3 Ensuring Soundness of Financial Sector

3.1 Overview

State Bank of Pakistan (SBP), as per its legal mandate, is entrusted with the responsibility of securing monetary stability and soundness of the financial system. The monetary policy objective of price stability includes financial stability as a secondary objective, which in turn ensures the soundness of financial system. Thus, SBP maintains financial stability in its dual role of being a central bank and regulator of the banking sector.

The existing financial stability assessment framework at SBP primarily focuses on the banking system stability. At the organizational level, ensuring financial stability is the integrated efforts of key functional groups in SBP. The organizational structure aimed at assessing and ensuring stability in the banking system includes Banking Policy and Regulations (BPR) group which continuously reviews the legal and regulatory framework and formulate policies in the light of recent developments and the needs identified through ongoing surveillance system. The Banking Supervision (BS) group conducts stability assessment of individual banks and assigns them risk-based ratings through both the onsite inspection and offsite monitoring. On macro economic front, the Monetary Policy & Research (MPR) group provides analysis of the developments and outlook for monetary and exchange rate management, which supports in making monetary policy and hence ensuring price stability.

The recent experience of financial crisis has spurred the regulatory authorities around the World to rethink the existing framework of financial stability and the role of central banks and regulators in ensuring financial stability. A number of areas emphasized include putting in place Macro Prudential Framework, strengthening the capital adequacy framework, review of provisioning requirements, strengthening of risk management systems and models, strengthening of stress testing techniques to capture the systemic risk and, improvement in disclosure requirements. SBP gives due importance to all these aspects and continuously strengthening its legal, regulatory, and supervisory framework to respond to these challenges and aligning its legal and regulatory framework with international best practices, codes, and standards. . To this end, it would be relevant to highlight that Pakistan complies with most of the Core Principles of Effective Banking Supervision while initiatives are already underway for ensuring the compliance with principles which are yet to be complied with.

In the wake of recent developments around the globe in the area of financial stability, SBP has taken the following measures in FY10 to ensure stability in the banking system.

3.2 Ensuring Stability of the Banking System

3.2.1 Strengthening of Capital Adequacy Regime

The State bank of Pakistan follows a policy of having large and well capitalized banks. In view of the global slowdown in growth and capital accumulation by financial institutions, the minimum Paid up Capital (free of losses) requirements for banks were revised downward in April 2009. And the locally incorporated banks were required to maintain minimum paid up capital (free of losses) of Rs 6 billion by December 31, 2009 and increase it gradually to Rs 10 billion by December 31, 2013. Banks and DFIs were asked to maintain a Capital Adequacy Ratio (CAR) of at least 10 percent. Growing regulatory capital requirements are primarily aimed at promoting sound, prudent, and solvent financial institutions. The risky nature of banking business especially in the context of financial crisis all over the world asks for more vigilant approach to regulate and monitor financial business. The higher capital requirements helped check the burgeoning growth of small and unfeasible financial institutions.

Despite slowdown in economic growth and bearish capital market conditions, the industry witnessed improved solvency during FY10. Some banks, which were short of MCR, met it through capital injection from their sponsors while more such investments are in pipeline. Some merger and acquisition transactions are also under process, when matured, will result in strong and solvent banks. The solvency ratio of entire banking industry remained in a comfortable zone at 14 percent in CY09. The CAR of majority of banks remained much higher than the required level of 10 percent which shows their capability to meet future challenges and achieve sustainable growth. A few banks, falling short of required CAR are under the prudent and continuous vigilance of SBP.

3.2.2 Developments in Implementation of Basel II

The capital adequacy regime in Pakistan was shifted to Basel II in June 2006. Starting with a parallel run of one and a half year, the capital requirement on the basis of Basel II simple approaches were made mandatory for all banks and DFIs operating in Pakistan from January 2008. However, the transition to advanced approaches was made discretionary in June 2008, and those institutions planning to adopt advanced approaches within the next five years were advised to submit their action plans to SBP. Further, to establish a mechanism of risk based capital assessment in the institution, guidelines on Internal Capital Adequacy Assessment Process (ICAAP) were issued in August 2008. Banks were given flexibility to adopt any available capital assessment methodology based on their size, nature, and complexity of the operations.

While the adoption of advanced approaches is still optional, SBP has been following a policy to improve internal risk management of banks. In this regard banks/DFIs were advised to put in place Internal Credit Risk Rating Systems and report the ratings of all corporate borrowers in eCIB. Similarly, in respect of consumer loans, banks were advised to start scoring of all obligors. The reporting of consumer scoring is mandatory since June 2010. Operational risk is another area of importance for SBP. And SBP is considering various options to help banks adopt sophisticated measures to assess and manage their operational risk.

