

4.4 Performance and Risk Analysis of Exchange Companies

Established under the Foreign Exchange Regulation Act, 1947, Exchange Companies (ECs) have been actively playing their role in facilitating the foreign exchange transactions. ECs have been growing steadily with expanding network, improving profits and sufficient capital. The sector poses limited systemic risk due to its small size, low leverage, minimum degree of inter-connectedness and relatively competitive structure; however, ECs do have reputational linkages with the banking sector. While SBP's guidelines comprehensively address the rising challenges of money laundering and financing of terrorism, ECs have the responsibility to manage such risks proactively. Going forward, Pakistani diaspora and expected growth in tourism present both opportunities and risks to the ECs.

Foreign Exchange Policy and its operations in Pakistan are formulated and regulated in accordance with the provisions of the Foreign Exchange Regulation Act, 1947 (Act). The objective of this Act is to regulate, in the economic and financial interest of Pakistan, certain payments, dealings in foreign exchange, securities, import/export of currency and bullion. Under section 3AA of the Act, SBP can authorize any company to deal in foreign currency notes, coins, postal notes, money orders, bank drafts, traveler's cheques and transfers²²³.

As of financial year ended June 30, 2017²²⁴, a total of 52 exchange companies (ECs) are functional which include 27 full-fledged ECs (ECAs) and 25 'B' category ECs (ECBs); however, no new ECB can be established now as it was one time opportunity provided to accommodate Authorized Money Changers with limited resources²²⁵. ECs are allowed to operate through branches, third party franchise agreements²²⁶, payment booths, company owned currency exchange booths and temporary currency exchange booths.

The scope of business of ECAs include buying and selling of foreign currencies, inward home remittances, outward remittances, export of foreign

currencies other than US dollars, branchless banking as agents of authorized financial institutions, collection of utility bills and installation of banks' ATMs at their branches. ECs are prohibited to engage in any other activity such as deposit taking, lending etc. Moreover, the scope of ECBs is restricted to buying and selling of foreign currencies and branchless banking as agents of authorized financial institutions.

ECs are playing a pivotal role in the management of foreign exchange in the country

The main purpose of establishing ECs is to facilitate the FX needs of individuals. Moreover, since their income is taxable, ECs help in increasing the tax revenue to some extent. The role of ECs has become even more significant in recent times due to increasing importance of combating money laundering and financing of terrorism. Since ECs are legally incorporated companies, they are well equipped to manage these challenges through due diligence of customers, documentation, corporate governance, systems and controls, computerization/automation, and human resources development.

²²³ ECs Manual 2017, Chapter 2, Section 1:

<http://www.sbp.org.pk/cpd/ec/2017/EC-Manual.pdf>

²²⁴ Financial year of ECs is from 1st July to 30th June: Chapter 3, Section 13(i) of ECs Manual, 2017.

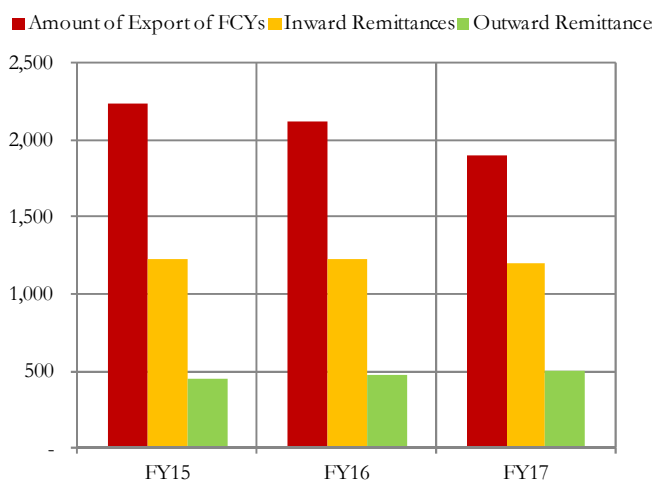
²²⁵ Chapter 8 of ECs Manual 2017.

²²⁶ Only existing Franchise arrangements between Franchiser (ECs) and their Franchises. ECs are not allowed to enter into new 3rd party franchise arrangements as per Chapter 4, Section 2(ii)a of ECs Manual 2017.

