

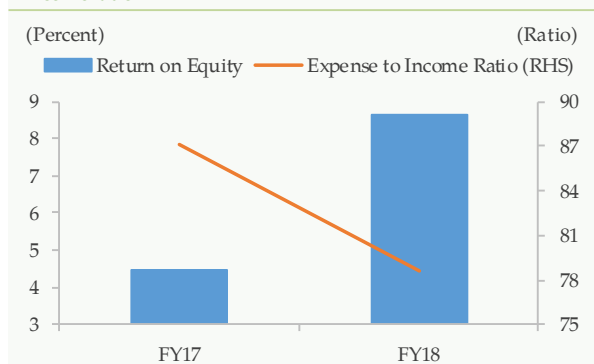
4.4 Performance and Risk Analysis of Exchange Companies

The performance of the Exchange Companies (ECs)—on the back of healthy expansion in asset and improved income—has remained encouraging during FY18. The growing demand for US dollars and rising kerb premium has resulted in an uptrend in foreign currencies exports. The role of ECs remains limited in facilitating inward remittances. SBP is strengthening the AML/CFT regime of Exchange Companies to mitigate the associated risks. Besides, major challenges faced by ECs relate to operational constraints emanating from uninsured cash and limited adoption of technology-based business applications. However, owing to their small size and limited interconnectedness with the banking sector, the ECs do not represent a possible source of systemic risk, though reputational risk remains.

There is synchronized upturn in assets and income during FY18...

The asset base of the Exchange Companies (ECs) has risen by 17.56 percent during FY18—up from 10.70 percent in FY17, primarily on account of rising fixed assets (branch expansion) and appreciation of USD, supported by 7.73 percent increase in paid-up capital.²⁰⁵ In addition, the Return on Equity (RoE) has almost doubled to 8.65 percent during FY18 from 4.48 percent a year earlier.²⁰⁶ Resultantly, the expenses to income ratio has declined, indicating improved operational viability (**Chart 4.4.1**).

Chart 4.4.1: RoE has risen with notable decline in expense to income ratio



Source: SBP

²⁰⁵ The ECs assets comprise of Cash, fixed assets and intangible assets. The balance sheet data is available up to June 2018 (FY18).

²⁰⁶ Total income has risen by 38.55 percent in FY18 against 17.89 percent in FY17.

²⁰⁷ Exchange Companies (only A category) are permitted to export foreign currencies—except for the US dollar—that are

Income of ECs rises as dealings in FCY surges...

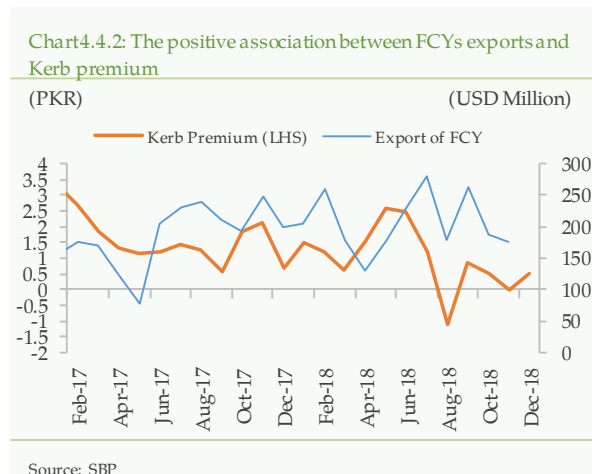
Selling foreign currencies (FCY)—that are in high demand—in the domestic market is a major source of income for ECs. Since US dollar commands highest demand in the domestic market, ECs profit through its sale-purchase transactions. They also benefit from export of FCYs that have low domestic demand.²⁰⁷

In FY18, ECs have exported USD 2,479.0 million worth of foreign currencies—up from USD 1,897.0 million in FY17. They have exported another USD 1,316 million worth of FCYs during H2CY18. These exports increase the supply of US dollar with the ECs, allowing them to do more sale-purchase transactions.

The rising external account vulnerabilities—in the backdrop of falling SBP forex reserves—have led to an increased volatility in the open market exchange rate and higher kerb premium (the difference between open market and inter-bank exchange rates). Rising kerb premium seems to be one of the reasons behind increased purchases from individuals

domestically not in demand and bring in equivalent US dollar in form of cash and through their FCAs maintained with banks in Pakistan. However, ECs are directed to sale at least 10 percent of the proceeds from export of FCYs in interbank market on an ongoing basis.

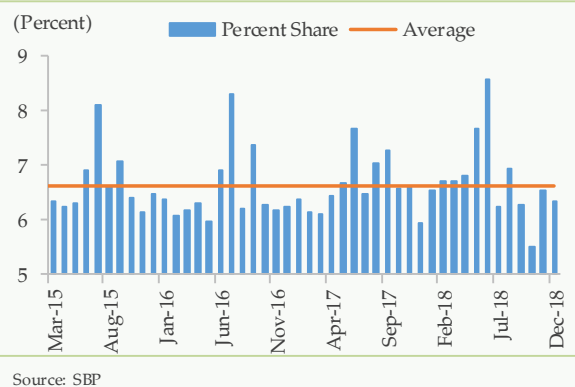
of foreign currencies other than US dollars²⁰⁸, which, in turn, have pushed up their exports. (Chart 4.4.2)



The inward remittances rise while the outward remittances contract...