The recent global financial meltdown has revealed a number of grey areas relating to regulation and supervision of financial institutions. Bank for International Settlement (BIS) and Supervisory authorities across the world are in the process of introducing a number of reforms to ensure overall financial stability. BIS has introduced minimum global standards for liquidity risk and strengthening the resilience of banking sector. The fully calibrated set of standards will be developed by the end of 2010 to be implemented by end 2012. The SBP recently conducted an impact assessment of the implementation of these proposals. The study revealed that our rules relating to capital adequacy are already quite conservative and adoption of these Basel II enhancements would not have significant impact on solvency ratios of our banks.

3.2.3 Consolidated Supervision: Needs and SBP Efforts

Since the financial liberalization program in early 1990s, Pakistani financial sector and institutions have transformed significantly. A number of private sector financial institutions were allowed entry into the financial market and leading public sector banks were privatized. Due to paucity of capital and entrepreneurs skills, these new banks and privatized banks were acquired by well-established Pakistani entrepreneurs and foreign investors. The last decade or so is also marked with a significant merger and acquisition activity in the financial market; since 2000, more than 40 transactions of mergers and acquisitions have taken place. Resultantly, a number of banks/ DFIs and their controlling groups now have presence in the areas where the banks hitherto were not active because of either regulatory restriction or lack of interest on their part. These areas include leasing, insurance, asset management, brokerage, and other non-banking finance services where banks or their groups operate essentially through separate entities. Different groups controlling 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. Moreover, a limited degree of universal banking is also being carried out by banks as they engage in leasing and investment banking activities. This diversified spectrum of business activities and ownership structures give rise to different risks and supervisory concerns, including the following:

Any shock to one group entity could jeopardize the stability of a bank/DFI both as direct financial impact or reputational damage. Such other group entity could be a subsidiary of the bank (downstream of risk) or parent of the bank or affiliate under the control of the parent (upstream risk).

- Bank/DFI together with other group entities could take exposures on single borrower, borrowing group, or sector that are beyond prudential limits or the banking group could adopt a risky asset-liability profile.
- Complex ownership and corporate structures could lead to ambiguity about the roles and responsibilities of different key proprietors and managers.
- 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, i.e., a group could shift more risky business activities to such group entities which are subject to less stringent regulatory regime.
- Non-arm length dealings in intra group transactions that could be detrimental to a group's bank and its depositors.

Realizing these challenges which the present corporate structure poses and for ensuring compliance with one of the Core Principles of Effective Banking Supervision (Principle No. 24 – Consolidated Supervision), the State Bank initiated a project for the consolidated supervision of banks. A framework was internally drafted by SBP in 2007-08 which was extensively discussed at different forums including banks. The framework along with proposed amendments in legislations was shared with Ministry of Finance and Securities & Exchange Commission of Pakistan (SECP). Later on, senior management of the SBP, SECP, and consultants from key regulatory bodies of a number of other countries had extensive deliberations about this. In the light of these discussions, necessary arrangements are being made for the consolidated supervision of banks and financial institutions in Pakistan. SBP has also signed an MoU with SECP for, inter alia, sharing information and regulatory expertise. To carry out consolidated supervision of banks and financial institutions, a dedicated joint task force has been established. The task force regularly monitors the risks posed by conglomeration in the financial sector and contemplates collaborative actions on the part of the SBP and SECP for managing such risks. The objectives and functions of the task force ensure the consolidated supervision of banks in line with some key essentials of effective consolidated supervision. The task force has the mandate to:

- Provide a dedicated forum for the exchange of regulatory information and expertise.
- Examine the ownership structure of financial industry and identify leading financial conglomerates which also own a bank and map their corporate structures.
- Monitor banking groups and their entities on regular basis to keep abreast of the health of the entire group.

- Whenever any signs of such stress emerges in any part of the group that could affect the stability of the bank or other group entities, activate mutual discussion and contemplate joint action for managing the risk on proactive basis.

