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ALLAMA IQBAL OPEN UNIVERSITY, ISLAMABAD

Course: Fundamentals of Money and Banking (1414) • Level: BS/AD

Semester: Autumn 2026

Assignment No. 2 (Units 5–9)

Total Marks: 100 • Pass Marks: 50

SOLVED ASSIGNMENT GUIDE

(For Study & Reference)

Note: This guide is prepared for study and reference purposes. Students are advised to read the relevant units of the course book, understand the concepts and then write the assignment in their own words.

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Question 1: What is a Bank? Kinds of Banks Working in Pakistan (20 Marks)

What is a bank? Explain the various kinds of banks working in Pakistan.

Introduction

A bank is so much a part of daily life that we rarely stop to define it. Salaries are credited to bank accounts, bills are paid through banks, savings are kept in banks and loans are taken from banks. Yet banking is a specialised, legally regulated business, very different from ordinary trade, because a bank deals in other people's money and in credit. In Pakistan, banking is regulated by the State Bank of Pakistan under the Banking Companies Ordinance, 1962, and no company may use the word “bank” or accept deposits withdrawable by cheque unless it is licensed under that law. This question first explains what a bank is and then describes the various kinds of banks working in Pakistan.

Meaning and Definition of a Bank

The word “bank” is traced either to the Italian word banco, meaning a bench — the benches on which money changers sat in medieval Italian markets — or to the German word banck, meaning a joint stock fund. In modern terms, a bank is a financial institution which accepts

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deposits from the public, repayable on demand or at agreed times, and lends or invests those deposits for profit. Crowther defined a banker as “a dealer in debts — his own and other people's”: the bank's own debt is the deposit it owes to customers, and other people's debts are the loans it owns. The Banking Companies Ordinance, 1962 (Pakistan) defines banking as “accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise”.

Three features distinguish a true bank from other lenders or finance companies. First, it accepts deposits from the general public, not merely from its members or shareholders. Second, those deposits are withdrawable on demand by cheque or electronic instruction, which makes bank deposits function as money. Third, lending and investment of the deposited funds is its regular business, conducted with the depositors' money rather than only its own capital. Along with these core activities, modern banks provide agency and utility services — collecting bills, transferring funds, issuing cards, providing lockers, and offering digital banking — but deposit-taking and lending remain their defining functions. Because banks create credit and hold the public's savings, they are licensed, supervised, required to keep reserves, and audited in a way ordinary businesses are not.

Kinds of Banks Working in Pakistan

Pakistan has a diversified banking structure headed by the central bank. The main kinds are as follows.

1. The Central Bank — State Bank of Pakistan

The State Bank of Pakistan, established on 1 July 1948, stands at the apex. It is not a commercial bank and does not deal with the general public for ordinary deposits; instead it is

the bank of banks and the bank of the government: it issues currency, controls money supply and credit, supervises all banks, manages foreign exchange reserves and acts as lender of last resort.

2. Commercial Banks

Commercial banks are the largest and most familiar category. They accept all types of deposits — current, savings and term — and provide short and medium-term loans, trade finance, letters of credit, guarantees and payment services to businesses and individuals. They include large public-sector banks such as the National Bank of Pakistan, privatised banks such as HBL, UBL, MCB and Allied Bank, smaller private banks, and branches of foreign banks operating in Pakistan. Scheduled banks are those commercial banks included in the schedule maintained by the State Bank because they meet prescribed capital and reserve requirements.

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3. Islamic Banks

Islamic banks conduct banking in accordance with Shariah, avoiding interest (riba) and instead using trade, leasing and partnership modes such as Murabaha, Ijara, Musharakah and Mudarabah. Pakistan has full-fledged Islamic banks such as Meezan Bank, Bank Islami and Faysal Bank (converted to full Islamic banking), as well as Islamic banking branches and windows of conventional banks, all regulated under the State Bank's Shariah governance framework. This segment has grown to roughly a fifth of the banking system's assets and deposits.

4. Specialised Banks

Specialised banks are created by the government to serve a particular sector neglected by commercial banks. The Zarai Taraqiati Bank Limited (ZTBL), originally the Agricultural

Development Bank, provides credit to farmers. The Punjab Provincial Cooperative Bank serves the cooperative sector. The Industrial Development Bank (IDBP) was created for industrial finance, and the SME Bank for small and medium enterprises — although some of these institutions have been restructured, merged or wound down over the years, they illustrate the category. The House Building Finance Company provides housing finance on a specialised basis.

