3 Ensuring Soundness of Financial Sector

3.1 Overview

The mandate for maintaining financial stability in Pakistan rests with the State Bank of Pakistan (SBP) in its capacity as the central bank and the regulator of the banking sector.[1] State Bank of Pakistan views its objective of safeguarding financial stability in the context of smooth and efficient financial intermediation, encompassing financial institutions, financial markets and the financial infrastructure, such that the process can withstand disruptions caused by internal and external events, and potential threats and risks are managed with the objective of minimizing systemic risk.

Recent and recurrent episodes of financial crisis have magnified the significance of financial stability and its dimensions. Every crisis – be it economic, currency, banking or, more recently, liquidity – has resulted in huge financial and banking losses and adverse economic consequences that transcend national boundaries. Keeping in view these considerations, most countries have developed elaborate frameworks designed to measure, monitor and safeguard financial stability. It is prudent to assess macroeconomic and financial sector vulnerabilities and to judge the implications of these two so that appropriate corrective actions and policies may be put into place to prevent a crisis. A number of advanced countries have adopted sophisticated models to conduct macroeconomic and financial sector surveillance. However, other developing countries, given the data limitations and size of the financial sector, have adopted simpler frameworks for assessment of financial stability.

In addition to the ongoing monitoring and assessment of the banking sector, SBP undertakes, as part of its financial stability assessment mechanism, an independent review of the Non-Bank Financial Companies (NBFCs), the Insurance sector, Pension Funds, and Capital Markets, though these segments of the financial sector are under the oversight of the Securities and Exchange Commission of Pakistan (SECP).

Given this division of regulatory responsibilities, SBP's existing framework for financial stability assessment is primarily focused on the stability of the banking system. In terms of organization, the assessment is undertaken as a shared responsibility within the central bank: the Banking Policy and Regulation (BPR) group undertakes policy formulation on the basis of the off-site surveillance of the banking sector in monitoring developments and keeping an active dialogue with banks. The Banking Supervision group, on the other hand, undertakes both off-site enforcement and on-site inspection. The newly established Financial Stability Department (part of the Monetary Policy and Research group) is mandated to independently assess financial stability from a policy-formulation and research perspective, and is also responsible for preparing the annual Financial Stability Review (FSR) and for developing a macro-prudential framework for financial stability.

While the financial sector continues to make advancements in response to ongoing implementation of financial sector reforms, SBP in its capacity as the leading regulator of the financial sector strives to play a facilitating role in enhancing its growth. The confidence of economic agents in the financial sector's ability to meet their financial needs in a convenient and secure manner has an important role in maintaining and promoting financial stability.

With this overview, the rest of the chapter is dedicated to discussing the regulatory measures taken by the SBP during FY09 to ensure the stability of the banking sector.

[1] SBP also regulates and supervises Development Finance Institutions and Foreign Exchange Companies.

3.2 Ensuring Stability of the Banking System

3.2.1 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), WAPDA, Lahore Electricity Supply Corporation (LESCO) and National Industrial Parks Management Company as SLR eligible.

As the economy of Pakistan experienced inflationary pressures in 2005 – 2008, SBP raised the CRR from 5 percent to 9 percent. However, in later half of 2008 to ease out the liquidity stress SBP reduced the CRR from 9 percent to 5 percent.

Presently the required CRR level for all banks including Islamic banks / branches is:

- Weekly average of 5 percent (subject to daily minimum of 4 percent) 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.

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

Moreover, Special Cash Reserve Requirements (SCRR) against FE-25 deposits, maintainable against US dollar equivalent amount, was lowered from 15 percent to 5 percent for commercial banks and for Islamic banks/branches the same was dropped from 6 percent to 2 percent. 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 SCRR, all banks are required to maintain cash reserve against their FE-25 deposits in US dollar equivalent amount at the rate of 5 percent.

3.2.2 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, more than 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 the 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 the challenges posed by the complex and dynamic environment and to ensure compliance with the core principle on Effective Banking Supervision (Principle No. 24 – Consolidated Supervision), the State Bank initiated a project for formulating a framework for consolidated supervision of the banking system. Initially a framework was internally drafted by SBP in 2007-08 and was extensively discussed at different forums within the bank. The framework along with proposed amendments in legislations has been shared with Ministry of Finance and Securities & Exchange Commission of Pakistan (SECP) and is under consultation between SBP and SECP for enhancing its effectiveness. SBP and SECP are deliberating upon the features of the framework and necessary amendments in legislations and related rules and regulations. 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. Once this joint consultation process is finalized and the required legal and regulatory changes are enacted, SBP would be able to implement the consolidated supervision framework in line with the principles of effective banking supervision. In the meanwhile, SBP has entered into MoU with SECP for, inter alia, sharing information and regulatory expertise. Besides, a dedicated joint task force has been established for specifically monitoring and managing the risks posed by conglomeration in the financial sector. The task force aims to monitor the financial groups on regular basis and initiate joint dialogue and regulatory actions as soon as any major trigger point is observed in any strategically important financial conglomerate.