3.2.4 Stress Testing

To assess resilience of banks towards exceptional but plausible shocks, SBP has been conducting sensitivity based stress testing using individual bank's portfolio since year 2004. In year 2005, it was made mandatory for all banks to conduct sensitivity based stress testing of its financials[1]. While sensitivity analysis provides quick but crude assessment of the impact of shocks on the financial position ignoring the inter relationships among the financial and macro economic variables in which the financial institution operates, scenario analysis fairly accounts for the impact of these interrelationships reflecting business cycle movements. Scenario analysis, though is complex and takes time, gives more reliable results. Realizing the importance of scenario analysis, SBP started Macro-stress testing of Credit risk to assess the resilience of the banking system towards credit shocks since June 2008. The models used for analysis forecast default rates for the quarter ahead. The stress testing expertise which were developed in- house was also shared with other regional countries and officials conducting stress testing trainings for capacity building of Nepal Rashtra Bank and Bangladesh Bank.

3.2.5 Risk Management

To establish a robust and comprehensive risk management framework in the banking industry, State Bank of Pakistan has taken the following policy measures:

a. New Disclosure Requirements and Internal Controls Over Financial Reporting-(ICFR)

Disclosure requirements were further refined in response to the changing risk environment. As per requirements of the revised International Accounting Standard (IAS-1), the banks are required to prepare quarterly, half yearly, and annual financial statements w.e.f. June 30, 2010, based on two statement approach for preparation of Profit and Loss Account (separate 'Profit and Loss Account,' and 'Statement of Comprehensive Income.'). The banks were advised to include the Surplus / (Deficit) on Revaluation of Available for Sales Securities (AFS) only in the 'Statement of Comprehensive Income'. However, the same shall be shown separately in the Balance Sheet, i.e., Statement of Financial Position below the equity. Balance Sheet was also renamed as 'Statement of Financial Position'.

To strengthen the control regime in respect of financial reporting, banks have been advised to submit a detailed review report on Internal Control over Financial Reporting (ICFR) for the quarter ended September 30, 2010 by October 31, 2010 to SBP. The report is to be duly approved by the respective 'Audit Committee' or 'the Board of Directors'. This review report shall discuss in detail all the stages of compliance with the road map earlier issued by the SBP to comply with reporting on adequacy of ICFR, identify gaps, and state the remedial measures taken and results of testing of controls. Furthermore, the statutory auditors of the banks/DFIs are now required to submit to SBP a 'Long Form Report', through the management of respective bank / DFI for the year ending December 31, 2010, instead of expressing opinion on ICFR in the annual financial statements.

[1] SBP issued Stress Testing Guidelines in year 2005 for conducting sensitivity stress testing. (See BSD Circular 7 of 2005).

b. Strengthening the loan Classification Provisioning Requirements

To enhance the resilience of the banking system, State Bank of Pakistan further strengthened the loan classification and provisioning requirements through gradual withdrawal of the benefit of forced sale value (FSV) of collateral to keep buffers for bad times. In response to the recent credit deterioration, SBP rationalized the provisioning requirements by making the FSV buffers available to the banks to ease off the pressures arising out of the building credit risk. During the period under review banks were allowed to avail the FSV benefit of collateral to the extent of 40 percent of FSV of pledged stock and mortgaged residential, commercial and industrial properties (land and building only) held as collateral against NPLs for three years from the date of classification for calculating provisioning requirement w.e.f. September 30, 2009. Later on, in June, 2010 it was decided to extend the benefit of Forced Sale Value (FSV) of mortgaged residential/commercial/industrial land (open plot, and where building is constructed separate valuation of land must be available) held as collateral against NPLs, from three years to four years from the date of classification of that particular loan / facility. However, this benefit would be available in such cases where FSV valuation of land is not more than four years old.

c. Deposit Protection Scheme

Financial liberalization program has significantly changed the ownership structure of banking system over the last two decades. Because of denationalization of state owned banks coupled with entry of new private banks, 80 percent of the banking system's assets are now owned by private sector banks. This development has almost neutralized the protection that was available to depositors under the Bank Nationalization Act, 1974, thus leaving the safety of deposits in case of bank failure to an arbitrary and implicit deposit protection mechanism.

Realizing this scenario and the importance of a formal explicit deposit protection scheme, SBP initiated a project for constituting an effective explicit deposit protection framework in 2008. In this regard, a 'concept paper' on the subject was developed, and the scheme was prepared after consultation with the stakeholders. Moreover, 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. The system is expected to remove any likely burden on taxpayers who could have to arrange bailout package in case of a bank failure as now the participating banks will contribute towards the fund through regular premium payments.

3.3 Strengthening Legal Framework

3.3.1 Anti-Money Laundering/ Countering the Financing of Terrorism

The Anti Money Laundering ordinance was promulgated in 2007 through a Presidential ordinance. Pursuant to the Supreme Court's orders, the said ordinance was enacted as AML Act 2010, as an act of Parliament. Therefore, the law attained permanent status.