5. Microfinance Banks

Microfinance banks provide very small loans, deposits and payment services to low-income households, micro-entrepreneurs and especially women, who lack the collateral and documents commercial banks require. Examples include Khushhali Microfinance Bank, Telenor Microfinance Bank (Easypaisa), FINCA, Mobilink Microfinance Bank (JazzCash) and U Microfinance Bank. They are licensed and regulated by the State Bank under the Microfinance Institutions Ordinance, 2001.

6. Development Finance Institutions (DFIs)

DFIs are non-deposit-taking or limited-deposit institutions that provide long-term finance for industry, infrastructure and housing. They include the Pak-Kuwait, Pak-Libya, Pak-Oman and Saudi-Pak investment companies, Pak Brunei Investment Company, and institutions such as the Pakistan Mortgage Refinance Company. They raise funds from the government, foreign lines of credit and capital markets rather than from public demand deposits.

7. Cooperative Banks

Cooperative banks are owned by their members and provide credit to members, especially in agriculture and small trade, on cooperative principles. They operate at provincial level (for

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example the Punjab Provincial Cooperative Bank) and have historically suffered from weak governance, so their share is now small.

Table 1: Kinds of banks in Pakistan at a glance

Kind of Bank	Examples in Pakistan	Main Function
Central bank	State Bank of Pakistan	Currency issue, monetary policy, supervision
Commercial banks	NBP, HBL, UBL, MCB, Allied Bank	Deposits, loans, trade and payment services
Islamic banks	Meezan Bank, Bank Islami, Faysal Bank	Shariah-compliant banking without interest
Specialised banks	ZTBL, Punjab Provincial Cooperative Bank	Credit for a specific sector (agriculture, cooperatives)
Microfinance banks	Khushhali, Telenor MFB, U MFB	Small loans and services for low-income clients
Development finance institutions	Pak-Kuwait, Pak-Oman, PMRC	Long-term industrial and infrastructure finance

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Conclusion

To conclude, a bank is a licensed institution that accepts deposits from the public, withdrawable on demand, and lends or invests them — a dealer in credit whose deposits themselves serve as money. Pakistan's banking structure is a pyramid: the State Bank of Pakistan at the top as regulator and monetary authority; commercial banks (conventional and Islamic) forming the broad base serving the general public; and specialised, microfinance, cooperative and development institutions filling the gaps for agriculture, the poor, small business and long-term development. Together, these kinds of banks mobilise the nation's savings and distribute credit to every sector of the economy.

Question 2: Types of Advances Offered by Commercial Banks (20 Marks)

What are the different types of advances offered by commercial banks to their clients?

Introduction

Lending is the most profitable and the most risky business of a commercial bank. Funds collected as deposits lie idle and earn nothing unless they are advanced to borrowers who pay interest or profit for their use; yet every advance carries the danger that the borrower may not repay. Bankers therefore classify their lending into different types of advances, each designed for a particular purpose, period and type of borrower, and each with its own method of operation and security. In Pakistan, commercial banks advance funds to traders, industrialists, farmers, exporters, salaried persons and students in many forms. This answer explains the principal types of advances offered by commercial banks to their clients.

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Meaning of Advances and Principles Behind Them

An advance is any credit facility extended by a bank — by actually paying out money, by allowing an overdraft, or by committing to pay on the client's behalf. A sound banker follows the classic principles of lending before granting any type of advance: safety (the borrower must be able to repay), liquidity (the bank must be able to recover the money when deposits are withdrawn), profitability (the advance must earn a reasonable return), diversification (funds must not be concentrated in one borrower, trade or locality), and purpose (the loan must finance a genuine, productive need). The various types described below are simply different practical shapes given to these principles.

Types of Advances

1. Loans (Term Loans)

A loan is a definite sum advanced for a fixed period at an agreed rate of interest, credited to the borrower's account (usually a separate loan account) and repaid in instalments or in one lump sum at maturity. Loans may be short-term (up to one year), medium-term (one to five years) or long-term (over five years). Personal loans, car loans, house loans, and project loans to industry are examples. Interest is charged on the whole amount sanctioned from the day it is disbursed, whether the borrower uses it all at once or not.

2. Cash Credit

Cash credit is the most popular form of working-capital finance for businesses in Pakistan. The bank fixes a credit limit against the security of goods, stocks or book debts; the borrower operates a cash credit account and withdraws and repays money as needed, within the limit. Interest is charged only on the amount actually utilised, not on the whole limit, which makes it economical for traders whose needs fluctuate with stock levels. The account is reviewed and the limit renewed periodically, usually every year.

