3 Ensuring Soundness of Financial Sector

3.1 Overview

State Bank of Pakistan derives its goal of financial stability from its legal mandate, as specified in the State Bank of Pakistan Act, 1956, "responsible for securing monetary stability and soundness of the financial system". Financial stability is defined in terms of the need to ensure and promote, in a lasting way, and without major disruptions, an efficient allocation of savings to investment opportunities[1]. Generally, maintaining financial stability depends on effective financial regulations which aim to provide the right set of incentives for the prudential conduct of, and risk behavior by financial institutions. The primary objective of financial stability policies and assessment is to provide early warning signals for crisis prevention as distinct from crisis mitigation. Stability of the financial system promotes: (i) a smooth and efficient financial intermediation processes that allocate savings to profitable investment opportunities, (ii) balanced development of different segments of the financial system, and (iii) proper transmission of monetary policy, whose effective conduct and implementation in turn facilitates price stability.

State Bank of Pakistan (SBP), the central bank and primary regulator of the financial sector, given its dual mandate of monetary policy and financial regulation and supervision, is in a unique position to conduct financial stability. SBP has a finger on the pulse of the economy and as such is able to decipher the monetary transmission mechanism and its impact on the economy and the financial sector. At the same time, vigilance on banking sector helps SBP to understand the financial transmission mechanism which helps in the formulation of the overall policy stance.

SBP has now been conducting financial stability analysis for the last 5 years or so. However, the framework for financial stability is still evolving. Starting in 2002, SBP conducted annual Financial Sector Assessment Program dovetailed with quarterly and annual Banking Surveillance Report. Integrating these reports, in 2007, SBP launched its first comprehensive Financial Stability Review (FSR) that offers a rich assessment of risks and vulnerabilities of financial sector and macroeconomic challenges.

With the objective of institutionalizing financial stability analysis, there was a need to have a designated department which can spearhead independent analysis and research, make policy recommendations, and monitor financial stability issues on an ongoing basis, as done in other central banks around the globe. Hence in February 2008, a separate Financial Stability Department was established in the Monetary Policy and Research Cluster, tasked with providing independent, policy-induced research on the financial sector to enable State Bank of Pakistan to achieve its objective of financial stability. The Financial Stability Department works in close coordination with both Banking Policy and Regulations Department (BPRD) and Banking Surveillance Department (BSD), in order to achieve its objectives.

With this overview in mind, the rest of the chapter is dedicated to discussing the various regulatory measures taken by the SBP during FY08 to ensure the stability of the financial sector.

3.2 Ensuring Stability of the Banking System

3.2.1 Capacity Building and Basel-II

Basel-II is a process rather than a destination therefore its implementation is an ongoing exercise. Skilled human resources, authentic data, and efficient IT systems are the prerequisites for smooth

[1] Mishkin, F. (1991): "*Anatomy of financial crisis*," NBER Working Paper, No. 3934

implementation of Basel -II. State Bank has always encouraged banks to adopt international best practices, develop systems and human resource skills. It has adopted a two-pronged approach for capacity building of the banking sector. SBP arranged a seminar on Basel II with the help of Standard Chartered Bank, UK to enhance the knowledge base of local bankers especially those related to the execution of Basel II. In addition, a SAARCFINANCE Seminar on Basel-II was held in Islamabad from June 26-28, June 2008.The purpose of the seminar was to share country experiences of Basel II implementation. State Bank has also arranged several trainings / presentations / seminars on different topics under Basel II for internal stakeholders. These programs helped SBP human resources to learn different techniques adopted under Basel II and grasp the intricacies involved in its implementation. Six cross functional teams have been deployed to address the issues pertaining to various areas i.e. (i) Credit Risk – Standardized Approach (ii) Credit Risk – Advanced Approaches (iii) Operational Risk (iv) Market Risk (v) Pillar II (Supervisory Review Process) and (vi) Pillar III (Disclosure Requirements). Members of these teams have diversified experience. Banking Inspection staff share their practical knowledge and industry practices to assist the back office functions of the Banking Surveillance Department.