The Asia Pacific Group on Money Laundering (APG) conducted Mutual Evaluation of Pakistan in 2009 to assess overall efficacy of legal, law enforcement, and financial regulatory regime to counter money laundering and terrorist financing in the country. The evaluation report was adopted after extensive deliberations in annual meeting of the body in July 2009. State Bank of Pakistan actively contributed during and after evaluation. As a part of the APG's recommendations and with the view to further improve the regulatory requirements, State Bank has issued instructions to banks including supply of timely records to law enforcement agencies and taking action against account holders who fail to furnish identity documents for establishing and maintaining business relationship with banks. New CNIC were demanded and acquired from all account holders and only three percent active accounts remained without new CNIC as of February 2010. The banking industry was asked to resolve issues through mutual suggestions and consultations. To this end, two Compliance Forum meetings were organized to streamline the process of actions under UNSC Resolutions, reporting of STRs, installation and development of monitoring software, and training of banks' staff.

3.3.2 Enhanced Focus on Corporate Governance

SBP has always strived to strengthen the corporate governance regime to cope with the changing pace of banking business. And the recent corporate governance scams throughout the world in the wake of global financial crisis has furthered the need. . The Prudential Regulations on Corporate Governance are being reviewed in line with international principles and best practices including the broader scope of Fit and Proper Test (FPT) requirement which now, inter alia, require from Pakistani banks to seek prior clearance from SBP under the FPT Criteria for appointment of key executives for their overseas operations. The due diligence procedure for directors, sponsors, and chief executives of the banks/DFIs has been further strengthened. Moreover, banks/DFIs have been provided flexibility regarding payment of remuneration to their non-executive directors for attending board/committees' meetings enabling banks/DFIs to appoint high caliber professionals for best strategic input in corporate affairs of the bank with optimal time commitment.

3.3.3 Privatization and Restructuring of Banks

Government of Pakistan and SBP are actively pursuing privatization of public sector institutions to enhance their competitiveness and operational efficiency, enlarge the ownership base, restrict government participation in business activities, ease drag on budgetary resources, enhance their revenues and utilize the sale proceeds for retirement of national debt and poverty alleviation. Keeping in view these objectives Privatization Commission has a timetable for privatization of banks as well as enterprises in other sectors. Recently in 2009, the government announced its new privatization policy, i.e., encouragement of public private partnership through sale of 26 percent shares with management control.

As a part of GoP's privatization plan, privatization of SME bank was initiated in 2006 by the Privatization Commission. The transaction was expected to be completed by the end of 2008; however, due to global financial crisis the transaction could not be executed on time. In 2009 it was decided by all the stakeholders that SME Bank needs restructuring prior to its privatization. In view of the new strategy, SBP in consultation with MoF has streamlined the modalities of restructuring, which are actively pursued.

SBP is also engaged in the restructuring /recapitalization transaction of FWBL with Ministry of Finance (MoF). Recently the GoP showed its intention to keep FWBL as a public sector institution by buying back shares from private shareholders of FWBL, through SBP. The modalities of this new strategy are being reviewed.

After corporatization of HBFCL, its financial restructuring is underway and a time bound transformation Plan is under active consideration of the stakeholders. The plan envisages ultimate privatization of HBFCL after completion of its financial restructuring. Whereas the restructuring proposals require GoP's financial support on account of VSS cost, payment of HBFCL's claim by the government and rescheduling/debt-equity swap of SBP's credit lines to HBFCL. As a first step, HBFCL has commenced initial phase of VSS for permanent employees, whereas HBFCL's proposals on rescheduling/debt-equity swap of SBP credit lines, is being reviewed by SBP.

3.3.4 Mergers and Acquisitions in the Banking Sector

Among the recent transactions, Telenor Pakistan has acquired majority shareholding of Tameer Microfinance Bank Limited. KASB Capital Limited and Network Leasing Corporation Limited were merged into KASB Bank Limited. SBP has allowed acquisition of majority shareholding in Arif Habib Bank Limited and Atlas Bank Limited subject to the condition; the two banks shall be merged into one banking company. The acquisition of RBS Pakistan by Faysal bank Limited and proposed merger of Albaraka Islamic Bank (Pakistan operation) and Emirates Global Islamic Bank Limited are under consideration.