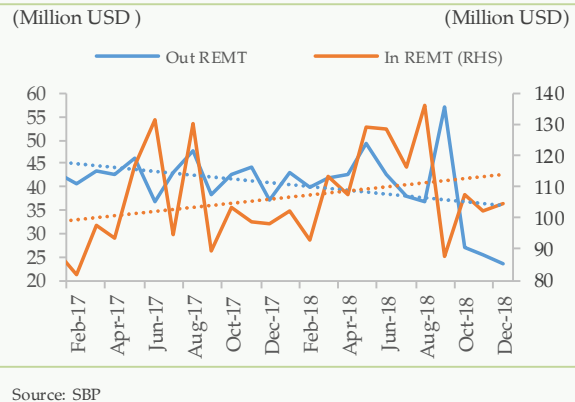
In CY18, inward remittances received through ECs have accelerated by 8.35 percent (USD 1,328 million)—up from 1.50 percent (USD 1,225 million) in the previous year. Moreover, in CY18, the inward remittances through ECs has accounted for 6.98 percent (on average) of the total inward remittances—slightly up from 6.73 percent in CY17. The ECs have channeled 7 percent of the total inward remittances in the last 4 years (Chart 4.4.3). Increased remittances inflow is due to additional bilateral arrangements of ECs with overseas tie-ups. Positively, it might have helped ease some dollar liquidity pressures witnessed during the reviewed year.

Chart 4.4.3: Stagnant share of inward remittances (through ECs) in total remittances



On the contrary, outward remittances show contraction of 7.74 percent in CY18 against growth of 2.53 percent in CY17. It seems that PKR depreciation has dampened the outflow of foreign currencies and served to provide some relief to the forex market. Moreover, the trends of inward and outward remittances have been diverging (Chart 4.4.4).

Chart 4.4.4: Diverging trends of inward and outward remittances



SBP's regulatory regime relating to ECs addresses the risks of money laundering and financing of terrorism ...

SBP, in order to mitigate the ML/FT risk, has put in place a comprehensive regulatory and supervisory

²⁰⁸ Rising kerb premium incentivizes non-resident Pakistanis to bring home foreign currencies and convert them into PKR at a better exchange rate.

framework, which is collected in the form of an ECs Manual.²⁰⁹

SBP has introduced various new measures during CY18. To enhance the documentation of transactions, exchange companies have been directed to retain copies of identification documents for all foreign currency transactions equivalent to USD 500/- or above.²¹⁰ In order to further strengthen the regulatory AML/CFT requirements, exchange companies have been required to record the inland movement of foreign currencies within their authorized branch network.²¹¹

Also, instructions have been issued under UNSC resolutions and Anti-Terrorism Act, 1997 to ensure proper screening of proscribed entities and individuals.²¹² Moreover, regular on-site inspections are also conducted by SBP to warrant its enforcement.

Uninsured cash and limited adoption of tech-based business applications may raise operational risk...

Cash constitutes a sizeable portion of exchange companies' assets. Being a risky asset, prone to theft or destruction, uninsured cash poses a key operational risk. Owing to their small size and inherently high risk of dealing in cash, the cost of insurance becomes unfeasible leaving them vulnerable to asset losses.

With a view to improving the operational risk management, the mechanism for monitoring through Close Circuit Television (CCTV) cameras installed at company outlets has been standardized by SBP. Resultantly, the improved surveillance will not only

minimize the operational risk but will also strengthen supervisory oversight of SBP.²¹³

Furthermore, the level of adoption and sophistication of technology-based solutions remains low, due to inadequate investment in related technology infrastructure and human resources.

...however, systemic risk remains contained...

In aggregate, the exchange companies sector is characterized by small balance sheet size and limited inter-connectedness with the banking sector. The overall share of ECs in the total assets of the financial sector stands at 0.06 percent as of end June-2018. Similarly, only two ECs are operated by banks as their subsidiaries, which manifests limited exposure of the banking sector, though reputational risk remains. All-in-all, the risk from ECs may not be systemic in nature.

Minimizing operational risk and improving governance are key priority areas for ECs...

Going forward, the focus of the exchange companies must be on limiting operational risk. Improvement in operations will not only expand their customer base but will also aid in achieving a stabilized exchange rate, through efficient management of supply of foreign exchange. Moreover, employment of technology-based governance applications will also support them in mitigating the risk of non-compliance with relevant regulations and laws.

²⁰⁹ ECs Manual 2018 lays out a robust set of guidelines covering areas such as documentation of transactions, Know Your Customer/ Customer Due Diligence (KYC/CDD) measures, identification of beneficial ownership, reporting of suspicious transactions/currency transaction reports, record-keeping and capacity building of human resource etc.

²¹⁰ EPD Circular Letter No. 08 of 2018;

<http://www.sbp.org.pk/epd/2018/FECL8.htm>

²¹¹ FE Circular No. 05 of 2018;

<http://www.sbp.org.pk/epd/2018/FEC5.htm>

²¹² FE Circular No. 09 of 2018;

<http://www.sbp.org.pk/epd/2018/FEC9.htm>

²¹³ FE Circular No. 15 of 2018;

<http://www.sbp.org.pk/epd/2018/FEC15.htm>