3.2.3 Strengthening of Capital Adequacy Regime

In August 2005, SBP rolled out instructions for enhancement of Minimum Capital Requirements (MCR) and the banks/DFIs were advised to increase their paid-up capital (net of losses) to Rs6 billion by the end of 2009, in a phased manner. To enforce prudent compliance by the banks/DFIs and to ensure timely follow up by the institutions anticipating a shortfall in MCR compliance, SBP issued instructions that the banks/DFIs should develop realistic plans accordingly to meet the prescribed MCR and submit a copy of such plan, approved by their Board of Directors to SBP by April 30, of every year. On receipt of the plans, the same were examined by SBP and followed up so as to prod the banks/DFIs towards meeting the requirement. As a result, the banks/DFIs have been meeting their respective paid-up capital requirements and presently most of the banks/DFI, with the exception of few banks, are meeting Rs5 billion paid-up capital requirement as of end 2008. Banks are on their way to meet the capital requirement of Rs6 billion by the end of 2009.

Recently, SBP has further enhanced the MCR requirements and the locally incorporated banks/DFIs are now required to enhance their paid-up capital (net of losses) to Rs10 billion by end of 2013 in a phased manner. The MCR requirement for foreign banks has also been raised to Rs10 billion to be achieved in the same phased manner. However, those FBs, whose head offices hold paid-up capital (free of losses) of at least equivalent to US$ 300 million and have a CAR of at least 8 percent or minimum prescribed by their home regulator, whichever is higher, will be allowed with the prior approval of the State Bank to maintain the following MCR:

- FBs, operating with upto 5 branches are required to raise their assigned capital to Rs3 billion latest by December31, 2010.
- FBs operating/desirous of operating with 6 to 50 branches are required to raise their assigned capital to Rs6 billion by December 31, 2010.

However, the MCR requirements for DFIs has been kept same as previously instructed and accordingly the DFIs will raise their paid up capital (free of losses) to Rs6 billion by December 2009. The increase in the paid-up capital was aimed at catalyzing mergers and acquisitions in the industry with the aim to promote presence of strong and well-established institutions in the market. Resultantly, some mergers have already taken place while some middle tier banks have initiated mergers process. Apart from enhancement in the MCR requirements, the absolute minimum CAR to be maintained by the institutions has been revised to 10 percent on both standalone and consolidated basis, effective from December 31, 2009. Previously, majority of the institutions were maintaining CAR slightly above the minimum 8 percent requirement. The new CAR requirements have a two-pronged effect.

3.2.4 Developments in Implementation of Basel-II

Implementation of Basel-II has been an active liaison area for SBP. Not only instructions/guidelines have been issued to banks/DFIs on frequent basis but kept active interactions with different stakeholders. In addition to general interaction, meetings on more specific issues have been held with individual banks, PBA and SECP. Furthermore, various capacity building initiatives have been carried out by holding trainings.

Detailed guidelines on Basel II implementation were issued in June 2006. The banks/DFIs were given timeline for adoption of the Basel II Accord and the available methodologies. In terms of the directives, the banks/DFIs were required to initiate parallel run for Standardized Approach from July 1, 2006 and go live from January 1, 2008. Furthermore, the banks/DFIs were to initiate parallel run for Advanced Approaches from January 1, 2008 and go live from January 1, 2010.

A major policy decision was made in June 2008 when it was decided that the transition to the advanced approaches of Basel-II be made discretionary for the banks/DFIs. However, the transition would be subject to approval by SBP after evaluation of the readiness of the institution and the efficacy of its systems. Similarly, the institutions desirous of making a transition to the advanced approaches within the next five years were required to submit their action plans for adoption of the advanced approaches.

The reporting formats covering the Standardized Approaches for Credit & Market risk and Basic Indicator and Standardized approaches for Operational risk were promulgated in March 2007. The banks/DFIs were accordingly advised to submit their Basel-II capital adequacy returns on quarterly basis on both standalone and consolidated basis along with a parallel submission of the Basel-I based returns.

Instructions have also been issued regarding two support areas for effective implementation of Basel-II. First, the banks/DFIs are required to put in place Internal Credit Risk Rating Systems which are a prerequisite for the advanced approaches of Basel-II. The systems are meant to provide two dimensional ratings on both obligor and facility. Second, a guideline for Internal Capital Adequacy Assessment Process (ICAAP) has been issued to supplement the detailed guidelines on Basel-II, and for facilitating the banks/DFIs on the same. The banks/DFIs are free to adopt any methodology for the Internal Rating System and ICAAP. However, they are to ensure that the methodology is commensurate with their operations.