3.3.5 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 banks and their branches whereas licenses for Microfinance banks and their branches are issued under the Microfinance Institutions Ordinance, 2001. Based on the aforementioned legal framework, State Bank of Pakistan has introduced a comprehensive branch licensing policy (BLP) allowing the banks to independently make their branch location decisions within broad parameters. The mainstay 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 8729 to 8999 showing a growth of 3.10 percent. In the same period total number of Islamic bank branches increased from 528 to 667 showing a growth of 26.33 percent. The total number of microfinance bank branches increased from 268 to 287 showing a growth of 7.09 percent.

3.3.6 Branchless Banking

State Bank of Pakistan is actively promoting branchless banking (BB) to radically reduce the cost of delivery of services and increase convenience for customers and expand coverage to new, previously unbanked/underserved segments of the population. Technology can help a range of market players including commercial banks, microfinance banks, Islamic banks, mobile phone operators, and technology companies to push the boundaries of access to finance.

Branchless Banking Regulations were issued by SBP in 2008 as part of the broader strategy to create enabling regulatory environment to promote Bank-led Model of BB. SBP allowed Tameer Microfinance Bank easypaisa and United Bank's OMN-I whereas First Microfinance Bank's model has been conjoined with Pakistan Post. Dubai Islamic Bank has also been allowed to start branchless banking at convenient public locations. On the other hand, SBP, to encourage innovation and use of alternate delivery channels allowed MCB Bank, KASB Bank, and Habib Bank to offer Mobile Phone Banking to their existing account holders.

3.4 Status of Islamic Banking in Pakistan

Islamic banking in Pakistan has shown tremendous growth since its re-launch in 2003. The total assets of Islamic Banking in Pakistan have reached Rs 411.1 billion in June 2010 compared to Rs 313 billion in June 2009—a growth of 31.1 percent. The deposits of Islamic banks have grown at even faster pace of 38.5 percent to reach Rs 329.8 billion in June 2010. The financing and investment portfolio grew at 21.5 percent reaching Rs 235.5 billion. As shown in Table 3.1, despite a continuous increase in size, the growth rates have maintained high levels since 2004, which is indicative of increasing acceptability of Islamic banking as a viable alternative to conventional banking. The share of the industry also increased to more than 6 percent with deposits reaching 6.4 percent of the total banking system. .

The number of Islamic banking institutions (IBIs) also increased to 19. Six are full-fledged Islamic banks and thirteen conventional banks have Islamic banking branches and windows. The branch network reached 667 branches. The growth in branches was shared evenly by the full-fledged Islamic banks and conventional banks having Islamic banking branches (see Table 3.2).
The growth momentum despite slowdown in overall economic activity during the last couple of years gives optimism about the industry's ability to achieve 12 percent share in next 2-3 years as envisaged in the Strategic Plan for Islamic Banking Industry in Pakistan.

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	54.0
Growth	188.0	184.0	187.0
Jun-06	59.7	57.9	87.6
Growth	58.0	56.0	62.0
Jun-07	107.4	89.2	157.9
Growth	80.0	54.0	80.0
Jun-08	163.1	163.4	229.6
Growth	52.0	83.0	45.0
Jun-09	238.2	193.8	313.0
Growth	46.0	18.6	36.3
Jun-10	329.8	235.5	411.1
Growth	38.5	21.5	31.3

P: Provisional Data

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

	2003	2004	2005	2006	2007	2008	2009	2010
Islamic banks (operating)	1	1	2	4	6	6	6	6
a) Branches of Islamic banks	8	10	32	48	122	223	389	479
Conventional banks operating Islamic banking branches	0	5	9	11	13	12	12	13
b) Total standalone Islamic banking branches of conventional banks	0	10	30	39	61	103	139	188
Total Islamic banking branches (a+b)	8	20	62	87	183	326	528	667

3.4.1 Initiatives Taken by SBP to Promote Islamic Banking

During the year under review, SBP took the following initiatives for promotion and development of the Islamic banking industry in the country.

- **Adoption of Shariah Standards**
    - Standardization and harmonization of Shariah practices within the Islamic Banking Institutions (IBIs) in Pakistan is a key objective of Islamic Banking Department. In this regard 'Essential of Islamic modes of financing' and related Model agreements were issued in 2005 as minimum requirements for Shariah compliant products. These general guidelines were later on made compulsory in 2008 with the advice that 'For the Islamic modes for which essentials have not been prescribed; AAOIFI Shariah standards may be used as guidelines by IBIs in consultation with their Shariah Advisers'.
    - The AAOIFI Shariah Standards are also being reviewed for adoption in Pakistan. During the year four AAOIFI Shariah Standards were adopted. These include AAOIFI's Shariah Standards No.3 (Default in Payment by a Debtor), No.8 (Murabaha to the Purchase

Orderer), No.9 (Ijarah & Ijarah Muntahia Bittamleek) and No.13 (Mudaraba). These standards are effective from July 1, 2010.