3. Overdraft

An overdraft allows a current account holder to draw more than his credit balance, up to an agreed limit and for an agreed short period. It is meant to meet temporary shortages — for example, when payments fall due before receipts arrive. Interest is charged only on the amount overdrawn and for the days it remains outstanding. Overdrafts may be clean (granted on personal security and creditworthiness) or secured against shares, deposits or property.

Because the facility is technically repayable on demand, it is unsuitable for long-term investment.

4. Discounting of Bills of Exchange

In trade, sellers often draw bills of exchange or hundis on buyers, payable after 30, 60 or 90 days. The seller need not wait: he can get the bill discounted at his bank, receiving the face value minus discount (interest for the remaining period) at once. On maturity the bank collects the amount from the acceptor. Bill discounting finances genuine trade transactions, is self-liquidating, and is considered a safe and liquid advance. Banks also discount post-dated cheques and purchase demand drafts and pay orders in similar fashion.

5. Advances Against Securities and Documents

Banks lend against the pledge or hypothecation of specific assets: pledge of goods and commodities (cotton, wheat, sugar) stored in godowns under the bank's lock; hypothecation of stocks, machinery or vehicles, where possession stays with the borrower but the bank holds a legal charge; advances against shares and marketable securities; loans against fixed deposits, savings certificates and insurance policies, which are nearly risk-free; and advances against gold and gold ornaments, common for small urgent needs.

6. Consumer and Retail Advances

Banks offer advances designed for individuals: credit cards (a revolving short-term advance), personal loans for salaried persons, auto loans for purchasing vehicles (including schemes like Roshan Apni Car), housing finance for purchase or construction of homes (including the low-cost housing schemes promoted by the State Bank and Naya Pakistan Housing), education loans, and advances through running finance facilities attached to salary accounts.

7. Agricultural and SME Advances

Under State Bank targets and schemes, banks advance production loans for seed, fertiliser and pesticides, development loans for tractors, tube-wells and livestock, and seasonal crop loans recovered after harvest. For small and medium enterprises, facilities include the SME Asaan Finance schemes, refinance facilities for exporters (Export Finance Scheme at concessional rates through the State Bank), and the Prime Minister's Youth Business and Agriculture Loan Scheme offering subsidised mark-up tiers through participating banks.

8. Syndicated, Consortium and Bridge Advances

Very large projects — power plants, motorways, big industrial units — exceed a single bank's exposure limits, so several banks join to provide one large advance jointly (syndication or consortium lending), sharing the risk. Bridge loans are short advances given in anticipation of a definite long-term inflow, such as proceeds of a share issue or a sanctioned long-term loan not yet disbursed.

9. Non-Fund-Based Facilities (A Related Form of Support)

Although no money is paid out initially, banks support clients through guarantees, letters of credit (which assure a foreign exporter of payment for imports), bid and performance bonds, and acceptances. These are called non-fund-based facilities; they become real advances if the client fails to pay and the bank must honour its commitment, so banks appraise them with the same care as loans.

Table 1: Main types of bank advances compared

Type	Purpose	Interest Charged On	Usual Period
Term loan	Fixed need: car, house, project	Full amount disbursed	Short to long term

Cash credit	Working capital against stocks	Amount actually utilised	Renewable, usually 1 year
Overdraft	Temporary shortage on current account	Amount overdrawn, daily basis	Very short term
Bill discounting	Finance trade receivables	Discount on face value of bill	30–180 days
Advance against deposits/shares	Urgent needs against own assets	Amount advanced	Short term
Consumer finance	Personal, auto, housing needs	Amount disbursed	Medium term, instalments

Secured and Unsecured Advances

Advances are also divided by security. Secured advances are backed by tangible security — goods, property, shares, deposits — which the bank can sell on default. Unsecured or clean advances rest only on the borrower's personal creditworthiness, signature and guarantees of third parties; they are granted sparingly, to clients of unquestioned reputation, and usually at higher rates. In practice most advances in Pakistan are secured, and banks additionally take personal guarantees of directors or sponsors of borrowing companies, post-dated cheques, and insurance of pledged stocks to strengthen their position.

