

Box 3: SBP's Initiatives to Strengthen Stability of the Financial Sector

SBP plays a pivotal role in ensuring stability of the financial sector. As such, “Strengthening the Financial Stability Regime”- remains a key priority for the SBP under its strategic plan “SBP Vision 2020”. In this regard, it has been endeavoring to implement a comprehensive Macroprudential Policy Framework (**MPPF**).

The widespread adverse outcomes of the Global Financial Crises (**GFC**) of 2008 necessitated devising and implementing a preventive framework (i.e. a MPPF) capable of responding to any threats to the financial stability. The aim was to increase the resilience of the financial system to withstand systemic risk.⁷³ The MPPF focuses on inhibiting excessive risk taking by financial agents, simplifying obscure and complex financial transactions and their markets, improving bank resolution regimes and bringing Non-Bank Financial Institutions (**NBFIs**) under enhanced scrutiny. In a nutshell, the focus is tilted towards macroprudential policies along with maintaining effective microprudential supervisory regimes for the financial sector.⁷⁴

During the year 2019, SBP – within its regulatory domain – took various measures to ensure smooth functioning of the financial sector.

Financial Stability- A Macro Perspective

As mentioned earlier, to ensure the system wide stability of the financial sector, SBP has been formulating and implementing a comprehensive and well-structured MPPF in Pakistan. Since the

institutional setup with well-defined objectives, legal mandate and accountability mechanism is one of the key pillars of a formal MPPF, SBP is in the final stages of operationalizing the overarching National Financial Stability Council (**NFSC**).⁷⁵

SBP further strengthened its systemic risk assessment capabilities by improving macro stress-testing processes. SBP communicated the risk assessment of the financial system and its interlinkages with the real economy through its flagship Financial Stability Review and other publications.⁷⁶

The financial system has been at a high risk of major operational disruptions due to wide-spread natural disasters and man-made threats. Financial authorities and financial industry participants have a shared interest in promoting the resilience of the financial system to such disruptions. International standard setting bodies encourage banks to have an effective Business Continuity Regime.⁷⁷ Bank for International Settlement (**BIS**) also encourages financial authorities and key financial industry participants to run industry-wide tests to assess the level of resilience across markets and the compatibility of the recovery strategies of individual participants.

Against this backdrop, SBP conducted the first joint industry-wide Business Continuity Planning (**BCP**) drill under a carefully designed scenario.⁷⁸ This was a mock exercise that generated a host of data and information regarding readiness of BCP/Disaster Recovery (**DR**) sites and

⁷³ Generally, it is perceived to be the likelihood of any event, which, if occurs, could cause system-wide disruptions (e.g. large-scale credit squeeze) and could lead to adverse implications for the entire economy (e.g. sharp and prolong fall in real GDP growth, higher unemployment etc.).

⁷⁴ Please see “Elements of Effective Macro Prudential Policies”, BIS, August 2016

⁷⁵ The NFSC will be a joint forum of SBP, Securities & Exchange Commission of Pakistan (SECP) and Ministry of Finance (MoF) to address financial stability related concerns.

⁷⁶ Mid-Year Performance Review of the Banking Sector, Quarterly Compendium: Statistics of the Banking System

⁷⁷ Please see “Guidance on Arrangements to Support Operational Continuity in Resolution”, FSB, August 2016

⁷⁸ The scenario envisaged that the primary site of all banks and SBP become inaccessible at some point in time during the day due to some disaster situation. SBP RTGS system and I-Link secure portal has been accessible from their respective DR sites. The third parties trading platforms whose access is based on subscription have remained operational as usual. The banks however, accessed above systems and platforms from their BCP or DR sites.

effectiveness of BCP and highlighted the overall effectiveness of the communication strategy adopted for performing the drill.⁷⁹

To safeguard small and financially unsophisticated depositors in the unlikely event of a bank failure, the Deposit Protection Corporation (**DPC**) further strengthened its framework. It introduced following measures; (a) advised all member banks to appropriately install or update their systems, including software(s)/ database(s), for maintaining a comprehensive depositor-wise database,^{80,81} and (b) issued standardized reporting formats along with explanatory notes to achieve banking industry-wide standardization of Single Depositor View (**SDV**) report.^{82,83}