Progress has been made in many significant areas which would culminate in smooth and effective implementation of Basel-II. Notably, meetings with many individual banks have been carried out so as to ascertain their comprehension of and involvement in Basel-II implementation. Action plans regarding the future vision of the institutions were sought and stock taking exercises were conducted. Wherever it was ascertained that the banks are lagging or their progress is not satisfactory, the officials were advised to take remedial steps. The constant and vigilant supervision ensured all the banks/DFIs transition to the standardized approaches of Basel-II. Most of the banks have already credit risk rated all their corporate clients and are reporting the same to the SBP, whereas the process of rating consumer loans is at advanced stages.

As the Standardized Approach for Basel-II relies heavily on credit ratings issued by the recognized rating agencies, steps have been taken to promote the rating culture in Pakistan. Not only the banks have been advised to educate their customers on the subject, liaison is also being carried out with SECP so as to consider mandating credit rating for at least the listed corporate institutions. In the same connection, the credit rating agencies are actively scrutinized on their annual re-recognition for the purpose of Basel-II. Previously they have not only been advised to make certain improvements/refinements in their methodologies, but also to strengthen their human resource. Accordingly, the rating agencies have enhanced their capacity.

The annual reporting formats and other requirements have considerably increased the disclosures of the institutions from the perspective of both SBP and market participants. SBP can gauge the performance and viability of the institution at a deeper level and has been doing so. All in all, Basel-II is a broad scoped process and significant improvements have been made in this regard.

3.2.5 Stress Testing

Although, SBP started working on stress testing during early 2000s, the work on stress testing got momentum after first FSAP of Pakistan in 2004. The focus on stress testing remained on simple sensitivity analysis which does not cover scenario analysis and macro-economic model based approaches. In year 2007, a separate division called ‘Risk Analysis Division (RAD)’ was established at Banking Surveillance Department with the objective to develop and implement ‘Model Based Approaches to Stress Testing’. To achieve the objective, a comprehensive methodology paper was prepared which sets forth a framework for stress testing. Further, as and initiative towards capacity building of SBP officers in the area of stress testing, a number of training workshops on Stress Testing were also conducted.

To enhance the capacity in risk assessment and stress testing, a project named ‘Banking Supervision Risk Assessment Model (BSRAM) ‘was initiated. The BSRAM has three modules, market risk, credit risk and operational risk module. Market risk and credit risk module have already been completed and are at User Acceptance Test (UAT) phase. Once implemented, it will improve the capacity to effectively monitor and manage the risk and facilitate in planned decision making on the basis of BSRAM results.

3.2.6 Risk Management

To establish a strong and comprehensive risk management framework in banks, State Bank of Pakistan took various policy measures:

a) New disclosure Requirements and internal controls on financial reporting

To align the disclosure of banks with the changing risk environment, the disclosure requirements for banks were revised in February 2006. The new disclosure requirements provide for more transparency, while fulfilling the requirements of Basel II. Further, keeping in view the importance of policy framework and to bring clarity, the banks were formally advised to formulate and regularly update policies in the areas of Risk Management, Credit, Treasury & Investment, Internal Control System and Audit, IT Security, Human Resources, Expenditure and Accounting & Disclosure.

Effective from December 31,2009, the statutory auditor(s) of a bank / DFI are required to give their opinion and report on Board’s endorsement regarding efficacy of bank / DFI’s internal controls over financial reporting (ICFR) following the best international practices to discharge this responsibility.

b) Strengthening the Provisioning Requirements

To enhance the resilience of the banking system, State Bank of Pakistan has further strengthened the loan classification and provisioning requirements. Though a number of changes have been made to align the provisioning requirements with the international best practices, the key change remained the gradual withdrawal of the benefit of forced sale value (FSV) of collateral. As a first step, in 2005, the benefit of FSV of collateral in provisioning against NPLs was withdrawn against the financing facilities of less than Rs5 million. As a second step, which was taken after a time lag of one year, the benefit was withdrawn on financing facilities of less than Rs10 million. In 2007, the benefit of FSV in provisioning was completely withdrawn on other than housing finance loans, which were given relaxation of two years. The very aim of withdrawal was to address the risk of any adverse shocks to the asset prices of the loan collateral. Lately in January 2009, keeping in view the changing market dynamics, the banks were allowed to avail the FSV benefit of collateral to the extent of 30 percent of the FSV of residential and commercial mortgage and pledge.

c) Deposit Protection Scheme

Denationalization of state owned banks coupled with entry of new private institutions has left the safety of deposits in case of a bank failure to an arbitrary and implicit deposit protection mechanism, as the *Bank Nationalization Act, 1974* covers only depositors of nationalized banks. Accordingly, need has been felt to set up a formal system of explicit deposit protection during the second half of 2008. A number of steps were taken. A 'concept paper' on the subject was developed, and the scheme was prepared after consultation with the stakeholders.