3.2.2 Implementation of Basel II

Implementation of the Standardized Approaches of Basel II commenced from January 01, 2008. Basel II requires more rigorous measures for calculation of Capital Adequacy Ratio (CAR) in contrast to Basel I. Basel II is not only more risk sensitive but also extends to such risk areas which are not covered under Basel I. Supervisors / Regulators would have to act proactively to assess the risks of the banks at individual and industry level. As stipulated by the State Bank, the banks / DFIs furnished their 1st MCR statements under Basel II framework on 31-12-2006 while parallel run will continue till 31-12-2008. SBP had provided detailed reporting formats under the new framework. Minimum Capital Requirement (MCR) Reports as of 31-12-2007 of the banks / DFIs have revealed that they are maintaining Capital Adequacy Ratio (CAR) of 13.86 percent under Basel II. However, this ratio is lower than the CAR of 14.74 percent under Basel I. The consolidated data of all banks / DFIs at 31-12-2007 shows the total eligible capital under Basel II is Rs. 542.23 billion as compared to Rs. 553.08 billion under Basel I. The reduction in the banking sector capital is due to more deductions applicable under the new framework. Total Risk Weighted Assets (TRWA) under Basel II remained at Rs. 3,912.89 billion on 31-12-2007 while these constitute Credit Risk Weighted Assets (83 percent of TRWA), Market Risk Weighted Assets (5 percent of TRWA), and Operational Risk Weighted Assets (12 percent of TRWA). Under Basel II, Operational Risk is a new category whereas investments Available for Sale (AFS) along with Held for Trading (HTM) have also been included to calculate market risk.

3.2.3 Changes in CRR/SLR and Changes in CRR/SLR on F.E. 25

Cash Reserve Requirement (CRR) and Statutory Liquidity Requirement (SLR) are used as tools of monetary policy. State Bank of Pakistan revised the definition of Time and Demand Liabilities in August 2007, to exclude deposits with tenor of less than one year from time liabilities and included the same in demand liabilities. This step was taken considering the overall liquidity situation of the banks and DFIs and to promote monetary stability by providing incentive of zero CRR to banks on deposits / liabilities which were long term in nature and hence less volatile.

To facilitate Islamic banking, the Islamic banks and branches were allowed to include their cash in hand and balance with National Bank of Pakistan held in current account towards SLR. To further encourage the Islamic Financial Products, GoP announced the Sukuks issued by Karachi Shipyard and Engineering Works (KSEW) and WAPDA as SLR eligible. Presently the required level of CRR is same for Islamic banks / branches and conventional banks, these are:-

- Weekly average of 9% (subject to daily minimum of 8%) of total Demand Liabilities (including Time Deposits with tenor of less than 1 year).
- Time Liabilities with tenor of 1 year and above does not require any cash reserve.

Whereas SLR for commercial banks is 19% (excluding CRR) of total time and demand liabilities and Islamic banks/Branches are required to maintain SLR at 9% of their time and demand liabilities.

Moreover, Special Cash Reserve Requirements (SCRA) against FE-25 deposits, maintainable against US dollar equivalent amount, was lowered for from 15% to 5% for commercial banks and for Islamic banks/branches the same was dropped from 6% to 2%. In June 2008, however, with overall improvement in foreign exchange market liquidity, threshold for SCRR against FE-25 deposits was raised to its original position. In addition to SCRA, all banks are required to maintain cash reserve against their FE-25 deposits in US dollar equivalent amount at the rate of 5%.

3.3 Strengthening Legal Framework

A strong and robust financial system has its footings in an effective legal and regulatory framework. With a mandate to ensuring the soundness and stability of the financial sector, SBP played a key role in formulating an enabling legal environment. The **Anti-money Laundering Ordinance** was enforced in September, 2007 through Presidential Ordinance. SBP has major contribution in drafting and finalization of the law. The Ordinance criminalizes money laundering and requires financial institutions to report Suspicious Transaction Reports (STRs) and extend mutual legal assistance on bilateral basis. The thrust of the law is to meet FATF recommendations. The Ordinance would go a long way in protecting financial sector from being used for money laundering and other financial crimes.