Moreover, to keep abreast with the international developments and collaborate with other deposit insurers, DPC acquired the membership of International Association for Deposit Insurers (**IADI**), which is the main global standard-setting body for deposit insurance.⁸⁴

Financial Stability- A Micro Perspective

As per BIS-FSB-IMF (2016), microprudential regulation and supervision complements the macro prudential framework. SBP being progressive regulator of the banking sector continuously work for bringing about refinement in its prudential standards in line with market dynamics and international best practices. The regulatory & supervisory regime is adequately compliant with international best principles & practices (e.g. Basel Core Principles of Effective Banking Supervision, FATF recommendations on

AML/CFT, OECD's principles of Corporate Governance etc.).

During the reviewed year, SBP took multiple initiatives to address risks and challenges facing the financial sector. The key measures included:

Foreign Exchange Policy and Operations: To promote ease of doing business in Pakistan, the registration of foreign borrowings/loans and the acquisition of services from abroad by the residents, have been delegated to Authorized Dealers subject to applicable rules and regulations.⁸⁵ The procedure for repatriation of foreign assets held in the form of shares of a company incorporated in Pakistan, under Assets Declaration (procedure & conditions) Rules, 2019 was issued.⁸⁶

In order to facilitate the manufacturing sector and importers cum exporters, Authorized Dealers were allowed to affect advance payment up to USD 10,000, or equivalent thereof, per invoice on behalf of manufacturing concerns and importers cum exporters for import of for their own use only.⁸⁷ Further to encourage home remittances through formal channels, incentive scheme was re-launched to promote marketing of product and services related to home remittances.⁸⁸ Moreover, to facilitate freelancers and pensioners, SBP enhanced the limits for Business to Customer (**B2C**) and Customer to Business (**C2B**) transactions through home remittance channel.

AML/CFT: To further align AML/CFT Regulations/Guidelines with requirements embodied in Financial Action Task Force (**FATF**) recommendations and observations highlighted in

⁷⁹ The BCP/DR drill was successfully conducted on Saturday December 07, 2019 as per designed scenario, engaging 600 plus staff members from all over Pakistan.

⁸⁰ The database must have the ability to provide Single Depositor View (SDV) i.e. to identify using a unique identifier, on any given date, all the accounts of any single depositor and calculate the total liability of a bank towards that depositor (including any interest/profit accrued on his/ her deposits).

⁸¹ DPC Circular No. 01 dated March 15, 2019

⁸² DPC Circular Letter No. 01 dated December 05, 2019

⁸³ This uniform database across the industry is critically important, and it will facilitate swift payout to protected depositors in case of reimbursement.

⁸⁴ The key objective of the IADI is to contribute to the stability of financial systems by promoting international cooperation in the field of deposit insurance and providing guidance for establishing new, and enhancing existing, deposit insurance systems.

⁸⁵ F.E Circular No. 6 of 2019

⁸⁶ F.E Circular No. 5 of 2019

⁸⁷ Please see EPD Circular Letter No. 1 & 12 of 2019

⁸⁸ EPD Circular Letter No. 15 of 2019

Pakistan's Mutual Evaluation Report 2018, SBP amended various provisions of these instructions. These amendments will provide further clarity on implementation of AML/CFT requirements by banks/ DFIs, including customer due diligence (CDD), correspondent banking, wire transfers/ funds transfers, reporting of Currency Transaction Report (CTR)/Suspicious Transaction Reports (STR) and internal controls, policies, compliance, audit and training areas. Further, SBP updated the guidelines on compliance of Government of Pakistan's notifications issued under United Nations Security Council (UNSC) Resolutions.^{89,90}

To further augment SBP efforts to strengthen overall AML/CFT regime, SBP introduced "Framework for Managing Risks of Trade Based Money Laundering and Terrorist Financing". Pakistan is among leading countries that have issued Trade Based Money Laundering (TBML) and Terrorist Financing". Pakistan is among leading countries that have issued TBML framework since it is an emerging phenomenon and is important from control of FX leakages perspective.⁹¹ SBP also strengthened the AML/CFT for Exchange Companies (ECs) through various measures such as

