careful vigil on the movement of money that is suspected of being utilised in the financing of terrorism. More generally, money laundering is the name given to the process by which the origin of illicit funds is disguised. In many countries, it is a crime to use laundered money. Facilitating money laundering indirectly supports the underlying activity; it is thus considered a criminal activity.

Money laundering occurs through banks and through NBFIs (Non-bank Financial Institutions) i.e., real estate companies, securities brokers/intermediaries, leasing companies and insurance companies. It is most likely to be prevalent in countries that do not have a developed financial and legal framework for detection/prevention of money laundering.

In Pakistan the issue of money laundering has not gone unnoticed. Currently, the policy makers are in the process of drafting the first legislation that will make money laundering a criminal offence. Various institutions of the country including the Securities and Exchange Commission of Pakistan, State Bank of Pakistan (SBP), Ministry of Finance, Federal Investigation Agency and other agencies are rigorously pursuing the implementation of an anti-money laundering framework. Recently, the International Development Agency (IDA) through the World Bank, has approved Technical Assistance of US \$26.5 million for a 4-year project on Banking Sector Reform (TABS). Keeping in view the significance of the issue of money laundering, the World Bank has extended its assistance to SBP and SECP for creating greater awareness and strengthening the institutional capacity of the regulators for prevention of such activities in the banking and non-bank financial sectors. The main objective of the Technical Assistance is to carry out amendments in rules, regulations Ordinances/Acts enforced by SECP and bring them in conformity with the detection/prevention of anti-money laundering activities e.g., irregular financial transactions, reporting customer identification, record keeping standards, internal policies and controls and verification of accounts through coordination with agencies. Studies and reports on best practices for development of capital market will also be developed in this project. The Technical Assistance has helped in the establishment

of an anti-money laundering (AML) Unit at the SECP that would comprise of experts from the private sector on a full/part time basis for in-house training needs and conducting research on an ongoing basis. The AML Unit would remain in existence post the expiry of the Project with funds provided through SEC, s own budget. As part of the Project, the Commission intends to create awareness among key stakeholders, such as creditors and institutional investors, through publications and seminars for the public at large in order to develop their understanding of the main perspectives and framework of anti-money laundering laws and issues.

## 7. FUTURE PLANS

The Future reform agenda of the SEC is largely developmental. The Commission intends to strengthen the capacity of market institutions to effectively perform the role of information dissemination and self-regulation. In near future, the Commission plans to work on following areas.

- Setting up of an OTC Market.
- Demutualisation of Stock Exchanges.
- New product development, e.g. derivatives – to give market depth/ means to hedge risks.
- Develop Mutual Funds/Pension Funds industry to give market institutional underpinning.
- Setting up of ECNs (Electronic Communication Networks).
- Replacement of COT System with margin Financing.
- Strengthening regulatory capacity of the Commission.

## 8. CONCLUSION

The visible positive outcomes of comprehensive reforms in the financial (non-bank) market in Pakistan have been extremely encouraging and endorse the right direction of regulatory measures taken by the Securities and Exchange Commission of Pakistan. However, the question remains that why the impact of reforms seems to be limited to secondary market only. Despite revolutionary reforms and macro-economic stability, the financial market has neither managed to mobilise significant savings nor channelled resources to productive investments. It appears that policy makers have to seriously look at imperfections in the supporting infrastructure that is essential for the growth of a financial system. A well functioning financial system requires an infrastructure that provides effective legal framework, ensures timely and accurate information and develops efficient regulatory framework. In order to achieve this, policy makers need to devise mechanisms for production and communication of correct information, establish strong regulatory bodies to limit the exercise of market power, and to develop a legal environment that has the capacity to provide protection to investors.

Financial sector is historically subject to massive regulations as governments usually keep a check on entry in to financial industry, capitalisation, and lending rates policies etc. The main justification of this higher level of regulation is the different nature of this industry, where state has to maintain public confidence in the financial institutions in order to encourage savings. The importance of effective regulation is more critical today than ever because the complex nature of modern financial transactions has increased the level of concealment of insider information by the firm managers and owners.

Although it has been generally witnessed that governments have failed to efficiently deliver financial services and the control of financial services sector has heavily tilted towards private managers, the disastrous experience of financial sector deregulation in Russia has been a classic example of liberalisation without adequate institutional framework. The governments are faced with a challenge to set up a regulatory framework that ensures transparent market functioning in the present wave of financial liberalisation. However, there have been several issues that need to be addressed to make these regulatory authorities more effective. The government has to ensure the visible independence of regulators and high level of technical expertise to understand complex financial transactions. A new design of regulatory framework is required that discourages both the *market and regulatory capture* and ensures fair treatment of all stakeholders. The regulation should not only give a 'voice' to stakeholders but should empower the owners, markets, and official supervisors to actively monitor the financial market. The players of the financial markets must understand that effective regulation through institutional building ensures market freedom and is the way forward towards ensuring proper financial market growth in Pakistan. This doable but an uphill task in Pakistan is still faced with serious internal and external political economy issues like crony alliances, policy inconsistencies, and geo-political instability.