Conclusion

In conclusion, commercial banks offer their clients a flexible family of advances: term loans for definite needs, cash credit and overdrafts for fluctuating working capital, bill discounting for trade finance, advances against goods, shares, deposits and gold, consumer, agricultural and SME facilities for households, farmers and small business, and syndicated loans for very large projects, supplemented by guarantees and letters of credit. All these forms serve one economic purpose — to move the community's savings into the hands of those who can use them

productively — while their differing structures of interest, security and maturity keep the banker's principles of safety, liquidity and profitability in balance.

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Question 3: The Five Cs of Credit and the Process of Obtaining a Bank Loan (20 Marks)

Explain in detail the concept of the five Cs of credit and the process to obtain a bank loan.

Introduction

Every bank loan begins with a question in the banker's mind: "Will this borrower repay?" Lending the public's deposits is a responsibility, and bad lending has destroyed more banks than any other cause. To answer that question scientifically, bankers all over the world use a classic framework called the five Cs of credit — Character, Capacity, Capital, Collateral and Conditions. Before granting any advance, the bank appraises the applicant against these five tests. If the applicant passes, a well-defined process follows, from application to disbursement and monitoring. This answer explains each of the five Cs in detail and then describes step by step how a bank loan is actually obtained in Pakistan.

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The Five Cs of Credit

1. Character — The Willingness to Repay

Character refers to the borrower's honesty, integrity and reputation — his willingness to repay even when repayment is difficult. Credit history shows that many defaults are not caused by inability but by unwillingness: borrowers who divert funds, hide liabilities or delay payments deliberately. The bank investigates character through the applicant's past dealings with banks, the e-CIB (Electronic Credit Information Bureau) report maintained by the State Bank, which records all loans and any default history, trade and market references, the borrower's standing in his business community, and his record of meeting tax and utility obligations. A borrower of

doubtful character fails the very first test, however profitable his proposal may look, because no security can fully protect a bank against a dishonest client.

2. Capacity — The Ability to Repay

Capacity is the borrower's cash-generating ability to service the loan — to pay instalments and interest on time from the income of his business or salary. The bank studies financial statements (for businesses: three years' balance sheets, profit and loss accounts), projected cash flows, the debt-service coverage ratio, existing borrowings, and the stability of income. For a salaried person, capacity is judged from salary slips, employer confirmation and the proportion of income consumed by all instalments, which banks generally keep below a fixed share of monthly income. A project may be honest and well-secured, but if its expected cash flow cannot comfortably cover repayments, the bank must refuse or reduce the facility — capacity is considered the most important of the five Cs because repayment is expected from income, not from selling security.

3. Capital — The Borrower's Own Stake

Capital means the borrower's own money invested in the business or project — his equity, net worth and reserves. A businessman who risks his own substantial funds alongside the bank's money has a strong incentive to succeed, and his capital provides a cushion that absorbs losses before the bank's money is touched. Banks therefore normally finance only a part of the project cost, requiring the borrower to contribute equity, expressed in rules such as the State Bank's debt-to-equity requirements for corporate borrowers. Thin capitalisation — a huge loan requested on a tiny own investment — signals that the borrower wants the bank to bear almost the entire risk, and is treated as a serious weakness.

4. Collateral — The Secondary Source of Repayment

Collateral is the security — property, stocks, machinery, deposits, shares or guarantees — pledged to the bank so that, if the borrower defaults, the bank can recover its money by selling it. The banker values collateral conservatively, applying margins (forced-sale value rather than market value), verifying title and ownership through land records and registries, and ensuring the security is insured and legally chargeable in the bank's favour. Collateral is deliberately called the secondary source of repayment: it reduces loss on default but can never substitute for character and capacity, because legal recovery in practice is slow and costly, and a loan recovered by auctioning a family's factory or home is a failure of lending, not a success.

5. Conditions — The Surrounding Circumstances

Conditions cover everything outside the borrower's direct control that can affect repayment: the general state of the economy, the condition and outlook of his particular industry, competition, government policy, interest-rate and exchange-rate movements, and the purpose and terms of the loan itself — its amount, period and repayment schedule must fit the need (short-term finance for working capital, long-term for fixed assets). The purpose is itself a condition: banks insist that the loan be used for the stated, genuine and lawful purpose, and they check end-use because diversion of funds is a common cause of default. A sound proposal can be rejected when industry or economic conditions are unfavourable — for example, lending heavily to a declining trade — while a marginal proposal may be accepted in a booming, well-supported sector.