Figure 4.4.1

Export of FCYs has declined while remittances have been steady

Amount of Export of FCYs, Inward and Outward Remittances by ECs (US\$ million)



Source: SBP

Export of FCYs by ECs has been declining over the last three years...

The demand for US Dollar in foreign exchange market is more than any other foreign currency, while supply of other foreign currencies is more than their demand. Therefore, ECAs are permitted by SBP to export the foreign currencies, other than US Dollars, which these companies purchase from customers but are unable to sell over the counter due to lower demand. ECAs are required to bring in equivalent US Dollars against the amount of foreign currencies exported by them, either through import of currency notes or credit in foreign currency accounts of ECAs maintained with the banks in Pakistan²²⁷.

Over the last three years, the amount of export of FCYs by ECs has been consistently declining, which can be attributed to (a) increased demand for Saudi Riyal due to rise in number of Hajj/Umrah pilgrims, and probably (b) decline in supply of cash FCY as

emigrant workers, particularly in Saudi Arabia, are avoiding visits to Pakistan due to job concerns.

(Figure 4.4.1).

...while both inward and outward remittances have stayed steady amidst measures taken by SBP to limit the associated risks

Home remittance is a very important source of foreign exchange flows in the country. At present, most of the ECAs have agency arrangements mainly with three Money Transfer Operators (MTOs) i.e. Western Union, Ria Financial Services and Money Gram. Inward remittances through ECs during the last three years have hovered around US\$ 1,200 million though there have been slight decline. On the other hand, outward remittances have somewhat risen over the same period; but, these are only 41.3 percent of the inward remittances during FY17.

ECs Manual 2017 of SBP entails a number of measures to regulate the risks arising from remittance transactions. These measures include limit on outward remittances to 75 percent of the inward remittances mobilized during the preceding month²²⁸, documentation, Know Your Customer (KYC), and Customer Due Diligence (CDD) requirements for all outward remittances regardless of the amount²²⁹, requirement of Crossed Cheque/Demand Draft/Pay Order for all outward remittances of USD 35,000/- or above²³⁰, and requirement of SBP's approval for all outward remittances of USD 50,000/- or above²³¹. Moreover, all inward and outward transactions of ECAs shall be routed through foreign currency accounts of the ECAs maintained with banks in Pakistan²³².

Sale and purchase activities of ECs have been growing...

²²⁷ ECs Manual 2017, Chapter 3, Section 9(iv)

²²⁸ ECs Manual 2017, Chapter 3, Section 9(iii)d

²²⁹ ECs Manual 2017, Chapter 6, Sections 2, 3 & 4.

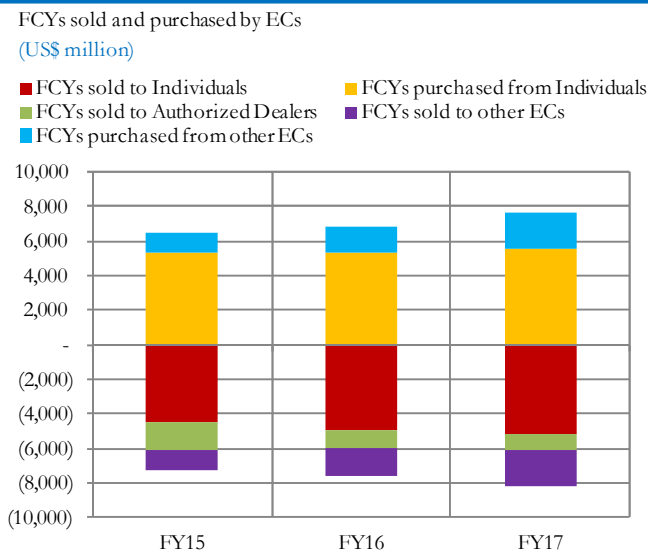
²³⁰ ECs Manual 2017, Chapter 3, Section 9(iii)h

²³¹ ECs Manual 2017, Chapter 3, Section 9(iii)i

²³² ECs Manual 2017, Chapter 3, Sections 9(ii)b & 9(iii)f

FCYs sold by ECs to individuals have been lower than the FCYs purchased from them in recent times. However, their amount has been growing as the ratio of FCYs sold to FCYs purchased moved up to 92.54 percent in FY17 from 84.65 percent in FY15. Moreover, FCYs sold by ECs to Authorized Dealers (Banks) have come down to US\$ 972 million in FY17 from US\$ 1,566 million in FY15 (Figure 4.4.2).