- AML/CFT instructions for ECs/ECs of 'B' Category were comprehensively revised and aligned with FATF Recommendations.
- Comprehensive Fit & Proper Criteria for Shareholders, Directors, CEO and Key Executives of ECs/ECs of 'B' Category was introduced.
- Guidelines on Risk Based Approach (RBA) for ECs Sector were issued.
- Revised guidelines for ECs Sector on Compliance of Government of Pakistan's

⁸⁹ SBP had updated the subject guidelines to further enhance the understanding of Targeted Financial Sanctions regimes for Terrorism Financing and Proliferation Financing, under United Nations Security Council (UNSC) Resolutions, and to further align said regimes with the requirements embodied in FATF Recommendations and observations highlighted in Mutual Evaluation Report 2018.

⁹⁰ BPRD Circular No. 09 of 2019.

Notifications issued under United Nations Security Council (UNSC) Resolutions was issued.

Corporate Governance: SBP required banks to formulate a comprehensive and transparent remuneration policy for the Chairman and other Directors. Further, along with other features, maximum limits were introduced on Directors' remunerations.

SBP advised the Banks/DFIs that their Board/Chairman would not appoint an 'Advisor' in any capacity. The objective of this requirement was to ensure that banks/DFIs should have appropriate skill mix of their Board of Directors keeping in view the overall risk profile of the institution.

Dynamic Provisioning (Implementation of IFRS-9): SBP advised the banking industry to carry out a gap assessment of their process and systems in order to devise a strategy to implement the IFRS-9 standard. In view of the assessments, SBP advised the banking industry to conduct a parallel run of IFRS-9 standard in 2020 financials and to implement this standard from Jan 1, 2020 onwards⁹². SBP prescribed timelines for various milestones towards the smooth implementation of IFRS-9 including formation of Board and Project Steering Committee, preparation of IFRS-9 compatible pro-forma, parallel run of IFRS-9 and its Director Review Report etc. This measure will help the banking industry to achieve the best international practices of impairment recognition.

Outsourcing Arrangements by Financial Institutions: Financial Institutions (FIs) are increasingly

⁹¹ EPD Circular Letter No. 13 of 2019

⁹² BPRD Circular No. 4 of 2019: Keeping in view the prevalent COVID-19 (Corona Virus Disease 2019) pandemic situation, SBP has extended timeline for the preparation of IFRS compatible pro forma financial statements till end August 2020 and parallel run for IFRS till July 1, 2020 (BPRD Circular Letter No. 15 of 2020).

using third party service providers including group companies to carry out various activities, functions and processes, thus, increasing their risk profiles. SBP issued revised Framework for Risk Management in Outsourcing Arrangements by FIs to address operational risk by updating the sections pertaining to Group Outsourcing, IT Outsourcing and governance of customers' confidential information. This will enable FIs to effectively manage their IT outsourcing activities and other outsourced services with group companies⁹³.

Supervisory Oversight: The initiatives, from the supervisory perspective, included disclosure of significant enforcement actions on SBP website, biometric verification of more than 90 percent account holders, industry assessment on compliance with AML/CFT requirements by seeking quarterly information. Moreover, banks were effectively engaged through written/ verbal follow-ups and supervisory meetings to ensure remedial actions had been taken to address the supervisory concerns.

Banking Conduct and Consumer Protection: Wide-scoped and timely information dissemination is essential for the prudent credit risk management. In this vein, SBP granted license to two private bureaus, M/s Aequitas Information Services Limited (AISL) and Data Check Limited under Credit Bureaus Act, 2015, which inter alia required the credit institutions to become member of at least one credit bureau. It is expected that these Bureaus would offer value added services and products in various dimensions including credit scoring, anti-fraud tools-fraud detection, portfolio monitoring, debt collection, marketing etc.

Financial Market: SBP, in coordination with Ministry of Finance, introduced a mechanism for

re-opening auctions of existing issues of Floating Rate PIBs (FPIBs)^{94,95} Further, SBP also abolished SLR eligibility limit on these securities.⁹⁶ Positively, those measures improved market participation in the auction of FPIBs and secondary market liquidity.