Table 1: The five Cs of credit summarised

C	What the Bank Examines	Main Evidence Used

Character	Honesty and willingness to repay	e-CIB report, references, past dealings
Capacity	Ability to repay from income/cash flow	Financial statements, cash-flow projections, salary record
Capital	Borrower's own investment and net worth	Balance sheet, equity contribution to the project
Collateral	Security available on default	Property documents, valuation, pledge of stocks/deposits
Conditions	Economic/industry climate and loan purpose	Industry reports, policy environment, end-use of funds

The Process of Obtaining a Bank Loan

The five Cs are applied through a formal process, which in Pakistan broadly follows these steps.

- Step 1 — Application: The borrower visits the bank (or applies online) and submits a loan application form with documents: CNIC, NTN and tax returns, bank statements (usually six months to one year), business registration, partnership deed or incorporation papers, audited financial statements for companies, salary slips and employer letter for salaried applicants, and documents of the property or asset offered as security.
- Step 2 — Initial interview and screening: The bank officer discusses the purpose, amount and period with the applicant, checks eligibility under the bank's policy and State Bank prudential regulations (for example, exposure limits and restrictions on lending to defaulters), and obtains the e-CIB report to verify credit history — the practical test of Character.
- Step 3 — Appraisal / credit analysis: The credit officer visits the business premises, verifies stocks and assets, analyses financial statements and cash flows (Capacity), checks the borrower's equity contribution (Capital), gets the collateral valued by an approved valuator

and its title verified by the bank's lawyer (Collateral), and studies industry and market conditions (Conditions). A detailed credit proposal or memorandum summarising all five Cs with a recommendation is prepared.

- Step 4 — Approval / sanction: The proposal is approved by the officer or credit committee having the required authority, depending on the amount. The bank issues a sanction letter (offer letter) stating the amount, mark-up rate, period, repayment schedule, security required and all terms and conditions, which the borrower signs in acceptance.
- Step 5 — Documentation and creation of charge: Legal documents are executed: loan agreement, demand promissory note, letter of hypothecation or pledge, mortgage deed for property (registered where required), personal guarantees, and insurance of the financed assets. Charges over company assets are registered with the Securities and Exchange Commission of Pakistan, and property charges are recorded with the relevant registrar/revenue authority.
- Step 6 — Disbursement: After all conditions are met, the loan is disbursed — credited to the borrower's account, paid directly to the supplier/dealer (usual for car, machinery and house loans), or released in tranches against project progress for construction and project finance.
- Step 7 — Monitoring and repayment: The bank monitors the account — inspecting stocks, checking account turnover, verifying end-use, collecting financial statements — while the borrower repays instalments on schedule. Annual reviews renew working-capital limits. On full repayment, the bank issues a clearance/no-dues certificate and releases the security and title documents; on default, it pursues recovery, rescheduling or, as a last resort, legal action and sale of collateral.

Conclusion

To conclude, the five Cs — Character, Capacity, Capital, Collateral and Conditions — form a complete credit-appraisal framework: character tests willingness, capacity tests ability, capital tests commitment, collateral provides a fallback, and conditions test the environment in which repayment must occur. The loan process — application, screening, appraisal, sanction, documentation, disbursement and monitoring — is simply the machinery by which these five tests are applied in practice. A borrower who understands this framework can prepare himself well: maintain a clean credit record, keep honest accounts and tax returns, invest his own share, offer clear security and choose the right loan for the right purpose — and such a borrower will seldom be refused by any bank.

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Question 4: Role and Functions of the State Bank of Pakistan (20 Marks)

Briefly discuss the role and functions of the State Bank of Pakistan.

Introduction

Every modern country has a central bank standing at the head of its monetary and banking system, and in Pakistan that institution is the State Bank of Pakistan (SBP). Established on 1 July 1948 under the State Bank of Pakistan Order, 1948 — Quaid-e-Azam Muhammad Ali Jinnah personally inaugurated it and described its establishment as one of the great achievements of the new state — the Bank today works under the State Bank of Pakistan Act, 1956 as amended, most importantly by the Amendment Act of 2022, which strengthened its autonomy and clarified its objectives, price stability as the primary objective, supported by financial stability and support for the government's economic policies. This answer discusses the role and functions of the State Bank in Pakistan's economy.