3.3.1 Enhanced Focus on Corporate Governance

To cope with the changing pace of banking business and recent corporate governance scams throughout the world, SBP has been striving hard to strengthen its corporate governance regime by broadening the scope of its Fit and Proper Test (FPT). Sponsor shareholders/directors have been clearly defined. They are now required to transfer their shares in a Blocked Account with CDC by July 31, 2008 to ensure continued stake/ownership in banks and to avoid use of sponsor shares as collaterals for financing

3.3.2 Restructuring/Privatization of Banks/DFIs

To turn around the financially distressed and inadequately capitalized financial institutions, SBP has been working on restructuring/ recapitalization of number of banks. SBP is actively coordinating with the Privatization Commission (PC) to finalize the privatization transaction of SME Bank. After completing the due process and related legalities by the financial advisors, PC called for Expression of Interest (EOI) from interested strategic investors. Short listing of the interested parties is under process.

SBP is also working on the recapitalization of First Women Bank Limited (FWBL). SBP, in consultation with the Ministry of Finance (MoF), engaged IFC to conduct a study on FWBL, and formulate a roadmap, containing various options and main steps to be taken by the Board and Management of the bank, to attract potential investment in FWBL. After thorough deliberations MoF delegated SBP to take necessary steps to restructure and privatize FWBL. SBP initiated the process of recapitalization of FWBL and transfer of management to a Strategic Investor in the light of IFC's recommendation and engaged Financial Advisors for the transaction through a transparent and competitive process. The process is at final stages and transaction structure will be finalized shortly.

The restructuring process of IDBP is also on the anvil. SBP has forwarded a complete financial restructuring plan for IDBP to the federal government. An independent valuation of the bank has been carried out and SBP is coordinating with the federal government for the best option. Once a decision is made by the government, SBP will process the transaction on fast track basis. Khushhali Bank

Limited has been successfully restructured by changing its legal structure and the process of its strategic sale to a strategic investor with appropriate interest and capacity to develop microfinance.

3.3.3 Enhancing the Outreach of Banking Services through Branchless Banking

Branchless banking guidelines were issued after exhaustive deliberations with all stake holders. Branchless Banking is a recent innovation and is expected to shift and change the mindsets of masses from traditional branch banking to the new way of doing business. Branchless Banking is a significantly cheaper alternative to conventional branch-based banking and it allows the banks to offer financial services outside traditional bank premises. The delivery channels like retail agents, mobile phone are to be used in branchless banking. One inherent feature of Branchless banking is that it can be used to substantially increase the financial services outreach to the un-banked communities and at the same time it helps in the promotion of financial inclusion in the country.

3.3.4 Mergers and Acquisitions in the Banking Sector

The financial system of Pakistan has embarked upon a guided consolidation process since early 2000. The aim is to foster financial stability by encouraging merger and acquisition within the financial sector having fewer but stronger banks capable of utilizing the economies of scale and withstanding economic downturns. The scope of consolidation through merger and acquisition has not been confined to the banking sector only rather the scope has been much broader, incorporating the entire financial sector, including leasing companies, investment banks and modarabas. The initiatives of merger among banks and NBFCs were further accelerated by the raising of regulatory minimum capital requirements9MCR) for banks and certain tax incentives offered in this regard

During the last 7 years, SBP has processed 10 acquisitions and 40merger transactions. Most of the transactions were merger of investment banks with commercial banks and banks with other banks while other transaction involved merger of DFIs/leasing companies with commercial banks. The exercise so far, has had a mixed color with both local and foreign stakeholders taking ownership of the banks. The recent transactions have witnessed higher foreign participation wherein ownership and management have been entrusted to the new acquirers after regulatory clearance granted.
To streamline consolidations, SBP took many important policy measures. A number of amendments were made in the legal framework to facilitate the process. Section 48 was amended to allow merger of NBFCs with banks under provisions of BCO, 1962. Foreign banks operating in branch mode has been defined as foreign banking companies in BCO 1962. To facilitate merger of foreign banking companies with other banks, Section 48 of BCO 1962 has been amended, wherein such scheme approved by the foreign banking company's head office can be sanctioned by SBP. SBP also proposed amendment in Income Tax Ordinance like section 57-A which was incorporated to carry forward of tax losses both amalgamated (target) and amalgamating (surviving) institutions.