In addition, Federal Board of Revenue (FBR) simplified the tax regime for nonresident companies investing in debt instruments and Government securities. The aim was to deepen our capital markets, support availability of long term rupee financing sources, encourage competition in the local currency debt market, and diversify the source of funding for the government.⁹⁷

Financial Market Infrastructures: In order to foster innovation in the payment industry and promote financial inclusion in the country, SBP decided to license non-banking entities as E-Money Institutions (EMIs). It is expected that EMIs shall offer convenient, cost effective, interoperable and

⁹³ BPRD Circular No. 06 of 2019

⁹⁴ Previously due to absence of re-openings, each issue of FPIBs was a separate security which resulted in market fragmentation and low liquidity.

⁹⁵ DMMD Circular No. 22 of 2019

⁹⁶ Earlier, FPIBs to the extent of 15% and 5% of Total Liabilities (subject to SLR) could be counted towards SLR for banks and DFIs respectively.

⁹⁷ <http://www.sbp.org.pk/press/2020/Pr-02-Jan-20.pdf>

secure digital payment products and services to end users in the country.^{98,99}

Moreover, in order to facilitate the growth of digital payment acceptance points in the country, SBP issued Rules for Digital On-boarding of Merchants for EMIs. These Rules layout the minimum requirements for simplified due diligence process of on-boarding individual and self-employed persons as merchants, services to be offered by these merchants, transaction limits, maximum account balance limits, security measures, dispute resolution mechanism and regulatory reporting to SBP.

Financial Stability- Financial Inclusion Perspective

The role of financial inclusion in promoting financial stability, besides supporting poverty reduction and economic growth, is well established in wide-ranging literature.¹⁰⁰

SBP is actively pursuing a financial inclusion agenda through its different work streams including Agriculture finance, Microfinance, Islamic Banking, SME finance, and Infrastructure and Housing finance. The key developments, during the reviewed year, in these areas were as below:

Agriculture Finance: In order to encourage banks/DFIs to enhance financing for development loans in crop and non-crop sectors, the maximum repayment tenure of development loans was increased from 5 years to 10 years.¹⁰¹

SBP continued to provide an enabling regulatory framework for channelizing financing to develop an efficient and standardized infrastructure for the storage of commodities. To this end SBP

introduced necessary amendments in Prudential Regulations of Agriculture. Financing, SME Financing, and Corporate & Commercial Banking. These initiatives will facilitate banks in financing against Electronic Warehouse Receipt (**EWR**).¹⁰²

Microfinance Besides banks, SBP also strengthened regulations for AML CFT for Micro Finance Banks (MFBs) through following measures:

- MFBs were allowed to use Proof of Registration (**POR**) Card held by Afghan Refugees as a Valid Identity Document for Account Opening.¹⁰³
- Amendments were made to align AML/CFT Regulations for MFBs with the Financial Action Task Force (**FATF**) Recommendations.¹⁰⁴
- MFBs were reiterated to ensure the strict observance of all applicable instructions on AML/CFT, already issued by SECP and SBP, including identification and verification of customers and their beneficial owner(s) and obtain information on the purpose and intended nature of business relationship. Moreover, MFBs were also advised to ensure optimal utilization of biometric technology and carryout the biometric verification of existing customers.¹⁰⁵

Additional guidance on Fit & Proper Test (Criteria) for MFBs was issued to ensure that persons subject to FPT shall become disqualified if they are designated/proscribed or associated directly/indirectly with designated/proscribed entities/persons under United Nations Security Council Resolution or Anti-Terrorism Act 1997.¹⁰⁶

Islamic Banking: SBP notified adoption of six Shariah Standards of Accounting and Auditing Organization for Islamic Financial Institutions (**AAOIFI**) including No. 2 (Debit Card, Charge Card and Credit Card), No. 5 (Guarantees), No.14

⁹⁸ PSD Circular No. 1 of 2019

⁹⁹ As of March 30, 2020, five (5) companies have been issued In-principle approvals for various innovative digital payments solutions.