Additionally, a draft Act for establishment of deposit protection fund was prepared and sent to the Ministry of Finance for approval. Once the Act is enacted, its formal launch will explicitly cover large number of eligible/small depositors of the banking system. Further, the system will remove the burden of a bailout package, in case of a bank's failure, on tax payers as participating banks will contribute towards the fund through regular premium payments.

3.3 Strengthening Legal Framework

3.3.1 Anti-money laundering Evaluation

Asia Pacific Group on Money laundering (APGML) and World Bank have jointly conducted mutual evaluation of Pakistan's anti-money laundering regime during January- February 2009. Mutual Evaluation is one of the important events of APG of which Pakistan is member since 2001. Since banking sector forms main chunk of the financial sector in the country, it was crucial for State Bank to properly prepare banks for the evaluation. To this end, SBP conducted three educational workshops for compliance officers in the first instance and then held meetings with senior executives to groom them for the event. SBP coordinated and held meetings with relevant quarters as well as with the visiting team. The final report as adopted in the Annual meeting of the body shows mixed results for the whole financial sector because separate rating for different sectors is not allowed. However, the report acknowledged, the measures taken by SBP to improve compliance level in phased manner. The evaluation team especially appreciated the set of instructions issued vide circular No. 7 dated March 9, 2009. These instructions have greatly improved regulatory regime and took Pakistani banks closer to international standards.

3.3.2 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 were 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. Thorough exercises have also been conducted for the compliance of CDC blocked shares status of every bank with respect to SBP's instructions. Similarly, Microfinance banks have also been required to deposit the sponsor shares in blocked accounts with CDC.

Key executives for overseas operations of Pakistani banks have been required to meet Fit and Proper Test (FPT) criteria and prior clearance from SBP. The due diligence procedure for foreign national appointees have also been focused and being practiced in coordination with other central banks/monetary authorities. Moreover, banks have also been provided flexibility regarding payment of remuneration to directors for attending board and its committees' meetings. For ensuring smooth transition, CEO and Board of every bank/DFI and MFB is required to submit two-months prior notice to SBP regarding removal or resignation of the CEO.

3.3.3 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 has been actively coordinating with the Privatization Commission (PC) to finalize the privatization transaction of SME Bank. After completing the due diligence process and related legalities by the financial advisers, PC called for Expression of Interest (EOI) from interested strategic investors and due diligence process of the interested parties was completed. However, the transaction could not be continued because of diminishing interest of selected parties due to global economic turmoil. SBP is again coordinating with PC to take up the matter on priority basis.

SBP is also working on the recapitalization of First Women Bank Limited (FWBL). SBP, in consultation with the Ministry of Finance (MoF), engaged a consultant to conduct a study on FWBL, and formulate a roadmap, containing various options and 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 in the light of the consultant's recommendation and is now coordinating with MoF as well as with major shareholders for early resolution of the 'Capital' issue of the bank.

The restructuring process of IDBP is also under active consideration of the SBP and Ministry of Finance (MoF). 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. Khushhali Bank Limited has been successfully restructured by changing its legal structure.

SBP is also endeavoring for restructuring/privatization of HBFC for its revival. Through a series of processes by the SBP, the corporation has already been corporatized through vesting order issued by the Finance Division. According to this order all the assets and liabilities of HBFC were transferred and vested in House Building Finance Corporation Limited (HBFCL).

3.3.4 Mergers and Acquisitions in the Banking Sector

In the backdrop of financial sector reforms, changes in the ownership structure of banking system in Pakistan and enhancement of Minimum Capital Requirements (MCR), financial sector in the country is being consolidated through mergers and acquisitions. Despite economic slowdown in domestic and international economies, mergers and acquisitions (M&A) is still the main feature of the financial landscape in Pakistan and is receiving greater attention. In the recent past, SBP has processed a large number of mergers/acquisition transactions. The activity is more prominent in the banking sector, involving M&A activity among banks as well across financial sector. SBP being the sole supervisory and regulatory authority of Commercial banks, Islamic Commercial banks, DFIs, Micro Finance banks and Exchange companies in the country is the sanctioning authority of amalgamation among banking companies. Any amalgamation which involves amalgamation of NBFC(s) with a banking company is also approved by SBP.

During the last 8 years, SBP has processed 11 acquisitions and 41merger transactions. Most of the transactions were merger of investment banks with commercial banks and banks with other banks while other transactions 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. During the period under consideration number of banks and NBFCs approached SBP for potential mergers, however, in most of the cases the mergers could not materialize due to one reason or the other on the part of the amalgamating entities. Among the recent transactions, Telenor Pakistan has acquired majority shareholding of Tameer Microfinance Bank Limited. KASB Capital Limited & Network Leasing Corporation Limited was merged into KASB Bank Limited.