These initiatives adopted by SBP resulted in reducing the number of banks from 46 in 1997 to 39 in the 2008, despite the fact that SBP issued new licenses to four Islamic banks and one foreign bank. The consolidation process has also contributed in strengthening the capital position of most of the merged entities. Moreover, consolidation also added to the development of a healthy competitive environment among bigger and stronger financial institutions. The number of foreign banking companies operating in branch mode decreased from 20 in 2000 to 7 in June 2008 due to change in their business strategies, resulting in selling of their business to locally incorporated banks and/or conversion of branch status to locally incorporated subsidiary. Going forward, if the process of consolidation continues, more stable banking system can be expected in the country.

3.3.5 Issuance of Global Depository Receipts

After gaining internal strength and stability, Pakistani banks started exploring opportunities for equity rising from capital markets abroad. To facilitate the banks in their efforts, SBP issued guidelines on issuance of Global Depository Receipts (GDRs). So far GDRs of MCB and UBL have been issued.

NBP GDRs are in process and will be completed shortly. To facilitate the issuance of NBP GDR, the Bank Nationalization Act was amended on the recommendations of SBP. A financial adviser has been hired however; the transaction could not be started due to liquidity crisis in the international markets and some other reasons. The transaction is expected to be completed this year.

3.3.6 Enhancing the Outreach of Bank Branches

State Bank of Pakistan Act 1956 and the Banking Companies Ordinance 1962 provides legal frame work for licensing of bank branches. Under Section 28 of the Banking Companies Ordinance 1962, State Bank of Pakistan has introduced a comprehensive branch licensing policy (BLP) for allowing the banks to independently make their branch housing decision within broad parameters. One of the most important mainstays of SBP Branch Licensing Policy (BLP) is to increase the level of outreach of the branches by making it mandatory for banks with a network of more than 100 branches to open at least 20 percent of their planned branches in the rural or underserved areas, outside the jurisdictions of big cities where no branch of any bank exist. However if banks are interested to open more than 20 percent branches in rural areas they may approach SBP anytime for permission. Furthermore, the revised BLP provides new options for enhancing the outreach of financial services which include opening of sub-branches, where bank can perform limited functions controlled by any nearby big branch allowing the bank to perform functions like cash receipt, payments, issuance of DD, PO, TT, MT and TC's, etc. Account opening, issuance of account number, KYC and CDD, however, will be performed by the controlling branch.

3.3.7 Protection of Borrowers and Depositors - Instructions on Lending and Deposit Rates

Depositors and bank borrowers are the two arms of flow of funds in the financial sector. To protect the interest of the depositors SBP advised all banks to pay a minimum of 5 percent profit to all depositors regardless of their account balances. On the other hand, to protect the interests of the borrowers, SBP advised the banks to ensure transparency and adequacy in re-pricing of loans, loan frequencies and loan documentation by linking the loan re-pricing to the relevant KIBOR rates. Banks were also advised to make complete disclosure of the lending and deposit rates of all consumer products offered by them and to clarify the pricing structure of the loan in the loan agreement.

3.3.8 Guidelines on Outsourcing Arrangements

Banks are increasingly using third party services to carry out activities, functions and processes as outsourcing arrangements to meet new and complex challenges like innovation in technology, increasing competition, economies of scale and improvement in quality of service to clients (i.e., customers, depositors or investors). The practice, however, can increase their dependence on third parties and consequently their risk profile. Especially, the outsourcing of I.T related processing activities outside Pakistan, which sometime involves divulgence of sensitive customer data to third parties, can have serious repercussions for the concerned financial institution and its customers in particular and the financial system in general. To mitigate such risks and to allow Banks/DFIs to effectively manage the outsourcing arrangements, SBP issued guidelines on outsourcing arrangements.