¹⁰⁰ See FSR 2018, Box-2

¹⁰¹ AC&MFD Circular Letter No. 02 of 2019

¹⁰² AC&MFD Circular Letter No. 03 of 2019

¹⁰³ AC&MFD Circular Letter No. 01 of 2019

¹⁰⁴ AC&MFD Circular No. 03 of 2019

¹⁰⁵ AC&MFD Circular No. 04 of 2019

¹⁰⁶ AC&MFD Circular Letter No. 04 of 2019

(Documentary Credit), No.18 (Possession), No.24 (Syndicated Financing) and No. 38 (Online Financial Dealings).¹⁰⁷ Adoption of these Shariah standards marks a major milestone towards the standardization of Shariah products and practices in Islamic banking industry of Pakistan with internationally recognized standards.

In order to provide Shariah compliant alternatives of conventional financing facilities to meet demand of faith sensitive clients, SBP enhanced the scope of Islamic financing/re-financing through various facilities.¹⁰⁸ Further, in order to facilitate availability of long-term affordable funding to low income segments, SBP launched 'Islamic Financing Facility for Low Cost Housing for Special Segments' on the basis of Mudarabah.

Considering the scheduled maturities of GoP Ijara Sukuk and limited issuance of sovereign Shariah compliant securities vis-à-vis increasing demand for investment opportunities by Islamic Banking Institutions, SBP supported the eligibility of Pakistan Energy Sukuk issued by Power Holding Private Limited (PHPL) as approved security for maintenance of SLR.¹⁰⁹ SBP also supported the declaration of obligations of SBP arising from Bai-Muajjal transactions as approved security for maintenance of SLR.

SME Financing: SBP launched "Small Enterprise (SE) Financing and Credit Guarantee Scheme for Special Persons" in line with the Government of Pakistan's priority to improve socio-economic life of the special persons in the country. Under the scheme, Banks and DFIs are required to provide financing facilities to special persons to meet credit needs for setting up of new business enterprises or for expansion of existing ones¹¹⁰. The end user rate is up to 5% which will be retained by banks.

Moreover, 60% risk coverage is also available to the participating institutions.

Infrastructure and Housing Finance: SBP is working for promotion of green banking & finance in the country, which broadly includes concepts like renewable energy, resource efficiency & sustainable development.

SBP updated and issued SBP Financing Scheme for Renewable Energy in July 2019. The major change in the Scheme was extension of its availability period by another three years i.e. till June 30, 2022.

With the intention to promote environment friendly alternatives, SBP introduced financing facility for establishment of zig-zag technology based brick kilns as well as upgradation/modernization of existing conventional brick kilns to modern zig-zag technology. The motivation behind expansion in the scheme is to help reduce emissions of carbon and other particulate matter from conventional brick kilns by adoption of new zigzag technology.¹¹¹

To further facilitate export-oriented industries for purchase of imported or locally manufactured machinery, SBP extended the scope of Long term financing facility (**LTFFF/ILTFF**) to all sectors besides increasing maximum financing limit for a single project from PKR 1.5 billion to PKR 5.0 billion.

The housing finance has negligible share in Pakistan. In order to promote housing finance especially low cost housing, SBP has launched low cost housing finance policy on March 11, 2019¹¹². The policy introduced following key initiatives:

- The regulatory relaxations allowed in the area of low cost housing finance included removal of

¹⁰⁷ IBD Circular No. 01 dated March 01, 2019

¹⁰⁸ These facilities included Islamic Financing Facility for Renewable Energy (IFRE), 'Islamic Financing Facility for Storage of Agricultural Produce (IFFSAP)', 'Islamic Refinance Facility for Modernization of SMEs (IRFMS)', 'Islamic Refinance Scheme for

Working Capital Financing of Small Enterprises and Low-End Medium Enterprises'.

¹⁰⁹ DMMD Circular No. 07 of 2019

¹¹⁰ IH&SMEFD Circular No. 07 of 2019

¹¹¹ IH&SMEFD Circular No. 09 of 2019

¹¹² Please see, IH&SMEFD Circular No. 4, 5 & 6 of 2019

general reserve requirement, increase in loan to value ratio, lowering of risk weights, exemption from exposure limit on real estate etc.

- In order to facilitate availability of long-term affordable funding for housing to special segments of society e.g. Widows, Transgender, special persons, SBP shall provide refinance against subsidized low cost housing financing by banks/DFIs (conventional and Islamic).
- SBP assigned targets for overall housing finance portfolio to banks and targets for low cost housing for special segments to both banks and HBFCL.