Though the prevailing laws, rules/regulations provide the basic legal/regulatory framework for merger/amalgamation/acquisition transaction, however, to facilitate and streamline the processing of merger/amalgamation/acquisition transactions, a comprehensive set of guidelines have been developed. These guidelines provide a step by step guidance to prospective acquirers/amalgamating entities for smooth processing of the transaction as well as providing self assessment criteria before approaching SBP. These guidelines have been divided into two parts. Part I deals with the acquisition of more than 5 percent shareholding/strategic stake in banks while Part II covers the amalgamation of banking companies. Since acquisition often precedes amalgamation, Part I and Part II of these guidelines should not be viewed in isolation, instead these guidelines are interconnected and reinforcing each other.

3.3.5 Strengthening Overseas Operations of Pakistani Banks

To strengthen overseas operations of the banks incorporated in Pakistan, an Overseas Branch Licensing Policy was issued in March, 2009. Under the new policy, various executives involved in overseas operations are included in the category of 'Key Executives' for assessment of their 'fitness and propriety' under SBP prescribed criteria. Banks are also required to plough back at least 34 percent of their overseas annual profit after tax to their respective head offices in Pakistan on yearly basis

3.3.6 Enhancing the Outreach of Banking Services

State Bank of Pakistan Act, 1956 and the *Banking Companies Ordinance, 1962* provide 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 location decisions within broad parameters. The main stay of BLP is to increase the level of outreach of branches in rural/underserved areas by making it mandatory for all conventional and Islamic banks to open at least 20 percent of their planned branches in such areas.

During the period under review total number of conventional bank branches increased from 8141 to 8729 showing a growth of 7.22 percent. In the same period total number of Islamic bank branches increased from 334 to 528 showing a growth of 58.08 percent. The total number of microfinance bank branches increased from 245 to 268 showing a growth of 9.39 percent.

Branchless Banking (BB) is a significantly cheaper alternative to conventional branch-based banking. BB allows financial institutions and other commercial players to offer financial services outside traditional bank premises by using delivery channels like retail agents, mobile phone, etc. BB can be used to substantially increase the financial services outreach to the un-banked communities. SBP issued Branchless Banking Regulations after exhaustive deliberations with all stake holders and consultants around the world. BB 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. SBP has allowed two banks (one commercial bank and the other microfinance bank) to pilot launch their BB initiative in partnership with renowned mobile network operators. Several banks are in the process of approvals/early discussions on Branchless Banking. Moreover, to enhance outreach of financial service at a mass scale, SBP has allowed number of banks to offer mobile banking services to their customers. SBP has also allowed five banks to offer Mobilink Genie (mobile banking service) to their existing customer base. A number of banks are also having initial discussions with SBP on launching the mobile phone enabled banking services.

3.3.7 New Bank Licenses

Section 27 of the *Banking Companies Ordinance, 1962* and Section 12 & 13 of *MFIs Ordinance, 2001* authorizes State Bank of Pakistan to issue new banking licenses. In this year one new Islamic bank license was issued to Albaraka Islamic Bank (presently operating as branch operations of Albaraka Bank Bahrain) while two microfinance banking licenses were issued to Kashf Microfinance Bank and NRSP Microfinance Bank. Kashf Microfinance Bank has started its operations all over the country.

3.3.8 Fair Debt Collection Guidelines

State Bank of Pakistan in its endeavor to further streamline the procedure of collection/recovery of debt has formulated guidelines on debt collection to set the minimum standards to be observed by Banks/DFIs to address the grievances of customers/borrowers. These guidelines are applicable to various types of consumer financing facilities including Credit Cards, Housing Loans, Auto and Personal Loans, etc.

3.4 Status of Islamic Banking in Pakistan

Over the last few years, the Islamic finance industry is reportedly growing at around 15 percent, globally. Considered a niche market—catering to financial needs of the Muslims—few years back, the Islamic finance (IF) has grown into a full-fledged financial market. Interestingly, the financial solutions provided by Islamic finance both on the asset and liability side are such that can reside on balance sheets of Islamic and conventional banks alike. The public and private sectors and regional and global financial hubs are collaborating effectively to make investments, build partnerships and alliances, and promote transfer of capital flow and knowledge-sharing.

Table 3.1: Trends in Islamic Banking in Pakistan

billion rupees; growth in percent

	Deposits	Financing & invest.	Total assets
Jun-04	13.2	13.1	18.8
Jun-05	37.8	37.2	54
Growth (percent)	188	184	187
Jun-06	59.7	57.9	87.6
Growth (percent)	58	56	62
Jun-07	107.4	89.2	157.9
Growth (percent)	80	54	80
Jun-08	163.1	163.4	229.6
Growth (percent)	52	83	45
Jun-09^{P}	238	194	313
Growth (percent)	46	19	36

P: Provisional data

In Pakistan, total assets of Islamic banking industry reached Rs313 billion as at end of June 2009 compared with Rs230 billion on June, 30 2008 (see **Table 3.1**). Similarly financing and investment portfolio of Islamic banks reached Rs194 billion at end June 2009 compared with Rs163 billion on June, 30 2008.