Figure 4.4.2
Sale and purchase activities of ECs have been growing



Source: SBP

Overall, FCYs sold by ECs has remained higher than FCYs purchased by them over the last three years. During FY17, 73.55 percent of total FCYs purchased by ECs have been from Individuals, while the remaining have been purchased from other ECs. Similarly, 62.77 percent of total FCYs sold have been to Individuals, 25.40 percent have been to other ECs, while the remaining 11.83 percent have been sold to Authorized Dealers during FY17.

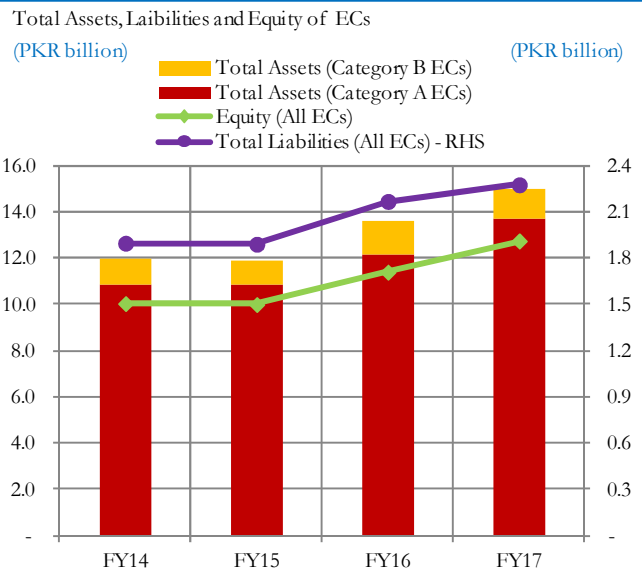
²³³ ECs Manual 2017, Chapter 6, Section 2

²³⁴ ECs Manual 2017, Chapter 3, Section 9(i)g

...while SBP's regulations are in place to manage the related risks

In order to minimize risks in sale and purchase activities of ECs, SBP has in place certain regulations. Some of these include documentation requirement for all foreign currency transactions regardless of the amount²³³, requirement of Crossed Cheque/Demand Draft/Pay Order for all sale transactions of USD 35,000/- or above²³⁴, and requirement of SBP's approval for all transactions of sale of foreign currencies to the individual customer of USD 50,000/- or above²³⁵.

Figure 4.4.3
Exchange Companies have been growing steadily



Source: SBP

ECs have been growing steadily...

Due to the transactional nature of activities of ECs, asset size may not be a good indicator of the extent of business development of ECs. Nevertheless, consistent growth in assets, observed during the last four years, does indicate stable performance of the ECs (Figure 4.4.3). Due to limited operations, only a small portion of assets of the ECs belongs to

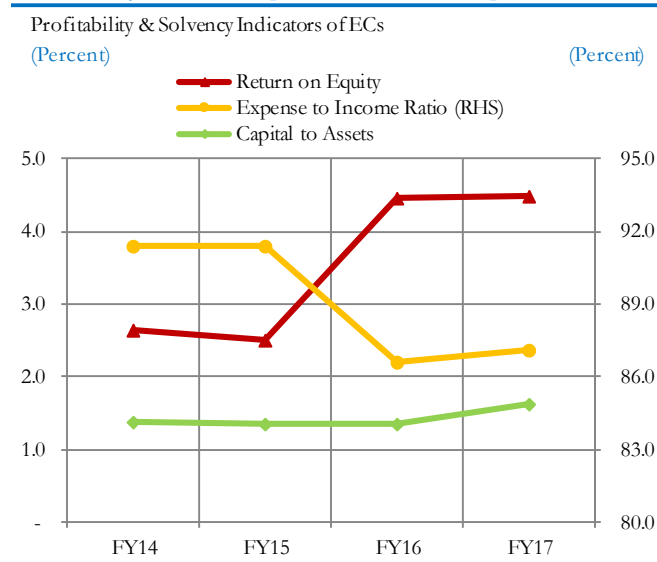
²³⁵ ECs Manual 2017, Chapter 3, Section 9(i)h