3.3.9 Entry of New Players in the Banking Sector

The soundness and stability of any financial sector can be gauged from the interest/entry of reputable international financial institutions/groups in the sector. Pakistan's banking sector is performing well attracting foreign investors. Barclays Bank Plc, a subsidiary company of Barclays Plc, was also issued a license to start banking business in branch mode as a foreign banking company. Barclays Plc is listed in London, New York and Tokyo. Barclays Plc is the 18th largest company in the world according to Forbes Global 2000 rankings (2007 list). The bank has brought US$ 90 million, SBP's minimum capital requirements. In the first year the bank plans to operate 10 branches. Pakistani operations will benefit significantly from the synergies and knowledge that Barclays, as one of the largest financial services providers, can offer. Its presence in the market will translate into superior customer service and will also contribute to financial inclusion and modernization. In the recent past, number of reputable international financial institutions like Temasek Holding Singapore, ABN AMRO Bank, Standard Chartered Bank, SAMBA Financial Group of Saudi Arabia, DEG Germany, Nomura European Investment, International Finance Corporation, etc have acquired strategic stake in various banking institutions. Entry of such strong foreign banks is a harbinger of the confidence of international business community in Pakistan's economy generally and banking sector particularly.

During 2007-08, three Development Financial Institutions (DFIs) viz Pak Iran Joint Investment Company Limited, Pak China Investment Company and Pak Brunei Investment Company were allowed to start their operation in the country. The permission was granted mainly to strengthen DFI sector and to enhance regional cooperation among the countries having their stake in these institutions. Through entry of these new players the number of DFIs operating in the country increased from 5 to 8.

3.4 Status of Islamic Banking in Pakistan

Islamic finance has developed more rapidly than conventional banking in the past 10 years, and is poised to expand even more vigorously in the foreseeable future, making it one of the most vibrant industries in global finance. According to some estimates the industry is said to have grown by approximately 15 percent in each of the past three years, partially as a consequence of the increased wealth in Islamic countries, which in turn was driven by high oil prices.

State Bank of Pakistan is also playing a leading role towards promotion and development of Islamic banking in the country. Establishing a full-fledged Islamic Banking Department at SBP to focus on all Islamic Banking issues provided the industry with the necessary impetus to grow and emerge as a preferred choice of the public. SBP's drive to promote Islamic banking as a parallel system, operating on a level playing field with commercial banking, is aimed at building a broad based financial system in the country to enable all segments of the population to access financial services and play their due role in the overall economic development. Up till June 2008, six full fledge Islamic banks were operating in the country. Due to merger of Prime Commercial Bank Limited and ABN Amro Bank N.V the total number of conventional banks having dedicated Islamic banking branches now stands at 12. The total assets of the Islamic banking industry are around Rs. 230 billions which accounts for a market share of about 4.5 percent (see **Table 3.1**). Total branch network of the industry comprises of 359 branches[2] with presence in over 50 cities and towns and covering all the four provinces of the country and AJK (see **Table 3.2**).

Table 3.1: Trends in Islamic Banking in Pakistan

billion rupees

	Deposits	Financing & invest.	Total assets
Jun-04	13.2	13.1	18.8
Jun-05	37.8	37.2	54.0
Growth (%)	188	184	187
Jun-06	59.7	57.9	87.6
Growth (%)	58	56	62
Jun-07	107.4	89.2	157.9
Growth (%)	80	54	80
Jun-08	163.1	163.4	229.6
Growth (%)	52	83	45

3.4.1 Initiatives Taken by SBP to Promote Islamic Banking

During the year under review SBP took major initiatives for promotion and development of the Islamic banking industry including:

[2] These numbers are as on September 1st 2008.