In terms of market share, total assets, financing & investment and deposits reached to 5.2 percent and 4.2 percent and 5.2 percent at end June 2009. Moreover, branch network of 6 full fledged Islamic banks and 12 conventional banks (having dedicated Islamic banking branches—IBBs) increased to 528 branches in June 2009 compared with around 326 branches in June 2008 (see **Table 3.2**).

Table 3.2: Islamic Banking Players (End-June)
(in number)

	2003	2004	2005	2006	2007	2008	2009
Islamic banks (operating)	1	1	2	4	6	6	6
a) Branches of Islamic banks	8	10	32	48	122	223	389*
Conventional banks operating Islamic banking branches	0	5	9	11	13	12	12
b) Total standalone Islamic banking branches of conventional banks	0	10	30	39	61	103	139**
Total Islamic banking branches (a+b)	**8**	**20**	**62**	**87**	**183**	**326**	**528@**

* Including 76 sub branches, ** Including 2 sub branches, @ Including 78 sub branches

To promote IF in Pakistan, SBP has formulated a comprehensive strategic plan for Islamic banking industry. Accordingly, IBIs are envisioned to expand their existing business and explore some new sectors like SME, Microfinance, and Agriculture. Further strengthening of the regulatory and Shariah compliance regime is also planned, primarily through adaptation of standards developed by international Islamic standard setting bodies like Islamic Financial Services Board (IFSB) & Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). The aim is to align the industry with the international best practices so as to enhance the credibility and international stakeholders' confidence in Islamic Banking efforts of SBP. It pleases to mention that SBP was ranked 2nd internationally for its efforts to promote Islamic finance in Islamic Finance news Poll 2008.

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:

Strengthening the Shariah Compliance Mechanism

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

- Phase wise adaptation of Shariah Standards of Accounting and Auditing Organization for the Islamic Financial Institutions (AAOIFI) is already underway. In the first phase, AAOIFI's Shariah Standard No.03 (Default in Payment by a Debtor), Shariah Standard No. 08 (Murabaha to the Purchase Order), Shariah Standard No.09 (Ijara & Ijara Muntahia Bittamleek) and Shariah Standard No.13 (Mudaraba), have been evaluated by SBP Shariah Board with a view to tailor them to the needs of local environment. The finalized Standards will be issued in due course.
- Considering the need and potential of Islamic banking industry, Shariah Standard on Sharikat ul-Milk has been prepared and evaluated by SBP Shariah Board. This Standard is applicable to all forms of joint ownerships, structured on the basis of Sharikat ul-Milk of asset or property excluding receivables and cash and cash equivalent. This Standard shall also be applicable to a Diminishing Musharakah based on Sharikat ul-Milk.
- A Shariah Advisory Forum (SAF)—comprising Shariah Advisers IBIs is working to resolve various Shariah concerns related to Islamic banking industry. Accordingly, different SAF Sub-committees have been formed for the purpose of evaluating the current practices such as those of Commodity Murabaha/Tawarruq, utilization of charity and its related issues in IBIs, practice of Hiba, etc.
- Also, in second phase of adaptation of AAOIFI Shariah Standards, SAF sub-committees for AAOIFI's Shariah Standard No.05 (Guarantees), AAOIFI's Shariah Standard No.06 (Conversion of a Conventional Bank to an Islamic Bank), AAOIFI's Shariah Standard No.10 (Salam & Parallel Salam) & AAOIFI's Shariah Standard No.11 (Istisna'a & Parallel Istisna'a) have been formed.

Islamic Financial Services Board Standards

- The Islamic Financial Services Board (IFSB), based in Malaysia, is an international standard setting body which aims at promoting the international Islamic financial industry through the issuance of Prudential Standards and Guidelines. Contributing towards the stability, transparency and a vibrant Islamic financial structure at international level, IFSB has issued Standards/Guidelines on various subjects, keeping in view the best international practices and Shariah compliance. SBP provided extensive support to IFSB's initiatives through participation in its various working groups and technical committees. The governor, SBP also held the position of chairperson of the council of IFSB in 2008.
- To strengthen risk management framework for IBIs, SBP has issued Risk Management Guidelines for Islamic Banking Institutions (IBIs) after customizing IFSB Standard—these guidelines are in addition to the risk management guidelines already issued for all banking institutions). These guidelines highlight the peculiar risks faced by the IBIs and recommends adequate risk management techniques. Similarly an impact study has been completed to facilitate the adaptation of IFSB Standard on Capital Adequacy. Moreover, SBP is also in the process of adapting IFSB Standard on 'Corporate Governance' in the light of feedback received from various stakeholders and available corporate governance structure.
- For adapting the IFSB Standard on 'Transparency and Market Discipline', a general recommendation report has been prepared keeping in view the current disclosure requirements. The report will be finalized in the light of feedback received from relevant SBP internal stakeholders. The guidance note on Key Elements of Supervisory Review Process issued by IFSB is also under study and a status report is being prepared to earmark the possible areas which may require regulatory focus

Issuance of SLR Eligible Sukuk

- In September, 2008 GoP issued its Ijarah Sukuk worth of Rs6.5 billion. This issuance has given Islamic banking industry a major boost by providing a risk free SLR eligible investment avenue. The step will go a long way in developing a well functioning Islamic capital market and Islamic money market. All Islamic banking institutions are eligible to participate in auctions.