ECBs (8.8 percent). Majority of the asset base of ECs is funded by the equity; however, liabilities of ECs have grown significantly in the last couple of years, which mainly represents the advance amount received by the ECs from the Global Money Transfer Operators as per their contractual arrangements.

...with improving profits...

Profitability of ECs has improved in recent years as total income has grown by 21.48 percent on average since FY15. Consequently, ROE has also risen from 2.50 percent in FY15 to 4.45 percent in FY17. However, ‘expenses to income ratio’ of ECs have been on the higher side despite some drop in the last couple of years (**Figure 4.4.4**).

Figure 4.4.4
Profitability of ECs has improved with sufficient capital



Source: SBP

In order to safeguard the interest of customers and to keep the spreads competitive, ECs are required that the spread between buying/selling rates of US Dollar, Pound Sterling, Euro, Saudi Riyal and UAE

Dirham shall not exceed one percent of their buying rate²³⁶. Moreover, for all other foreign currencies, ECs shall ensure maintaining a competitive spread.

...and sufficient capital

Minimum authorized and paid-up capital of ECAs and ECBs are set at PKR 200 million²³⁷ and PKR 25 million²³⁸, respectively. The number of ECs non-compliant with the minimum capital requirement has considerably come down in recent years.

SBP is actively coordinating with these non-compliant ECs in order to bring their capital up to the requirement. Nevertheless, overall solvency position of the ECs has been more than adequate since CY14 as indicated by improving capital to assets ratio, which stands at 84.85 percent at the end of FY17. Moreover, ECs are required to limit their exposure at the close of business each day at a level not higher than 50 percent of their capital base; where exposure is the higher of the overbought or oversold positions at the close of day²³⁹. With regard to liquidity management, ECAs are required to maintain 25 percent of their capital (10 percent for ECBs) as Statutory Liquidity Reserve (SLR) with SBP in the form of unencumbered approved government securities²⁴⁰.

ECs pose limited systemic risk

Systemic importance of ECs is much lower than other financial institutions due to their small size, low leverage, limited inter-connectedness and relatively competitive structure. Share of ECs in total assets of the financial sector stands at 0.06 percent as of end FY17. Moreover, inter-linkages between ECs and commercial banks are limited to the amount of FCY sold to them by ECs which is rather low (11.83 percent of the total FCY sold in

²³⁶ ECs Manual 2017, Chapter 3, Section 11

²³⁷ ECs Manual 2017, Chapter 3, Section 2

²³⁸ ECs Manual 2017, Chapter 8, Section 3

²³⁹ ECs Manual 2017, Chapter 3, Section 10.

²⁴⁰ ECs Manual 2017, Chapter 3, Section 3 & Chapter 8, Section 4.

FY17) and FX accounts maintained with them for remittances (**Figure 4.4.4**). Further, share of the largest EC in total assets of the ECs sector stands at 9.81 percent as of end FY17.

From the group-level perspective, it is important to mention that a few ECs are direct subsidiaries of banks. This poses reputational risk to the bank in case the respective EC gets in any kind of trouble. Hence, both banks and ECs need to manage the risks faced by ECs on a group-wide basis.

SBP's ECs Manual addresses the rising challenges of money laundering and financing of terrorism

Money laundering and financing of terrorism are some of the major challenges faced by the ECs. Since the inception of ECs, SBP has been issuing various instructions followed up with individual interactions during its monitoring and enforcement activities. The ECs Manual enlists a comprehensive set of guidelines on Anti Money Laundering (AML) and Combating Financing of Terrorism (CFT) for ECs to follow. Some of the important areas covered by these guidelines include customer due diligence and verification, documentation of transactions, record keeping, reporting of suspicious transactions, training of the company's human resource, and compliance of legal and regulatory framework. Further, through its on-site inspections and off-site surveillance, SBP has been ensuring that these guidelines are being followed by ECs in true spirit.