Table 3.2: Islamic Banking Players (End-June)

(in number)

	2003	2004	2005	2006	2007	2008
Islamic banks (operating)	1	1	2	4	6	6
a) Branches of Islamic banks	8	10	32	48	122	223
Conventional banks operating Islamic banking branches	0	5	9	11	13	12
b) Total standalone Islamic banking branches of conventional banks	0	10	30	39	61	103
Total Islamic banking branches (a+b)	**8**	**20**	**62**	**87**	**183**	**326**

a) Strengthening the Shariah Compliance Mechanism

SBP has put in place a comprehensive Shariah compliance framework for Islamic banking institutions, for further strengthening of which the following initiatives have been taken:

- Issuance of Instructions and Guidelines for Shariah Compliance in Islamic Banking Institutions
- Revision of Fit and Proper Criteria for Shariah Advisors of Islamic Banking Institutions
- Adaptation / Adoption of Shariah Standards developed by Accounting and Auditing Organization for the Islamic Financial Institutions (AAOIFI).
- Finalization of Shariah Compliance Inspection Manual & Training to BID officials
- Incorporation of Questionnaire on Shariah Compliance in the Institutional Risk Assessment Framework

b) Islamic Financial Services Board Standards

The Islamic Financial Services Board (IFSB) serves as an international-standard setting body of regulatory and supervisory agencies working to ensure the soundness and stability of the Islamic financial services industry. It promotes the development of a prudent and transparent Islamic financial services industry by introducing new, or adapting existing international standards in consonance with Islamic Shariah principles, with recommendations for their adoption. Being the full member of IFSB, SBP is responsible to support and adopt / adapt different standards approved by it.

To introduce world class regulations and be part of the global Islamic banking industry, a process has been put in place to introduce these standards in Pakistan. This process includes exposure of the stakeholders of this industry and public to the draft guidelines / regulations. After necessary adjustments, based on the feedback, laws and other regulatory considerations these standards are being rolled out. In this regard, Risk Management (RM) guidelines for Islamic Banking Institutions (IBIs) have been formulated with a view to further strengthens the regulatory framework in the area of risk management for IBIs. Similarly, SBP is in the process of implementing capital adequacy standard issued by IFSB in Pakistan and is carrying out an ‘impact study’ for the said purpose. The implementation of IFSB capital adequacy standard in Pakistan will be another milestone in ensuring proper risk management in IBIs in line with international standards recognizing the peculiar risk profile of Islamic banking products and services.

c) Liquidity Management and SLR Eligibility of WAPDA and KSEW Sukuk

State Bank of Pakistan has formed a Task Force to map out a plan for introducing short term and medium term liquidity management products based on innovative Islamic Structures. It has already prepared a structure for short term Shariah compliant government instrument which has been sent for Government approval. It is worthwhile to mention that WAPDA Sukuk (1st and 2nd Issue) and Karachi Shipyard & Engineering Works Limited (KSEW) (1st and 2nd Issue) Sukuk have been notified as approved securities for the purposes of meeting Statutory Liquidity Requirement (SLR) for Islamic banking institutions.

d) Accounting and Taxation Issues
For development of Accounting Standards for Islamic Modes of Financing, a Committee was constituted at Institute of Chartered Accountants Pakistan (ICAP), in which SBP is also represented. The committee is reviewing the accounting standards prepared by Accounting and Auditing Organization for Islamic Financial Institutions, Bahrain (AAOIFI) with a view to adapt them to Pakistani circumstances. The committee has prepared the standards on Murabaha and Ijara and is now working on Diminishing Musharaka Standard.

Also there have been some major taxation issues in Islamic banking industry due to its very nature of asset backed / trade based modes of financing. SBP, along with other relevant bodies took up relevant issues with Central Board of Revenue for resolution of tax problems being faced by the industry. Lately in the Finance Bill 2007 it has now been ensured that taxation of Shariah compliant Islamic banking would be treated at par with conventional banking.

e) Capacity Building Initiatives
During period under review some noteworthy initiatives taken by Islamic banking department which include organizing:

- Workshop jointly with IFSB on “Capital Adequacy Standard" and "Transparency and Market Discipline"
- Awareness programs for officers of various departments of SBP and
- Seminar on Islamic Financial Accounting Standards on Murabaha and Ijarah..