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 AAOIFI with a view to adapt them in Pakistan. The committee has already prepared standards on Murabaha and Ijara.
- Keeping in view the representation of PBA subcommittee on Islamic banking regarding practical issues in implementation of Islamic Financial Accounting Standard for Ijarah (IFAS 2), all IBIs—through IBD Circular No. 1 of January, 2009—were asked to implement the said standard w.e.f January 1, 2009.

Capacity Building Initiatives

- Islamic Banking Department (IBD) aims at developing and promoting the Islamic banking industry as a parallel and compatible banking system in the country. Besides focusing on the introduction of Shariah compliant regulatory and supervisory framework, it gives due importance to the promotion of this growing industry through providing capacity building opportunities like intellectual sessions, knowledge sharing and awareness programs.
- **Seminar on Risk Management.** A seminar on risk management guidelines (based on Risk Management Standard issued by the Islamic Financial Services Board) was organized by

IBD at Learning Resource Centre, on September 1, 2008.The seminar was held to discuss various issues in implementation of these guidelines.

- **Lecture (on Takaful) for SBP officials.** Takaful is an emerging field in Pakistan; however it is relatively new concept for many people. On October 28, 2008 Islamic Banking Department conducted a half-day program for SBP employees, on 'Takaful' at LRC to create better understanding of the subject.
- **Islamic Banking Awareness program.** An awareness/ training program for officers of various departments of SBP was arranged from April 13-18, 2009. Various leading experts from SBP and the industry made presentations on various aspects of Islamic Banking.
- **Facilitation Workshops on IFSB Standards.** Islamic Banking Department arranged a three- day work shop on IFSB Standards in collaboration with Islamic Financial Services Board (IFSB). The workshop was held at Learning Resource Centre (LRC) from February 23 to 25, 2009 attended by large number of industry practitioners and representatives from SBP.
- **Lecture Session on 'Riba'. Elimination of interest/Riba** is central to the Islamic banking and finance. A lecture on Riba was arranged wherein distinguished Shariah scholar Justice (retired) Khalil ur Rahman shared his knowledge and understanding of Riba.
- **Standardized curriculum for various academic programs.** IBD has taken the initiative to develop a model course outline for Islamic banking and finance for educational institutions that are either offering or planning to offer Islamic banking and finance course at various levels like certificate, diploma, etc. The course out line has been sent to Higher Education Commission for their consideration and circulating the same to member institutions.
- **To address the queries raised by various stakeholders.** A document on Frequently Asked Questions (FAQs) on Islamic Banking was released in December 2008. The document answers various questions on Islamic finance. SBP officials are also conducting training sessions on Islamic finance at various forums across the country.

3.5 Vigilant Supervisory System

3.5.1 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. As a further development, the Quarterly Data File Structure (DFS) for Micro Finance Banks (MFBs) have been designed and deployed on portal which covers both hard copies of *Quarterly Report of Condition and e- Quarterly Report of Condition* prescribed for MFBs on quarterly frequency. MFBs have started parallel reporting on data acquisition gateway (DAG) Portal, which after parallel run will help discontinue submission of hard copy, required quarterly regulatory returns, by Sep-09. This will relieve the paper based reporting presently being made by MFBs and would save considerable time of both reporting institutions and SBP officials.

3.5.2 Automated Quarterly NPLs Reports

To bring improvement in NPLs data compilation, analysis and dissemination among stakeholders, SBP has automated MIS reports relating to Non-Performing Loans creating a link with the *Quarterly Report of Condition (QRC)* uploaded by reporting institutions (RIs) on DAG Portal. This will help reduce the time in preparation and dissemination of information on NPLs and the required corrective measures in this regard.

3.5.3 Liquidity Management Post September 2008

In early October 2008, the financial sector in Pakistan witnessed liquidity pressures as deposits from some of the banks were withdrawn beyond the normal historical trend, which is associated with the Ramadan and post Ramadan cash utilization. In the ensuing weeks some of the smaller banks came under liquidity stress and could not maintain their statutory liquidity requirements. Working vigilantly during this period, SBP assessed the position of individual banks on daily basis and besides providing input for various policy measures, including changes in Cash Reserve Requirement and Statutory Liquidity Requirement regime, engaged the management and board of the institutions, which were under pressure, for improving their situation. To this end other market participants were encouraged to ease out funding. Accessibility of the market participants to normal discount window of State Bank was improved and a lender of last resort facility, duly supported by the government of Pakistan, was instituted for smaller banks. Thus the timely and effective actions and policy initiatives resulted in improvement of the situation over next couple of quarters, and by the end of March 2009 all banks were comfortably compliant with statutory liquidity requirements.