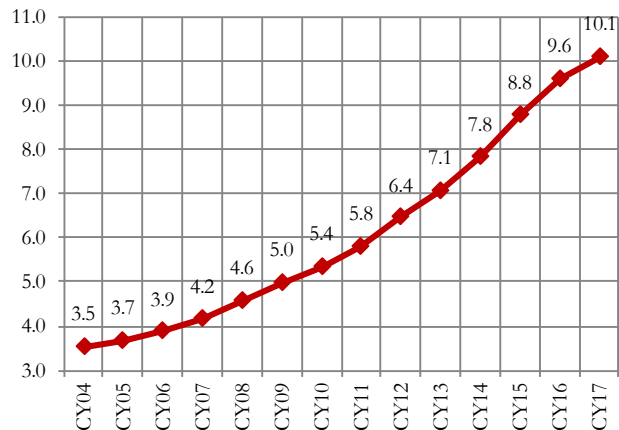
ECs need further work in the areas of operational risk

Due to its small size and transactional nature of activities, footprint of any EC is relatively small both in terms of physical and human resource. With limited resources, it is not surprising that core business applications used by ECs are not as sophisticated as other market players (banks, for instance). Nevertheless, with continuous advancement in information technology, more and

more simple and cheap software solutions are arriving in the market every day. Hence, in the near future, ECs are expected to utilize these advancements to their benefit, which will improve certain areas of operational risk including frauds and accuracy of records.

Figure 4.4.5
Pakistani diaspora is increasing every year

Number of Overseas Pakistani Workers*
(Number in million)



* Registered for overseas employment through Bureau Of Emigration & Overseas Employment
Source: <http://www.beoe.gov.pk/files/statistics/2017/country.pdf>

Pakistani diaspora presents both opportunities and risks...

Inward remittances are directly linked to the Pakistani diaspora dispersed across different regions of the World. Indications are that the growth of this diaspora may have slowed down in the last couple of years. The number of overseas Pakistani workers registered for overseas employment through Bureau of Emigration & Overseas Employment stands at 10.1 million as of end CY17 (**Figure 4.4.5**).

However, this number is not a true representative of the diaspora since the number of returned emigrant workers is not available. Moreover, there is slight decline in home remittances in recent years as well.

Nevertheless, ECs need to devise better plans to cater to the needs of existing diaspora so that the use of informal channels can be curtailed.

...so does the prospective growth in tourism

With the improvement in law and order situation in the country in recent times, annual tourist arrivals to Pakistan have more than tripled since CY13 to 1.75 million in CY16, while resident travelers returning to the country have increased by 30 percent to 38.3 million²⁴¹. Moreover, Pakistan has been ranked the world's top travel destination for 2018 by the British Backpacker Society²⁴². Hence, tourism is expected to pick up in the future, leading to increase in sale and purchase activities of ECs. This will also mean that ECs will end up having more foreign currencies with them thus resulting in rise in export of those currencies. ECs need to further invest in their core business applications in order to effectively utilize these opportunities in the future. Moreover, they also need to strengthen their 'know your customer' (KYC) processes by further improving their transaction monitoring mechanism to avoid dealing with proscribed persons/entities.

ECAs should look to further their role in mobilization of home remittances

ECAs are well placed to mobilize remittances as unlike banks, their branches remain open till late evening and their services are available on Saturdays. ECAs may focus on offering better services and undertake aggressive marketing campaign to increase their client base. This has great significance not only from the perspective of the ECAs, due to an important revenue stream, but it will also help to support supply side resulting in stabilized exchange rate.

²⁴¹ Pakistan Tourism Development Corporation via Bloomberg: <https://www.bloomberg.com/news/articles/2017-09-27/as-terror-attacks-recede-tourism-in-pakistan-starts-to-thrive>

²⁴² <http://gulfnews.com/news/asia/pakistan/pakistan-tops-list-of-world-s-best-travel-destination-for-2018-1.2148655>