3.5 Vigilant Supervisory System

3.5.1 Revisiting Institutional Risk Assessment Framework (IRAF)
Institutional Risk Assessment Framework (IRAF) is used as a tool, in addition to CAELS, to assess performance of individual institutions on continuous basis. IRAF not only provides an opportunity to the financial institutions to carry out their assessment through IRAF self-assessment questionnaires but also indicates the gap regarding compliance with SBP regulations. Moreover, to assign composite IRAF rating to a financial institution, the system also considers onsite inspection findings, offsite supervision assessment, various financial performance indicators and market information and intelligence. The process, on the whole, provides continuous and updated system of offsite supervision and, therefore, augments SBP’s capacity to spot vulnerability of the financial institutions to various risks at an early stage. IRAF depicts complete picture of a financial institution at certain point of time to check the financial health of a bank/DFI.

During 2007-08, some major enhancements have been made in the existing IRAF mechanism to reflect more precise risk rating of the financial institutions. Self assessment questionnaires were restructured in the new system and instead of only two options available to financial institutions either ‘Yes’ or ‘No’ they can now respond to every question on a scale of 1 (fully compliant) to 5(noncompliant). This allows a certain degree of flexibility to the financial institutions to evaluate and reflect their actual degree of compliance. Similarly, different standards have been set for more objective evaluation of market information and intelligence component. Likewise, weightages assigned to different components and subcomponents have been revisited according to their importance. Moreover, IRAF has also been upgraded to encompass emerging fields of development finance like Islamic banking and agriculture finance.

3.5.2 Online Submission of Returns

State Bank of Pakistan continued to bring improvement in its various supervisory processes in place for financial institutions under its purview. Arrangements have been made to enable reporting institutions upload online, through Data Acquisition Gateway (DAG) portal, their Weekly Statement of Position under the Reporting Chart of Accounts (RCOA). As a further development, the reporting institutions may now be able to upload online Quarterly Report of Conditions (QRC) in addition to the Weekly Statement of Position (WSP) as mentioned above. This will significantly reduce paper work and the time involved in the transmission of returns in hard copies. Besides, this will relieve the burden of reporting institutions in meeting overlapping requirements of various departments of State Bank of Pakistan and also minimize the time involved in processing and analyzing the submitted information for decision making.

3.5.3 Consolidated Supervision: Needs and SBP Efforts

In Pakistan, financial markets and institutions have witnessed significant changes during the last few years in terms of consolidation as well as diversification. Since 2000, about 40 transactions of mergers and acquisitions have been executed within banks and between banks and non-bank finance companies. On the other hand a number of banks/ DFIs as well as their holding groups have expanded their activities into the areas where the banks hitherto were either not allowed or not interested. These include insurance, asset management, brokerage, leasing and other non-banking finance services essentially through separate entities. Along with financial services, various groups that control different banks have also stakes in non-financial / real sector of economy. These stakes in financial and non-financial sectors also cross over to and from foreign jurisdictions. This gives quite a diversified spectrum of activities that a bank is involved in and has related relationship with, which raises various supervisory concerns for the State Bank of Pakistan, including following:

- Any trouble in another group entity could affect the stability of the bank/DFI. Such other group entity could be a subsidiary of the bank (i.e. downstream of risk) or parent of the bank or affiliate under the control of parent (i.e. upstream risk).
- Bank/DFI together with other group entities under its control could take exposures on single borrower, borrowing group, or sector that are beyond prudential limits.
- Increasing complexities in the ownership and managerial structure of a group can make the supervision of financial institutions in the group difficult.
- Possibilities of regulatory arbitrage and non-arm length dealings in intra group transactions.