The Overall Role of the State Bank

The State Bank is not an ordinary bank: it does not compete with commercial banks, does not seek profit, and does not accept deposits from ordinary citizens for profit. Its role is that of the guardian of the monetary system — the sole issuer of currency, the controller of money and credit, the supervisor of banks, the banker of the government, and the custodian of the country's foreign exchange reserves. Every rupee note in circulation bears the promise and signature of its Governor, and every commercial bank in the country operates within rules it sets. In a developing economy, its role extends further: it has historically promoted new

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institutions and markets — for agriculture credit, microfinance, Islamic banking, housing finance and digital payments — which commercial banks would not have created on their own.

Functions of the State Bank of Pakistan

1. Sole Issuer of Currency

The State Bank has the monopoly of issuing currency notes in Pakistan (one-rupee and higher coins and notes are issued by the federal government, while all banknotes come from the SBP). It maintains an Issue Department, keeps statutory reserves against note issue, arranges printing through the Pakistan Security Printing Corporation, distributes currency through its offices and currency chests, and withdraws soiled and counterfeit notes. A clean, trusted and adequate currency supply is the most visible of its functions.

2. Controller of Money Supply and Credit (Monetary Policy)

The Bank formulates and implements monetary policy to keep inflation under control while supporting growth. Its instruments include the policy rate (the interest rate at which it lends to banks, which anchors all other interest rates), open market operations (buying and selling government securities to add or absorb liquidity), the cash reserve requirement and statutory liquidity requirement imposed on banks, and moral suasion. Its Monetary Policy Committee announces decisions regularly, and the Bank publishes monetary and inflation data and forecasts to guide public expectations.

3. Banker to the Government

The State Bank maintains the accounts of the federal and provincial governments, receives their revenues, makes their payments, manages public debt — conducting auctions of treasury bills, Pakistan Investment Bonds and Sukuk — and advises the government on financial and

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economic matters. It acts as the government's agent in dealings with the IMF and other international institutions, although the law now restricts direct government borrowing from the central bank to prevent inflationary money creation.

4. Bankers' Bank and Lender of Last Resort

All scheduled banks keep their reserve accounts with the State Bank, settle interbank payments through it, and look to it in liquidity emergencies. As lender of last resort, the SBP provides short-term accommodation to solvent banks facing temporary shortages, preventing panic and bank runs. It operates the country's core payment infrastructure, including the Pakistan Real-Time Inter-Bank Settlement Mechanism (PRISM) for large-value transfers and oversight of retail systems such as Raast, its instant payment system.

5. Regulation and Supervision of Banks and Financial Institutions

The Bank licenses banks, microfinance banks and exchange companies, issues prudential regulations governing capital adequacy (under Basel standards), exposure limits, loan classification and provisioning, anti-money-laundering controls, and consumer protection, and inspects institutions on-site and off-site to enforce them. It can issue directives, impose penalties, remove unfit directors, and, in extreme cases, restructure or wind up a failing institution. Through the Deposit Protection Corporation, a subsidiary, it also protects small depositors up to a prescribed limit if a bank fails.

6. Custodian and Manager of Foreign Exchange Reserves

The State Bank holds and manages Pakistan's foreign exchange reserves, implements the foreign exchange regime under the Foreign Exchange Regulation Act, 1947, sets the framework within which the rupee's market-based exchange rate operates, regulates authorised dealers

(banks) and exchange companies, oversees export and import payments and workers' remittances, and manages external debt payments. Adequate reserves and a stable external position are central to a stable rupee and low imported inflation.

7. Developmental and Promotional Role

Uniquely important in a developing country, the SBP promotes financial development and inclusion: it created refinance schemes for exports, renewable energy, agriculture and SMEs at concessional rates; it founded and nurtured specialised institutions; it drives Islamic banking through its Shariah framework and a roadmap toward a fully interest-free system; it leads the National Financial Inclusion Strategy, promotes digital banking, branchless banking (Easypaisa, JazzCash agents) and the Banking on Equality policy for women; and it licenses digital banks to widen access.

8. Research, Data and Advisory Functions

The Bank collects and publishes statistics on money, banking, prices, balance of payments and the economy, issues annual and quarterly reports and reviews, and conducts economic research. Its data are the primary source for the government, researchers and international agencies studying Pakistan's economy.