3.5.4 Framework for Problem Bank Management and Contingency Plan

Learning from the financial stress witnessed in autumn 2008, the State Bank of Pakistan improved its internal processes for dealing with such situations. In this context based upon the already approved Problem Bank Management Manual, a framework for Problem Bank Management and Contingency Plan was prepared. The framework, in addition to the problem bank management policy, identification mechanism and supervisory responses, also incorporates the processes for emergency financing facility under lender of last resort, prompt corrective actions regime, and procedures for closure and liquidation of a bank. Bank take over procedures, sources and structure of information required during the crisis and host of other templates and checklists have been incorporated to facilitate the supervisory actions. It is expected that this experience would allow SBP’s supervisory team to better manage any stress situation in future.

3.5.5 Problem Banks Resolution

Over the period, SBP has strengthened its supervisory capacities and has put in place an overarching supervisory framework to closely and actively monitor the financial performance and health of financial institutions. Notwithstanding, there do occur episodes of mild to serious supervisory challenges testing the strength and effectiveness of the supervisory framework. The financial distress faced by The Bank of Punjab was one such episode during the year warranting urgent and timely intervention by SBP.

To rescue the bank, SBP initiated a comprehensive resolution process by fully engaging all stakeholders including the government of Punjab (GOPb) and the federal government because of the public sector status of the bank. Recognizing the weaknesses, GOPb changed the management and the Board of Directors of the bank. To recoup the financial health of the bank, SBP played its role in encouraging the government of Punjab, being the major shareholder, to inject a fresh capital of Rs10 billion.

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 on-site inspections of financial institutions, i.e., commercial and Islamic banks, Development Finance Institutions (DFIs), Microfinance Institutions (MFIs) and Exchange Companies under the jurisdiction of SBP. BID also prepares special reports on cases of written-off 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 course of on-site inspections.

During 2008-09, the department conducted full scope inspections of 35 banks/DFIs and 42 exchange companies (both A and B categories). In addition to the full scope inspection, the department has undertaken 3 IS inspections, 25 special inspections of banks/DFIs/exchange companies and handled numerous 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 been restructured to meet its objectives, i.e., to perform effectively under the given mandate, to better utilize the human resources, and to effectively oversee the level of emerging risks. The redefined structure of BID entails identifying and developing a resource pool in various specialized areas like Basel-II implementation, Sharia compliance, consumer banking and anti-money laundering. Dedicated teams have been constituted for conducting inspections of Islamic banks, Microfinance Institutions, Information System Audit and Treasury and Forex related assignments. Besides, the Department also provides assistance to Consumer Protection Department and other departments 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. A manual for conducting IS related inspections has recently been developed in-house to ensure accuracy, integrity and adequacy of the systems used by the banks and DFIs.

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. A group of officers was constituted to develop in- house expertise, who could conduct on-site inspection to assess the Basel-II implementation at banks/DFIs in line with SBP instructions.

3.6.4 Development of Inspection Manual and IT Tools for Evaluation of Consumer Finance Portfolio

BID has recently devised IT tools for assessing consumer finance portfolio of the banks, primarily to validate consumer loan classification process, identification of refinanced loans and multiple loans to a single borrower. These tools would further strengthen the inspection process and help in identifying the gaps/ deficiencies which exist in the control environment / systems of commercial banks. In addition, a manual has been developed for conducting inspection of consumer finance portfolio to streamline the inspection process.

3.7 Consumer Protection

Consumer Protection Department (CPD) has been established in 2008 to deal effectively with public grievances against banks/DFIs, and to prepare and review consumer protection policies and guidelines. The creation of CPD is a mandate of SBP to create/promote culture of social responsibility in financial institutions for amicably resolving disputes, thereby protecting the right of customers. During the period, the department handled about 8,000 complaints. Fair debt collection guidelines were issued in collaboration with BPRD.

The role of CPD is also important in sharing credit data with financial institutions through Electronic Credit Information Bureau (e-CIB). Online collection and dissemination of credit data from and to banks and financial institutions is meant to promote a sound credit culture, prudence and professionalism among financial institutions, adoption of best business practices and making informed and responsible lending decisions in timely manner. The rejuvenated e-CIB is practicing matching standards being pursued in more advanced financial centers around the world. The e-CIB database has now been capturing more than 5 million borrowers' records of more than 100 member financial institutions. Besides, an exclusive web enabled e-CIB help desk provides facilities to general public as well as financial institutions to lodge their complaints online. Host of new functions offered by the e-CIB help users get information in a variety of ways depending upon their specific needs. During the last year this department also arranged about 40 trainings for financial institutions about Credit Information Bureau.