Cognizant of its responsibilities as a supervisor of the banking sector, which is facing a complex and dynamic environment and in order to ensure compliance with the core principle (No. 24) for effective banking supervision, the State Bank initiated a project in 2006 to formulate a framework for consolidated supervision of the financial sector. This framework will enable State Bank to supervise the banks / deposit taking institutions on consolidated basis. The framework envisages extending the SBP's supervisory ambit to banking group level. Initially a framework was internally drafted by SBP in 2007 and extensively discussed at different forums within the bank. In order to ensure that the framework fulfills the intended objectives in line with the established standards and core principles, the services of a renowned consultant have also been acquired by SBP. Further, legal amendments in the Banking Companies Ordinance, 1962, required to enable SBP to carry out effective consolidated supervision, are being deliberated upon amongst various internal and external stakeholders. Besides, consultation process with external stakeholders is also underway to disseminate the supervisor's thought process as well as to gather their feedback. Once the recommendations from the consultant are received and the required legal changes are enacted SBP would be able to implement the consolidated supervision framework in line with the principles of effective banking supervision.

3.5.4 Forum for Banking Departments

A committee, namely, Banking Policy Committee (BPC) was reconstituted, comprising executive directors and directors of the departments in the Banking Cluster, as a forum for discussions and collective decision making on banking issues relating to policy, regulations, supervision, enforcement and development. The committee is to be chaired jointly by the Executive Director Policy and Executive Director Supervision. The forum called Banking Team, functioning prior to restructuring of SBP, has been replaced with BPC.

3.6 Proactive Inspection

Banking Inspection (on-site) Department (BID) is striving to secure stability of the financial system and safeguard the interests of stakeholders through proactive inspections. BID conducts on-site inspections of financial institutions i.e. Banks, Development Finance Institutions (DFIs), Microfinance Institutions (MFIs) and Exchange Companies under the jurisdiction of SBP. BID also prepares special reports on write-off cases of loans, advances and other special investigations based on requests from internal and external stakeholders. Another important role of the department is to provide policy input to policy-making departments regarding issues encountered during the on-site inspections. As a result the existing policies are modified or replaced or new policies framed.

During 2007-08, the department has conducted full scope inspections of 35 banks/DFIs, 38 exchange companies (both A and B categories). In addition to the full scope inspection, department has under taken 3 IS inspection, 20 special inspections of banks/DFIs/exchange companies and handled more than 500 complaints. To improve and strengthen its capabilities, and to meet the emerging supervisory challenges, BID undertook some major initiatives as detailed below:

3.6.1 Restructuring the Department

BID has restructured to meet its objectives: to perform effectively under the given mandate, to better utilize the human resources and to effectively oversee the levels of emerging risks. The redefined structure of BID entailed identifying and developing a resource pool in specialized areas to meet the future challenges like Basel-II implementation, Sharia Compliance Reviews, Information System inspection, consumer banking, Treasury and Forex inspections and Anti-money Laundering. The Department also provides assistance to the newly established Consumer Protection Department by investigating complaints through a special division.

3.6.2 Inspection of Information System

Increasing use of technology and systems in the regulated institutions has added a new dimension to the banking business. Consequently, new risks have emerged that need to be evaluated. To ensure accuracy, integrity and adequacy of the systems used in the banks and DFIs, BID conducts IS inspection of selected financial institutions under its purview.

3.6.3 Basel-II Implementation

The Basel-II Capital Accord provides a comprehensive and more risk sensitive capital allocation methodology. Its implementation poses tremendous challenges not only in Pakistan but also throughout the world. To ensure the implementation of Basel-II, a special group of officers was constituted, who conducted on-site inspection to ensure Basel-II implementation. Banks operating in Pakistan except three public sector institutions, shifted to standardized approach.

3.6.4 Devising Tools for Anti Money Laundering (AML)

BID has undertaken a developmental project with the objective to devise tools that would facilitate in assessing preparedness of banks regarding AML. The importance of effective controls safeguarding the banking sector from the risk of money laundering cannot be over emphasized. While comprehensive regulations for anti money laundering have been issued by State Bank of Pakistan, the newly promulgated Anti-Money Laundering Ordinance, 2007, makes non-reporting of suspicious transactions an offence punishable with imprisonment and fine. The tools and methodology developed will help in assessing the adequacy and effectiveness of policies, procedures and controls relating to anti-money laundering and identify the weaknesses and deficiencies that should be worked upon to effectively tackle anti-money laundering risk.