Table 1: Functions of the State Bank of Pakistan — a summary

Function	What It Involves
Currency issue	Monopoly of note issue; distribution and withdrawal of currency
Monetary policy	Policy rate, open market operations, reserve requirements
Banker to government	Government accounts, payments, public debt auctions
Bankers' bank	Reserve accounts, clearing, lender of last resort,

	PRISM/Raast oversight
Supervision	Licensing, prudential regulations, inspection, deposit protection
Exchange management	Reserves, exchange-rate framework, regulation of dealers
Development	Refinance schemes, Islamic banking, financial inclusion, digital banking

Conclusion

In conclusion, the State Bank of Pakistan is the pivot of the country's entire financial system. As currency issuer it provides trusted money; as monetary authority it protects the value of that money against inflation; as supervisor it keeps banks safe and honest; as banker to the government and custodian of reserves it safeguards the state's finances at home and abroad; and as a development institution it continually widens the reach of banking to farmers, small businesses, women and the unbanked. The 2022 strengthening of its legal autonomy recognises a simple truth proven worldwide: an independent, competent central bank is the first line of defence of the value of money and of the savings of every citizen.

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Question 5: Notes on Islamic Banking, Digital Banking, Microfinance Banks and ATM (20 Marks)

Write a note on the following: (i) Islamic banking (ii) Digital banking (iii) Microfinance banks (iv) ATM

Introduction

Pakistan's banking system is changing rapidly in four directions at once: it is becoming more Islamic, more digital, more inclusive of the poor, and more self-service. The four topics of this note capture these changes. Islamic banking is replacing interest with Shariah-compliant trade and partnership; digital banking is moving the branch into the customer's mobile phone; microfinance banks are taking formal banking to low-income households that commercial banks ignored; and the ATM — the automated teller machine — was the first step of this self-service revolution and remains its most visible symbol. Each is explained in turn below.

Part (i): Islamic Banking

Islamic banking is banking conducted in accordance with the principles of Shariah (Islamic law), as interpreted by qualified Shariah scholars. Its defining feature is the complete prohibition of riba (interest): money cannot be lent merely for a predetermined increase, because in Islam money is a medium of exchange, not a commodity, and profit must be earned through trade, services, leasing or genuine partnership in which risk is shared. Other prohibitions shape its operations as well: avoidance of gharar (excessive uncertainty) and maysir (gambling or speculation), and refusal to finance prohibited businesses such as alcohol, gambling and pork.

In practice, Islamic banks use a set of approved contracts. Murabaha is cost-plus sale financing: the bank buys an asset the client needs and sells it to him at a disclosed profit, payable in

instalments — the most widely used mode for trade and consumer finance. Ijara is leasing: the bank owns an asset (car, machinery) and rents it to the client, transferring ownership at the end under Ijara-wa-Iqtina arrangements. Musharakah is joint partnership in which bank and client contribute capital and share profit and loss; its diminishing form (Diminishing Musharakah) is the main mode of Islamic house and car finance, the client gradually buying the bank's share. Mudarabah is a partnership where one party provides capital and the other provides skill and management — it is also the basis on which Islamic banks accept investment deposits, sharing actual profit with depositors instead of paying fixed interest. Salam and Istisna finance agriculture and manufacturing by advance payment for future delivery, and Sukuk are asset-backed certificates through which governments and companies raise funds.

In Pakistan, Islamic banking was revived on a permanent footing when the State Bank licensed Meezan Bank in 2002, and it has grown to about one-fifth of the banking industry's assets and deposits, through full-fledged Islamic banks, Islamic subsidiaries and Islamic branches/windows of conventional banks. The Federal Shariat Court's 2022 judgment directed the elimination of riba from the economy by 2027, and the State Bank's strategic plan targets a much larger Islamic share, so this segment is expected to become the mainstream of Pakistani banking in the coming years. Its challenges include a shortage of trained Shariah-compliant bankers, limited Shariah-compliant investment avenues for liquidity, and public questions about whether some products differ from conventional banking in substance or only in form — questions its scholars and regulators continue to address.

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Part (ii): Digital Banking

Digital banking means the delivery of banking services through electronic channels — internet banking websites, mobile banking apps, and digital wallets — without the customer visiting a physical branch. Through a bank's app a customer can check balances and statements, transfer funds instantly within and between banks, pay utility bills, taxes and school fees, top up mobile credit, open accounts digitally (including the Roshan Digital Account for overseas Pakistanis and Asaan Mobile Accounts for the unbanked), apply for cards and loans, and invest. The State Bank's Raast system, launched in 2021, provides free, instant, round-the-clock person-to-person transfers using a mobile number as an identifier, while branchless banking agents (Easypaisa and JazzCash shops) act as human ATMs-cum-branches in every neighbourhood.

The advantages are speed, convenience (24/7 service from anywhere), low cost for both bank and customer, automatic records that support transparency and tax documentation, and financial inclusion of remote and low-income users who could never be served profitably by brick-and-mortar branches. In Pakistan the State Bank has issued digital bank licences to new entrants (such as Easypaisa Bank, Mashreq's digital operations and others) under its Licensing and Regulatory Framework for Digital Banks, 2022, aiming at fully branchless banks. The risks are equally real: cyber fraud, phishing, data privacy breaches and system outages; hence the State Bank requires strong customer authentication, transaction alerts and fraud controls, and customers must guard their PINs and one-time passwords. Digital banking is not merely a new channel — it is steadily becoming the primary way Pakistanis bank, with branch visits reserved for complex matters.

Part (iii): Microfinance Banks

Microfinance banks are specialised, licensed banks that provide very small financial services — micro-loans, small deposits, remittances and micro-insurance — to low-income people who are excluded from commercial banking because they lack collateral, salary slips, documented income or credit history. The model descends from the Grameen experiment of Professor Muhammad Yunus in Bangladesh, which proved that the poor are bankable: tiny loans for seeds, livestock, sewing machines, rickshaws and small shops, often given to groups (especially women's groups) whose mutual guarantee substitutes for physical collateral, are repaid with very high recovery rates because the loans finance real survival-level livelihoods.

In Pakistan, microfinance banks are licensed and regulated by the State Bank under the Microfinance Institutions Ordinance, 2001. Leading institutions include Khushhali Microfinance Bank (the first, established in 2000), Telenor Microfinance Bank (operator of Easypaisa), Mobilink Microfinance Bank (JazzCash), U Microfinance Bank, FINCA Microfinance Bank and First MicroFinance Bank (linked to the Aga Khan network). Maximum loan sizes are prescribed by regulation and have been raised over time to a few hundred thousand rupees (and more for micro-enterprise and housing loans), deposits are accepted and protected like other banks' deposits, and the institutions report borrowers to the microfinance credit information bureau, helping clients build a formal credit history and graduate to commercial banking. Their role in poverty reduction, women's economic empowerment, rural finance and disaster recovery (for example, loan restructuring after floods) is widely recognised. Their difficulties — high operating costs of tiny loans, pressure to charge high mark-ups to cover those costs, over-

indebtedness of some clients borrowing from several lenders, and exposure to floods and crop failures — are managed through regulation, credit bureaus and client-protection rules.

Part (iv): ATM (Automated Teller Machine)

An Automated Teller Machine is a self-service electronic machine that performs the routine work of a bank teller without human staff: dispensing cash, accepting deposits (in cash-deposit machines), showing balances and mini-statements, transferring funds, paying bills and changing PINs. A customer uses a plastic debit (ATM) card together with a secret Personal Identification Number (PIN); the machine reads the card, verifies the PIN and connects online to the bank's central computer, which checks the account and authorises the transaction in seconds. In Pakistan, machines of different banks are interconnected through the 1LINK switch (with PayPak as the domestic card scheme), so a customer of one bank can withdraw from another bank's ATM for a small fee disclosed on screen, and ATMs operate twenty-four hours a day, including in bank lobbies, markets, airports and petrol pumps.

The ATM transformed banking habits: it ended the need to visit a branch during limited hours for the commonest transaction — cash withdrawal — and it made the salary account and debit card universal. Banks benefit because machines handle millions of routine transactions at a fraction of the cost of teller staff. Alongside the benefits stand safety rules every user must observe: never share the PIN, shield the keypad while entering it, beware of skimming devices fitted over card slots and of strangers offering “help”, count cash and take the receipt, and report a retained or misused card immediately to the bank's helpline. The ATM was the first generation of self-service banking; mobile and digital banking are its successors, but in a still

cash-intensive economy like Pakistan's, the ATM remains an essential bridge between digital accounts and physical cash.

Conclusion

To conclude, these four developments describe one story from four angles: Pakistani banking is being reshaped to serve more people, in more acceptable ways, at lower cost. Islamic banking supplies the ethical and legal form — finance without riba, based on trade, leasing and partnership — and is growing toward becoming the system-wide standard. Digital banking supplies the channel — instant, branchless service through phones and the Raast system. Microfinance banks supply the outreach — small, collateral-free formal finance for the poor, especially women and rural households. And the ATM supplies the everyday self-service habit that started it all, linking digital accounts to physical cash around the clock. A student of money and banking in Pakistan must understand all four, because together they are the present and the future of the industry.

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