- These standards were adopted after a thorough review which included consultation with IBIs, Shariah Adviser Forum (SAF), different SBP departments and SBP Shariah Board.
- In the next phase, Shariah Standards on Sharika (Musharaka) and Modern Companies, Investment Sukuk, Guarantees, Conversion of a Conventional Bank to an Islamic Bank, Salam and Parallel Salam, Istisna'a and Parallel Istisna'a, will be adopted.

- **Criteria for conversion of conventional banking branches into Islamic banking branches**

Considering the growing interest of conventional banks, having Islamic banking operations to convert their branches into Islamic banking branches, SBP issued detailed criteria for conversion. The conversion criteria are likely to streamline the process and facilitate conventional banks in conversion of their existing conventional branches into Islamic banking branches.

- **Islamic Financial Services Board Standards (IFSB)**
  - SBP is effectively coordinating with IFSB on various supervisory and regulatory aspects. SBP is working closely with IFSB in its various Working Groups, Technical Committees and work related to the Council of IFSB. These coordinated international efforts are likely to create a better enabling supervisory and regulatory environment for Islamic finance to progress.
  - IFSB Exposure drafts on Practices for Smoothing of Profit to PLS Account Holders and Guidance Note in Connection with the Risk Management and Capital Adequacy Standards: Commodity Murabaha Transactions were reviewed in consultation with Islamic banking industry. Feedback was sent to the IFSB.
  - SBP is actively participating in development of Guidance Notes for Stress testing of Islamic Financial Institutions (IFIs) and liquidity risk management. The GNs will strengthen the regulatory and risk management framework for IFIs, making the Islamic financial system more sound and stable.
  - Coordinated with IFSB to conduct a Study on Displaced Commercial Risk and provided facilitation to conduct a survey on Islamic capital markets.

- **International Islamic Financial Markets (IIFM)**

SBP is also a founding member of IIFM, a Bahrain based institution focusing on development of liquidity management solutions and standardization of documents for hedging transactions. SBP sits on the IIFM Board and actively participates in setting its strategic direction. The IIFM during the year issued Master Tahawat (Hedging) Agreement (TMA) to facilitate the member countries/organizations to undertake Tahawat transactions. The next step is development of Master Agreement for profit rate swaps and currency swaps; SBP is actively engaged with IIFM in these projects as well.

The IIFM will organize a workshop in Pakistan in October/November 2010 in collaboration with SBP to orient the financial sector of Pakistan with the TMA and the profit rate and currency swaps.

- **Awareness Campaign**

Lack of awareness is one of the key impediments in growth of Islamic finance; the awareness creation accordingly is an important function of Islamic Banking Department (IBD). During the year, a comprehensive awareness program was formulated to improve awareness about Islamic banking in the country. The major elements of the program were:

- Orientation Program for SBP Departments
- Orientation Programs for Senior Management of Conventional Banks and SBP
- Orientation Sessions for Business Community
- Partnership with SBP (BSC) Bank to utilize its field network for creating awareness
- Orientation Program for Academia
- Orientation Program for Government Departments & Agencies
- General Public

For the SBP and conventional banks' senior management dedicated sessions of 2-3 hours with prominent Shariah scholars/Islamic banking professionals/ SBP Shariah Board members have been planned. IBD successfully conducted sessions with prominent scholars like Dr. Umer Chapra and Dr. Zamir Iqbal.

None of the initiatives discussed above can be successful if business community is not convinced with the Islamic banking practices as genuine and truly Islamic and also feel some business sense/advantage in banking with Islamic banking institutions. Under the partnership with SBP (BSC) the BSC field offices are mandated to reach to the business community across the country. The field offices of SBP-BSC are being utilized and a formal partnership has been developed with SBP-BSC to promote/propagate Islamic banking in their respective regions. Further, to strengthen the consultative mechanism at the grass roots level, Islamic banking focus groups are being created in BSC offices. These groups will be instrumental in giving a flip to the awareness creation efforts besides being a good platform for collecting feedback on SBP initiatives for Islamic finance. Orientation sessions for local chambers of commerce, trade and industrial associations, agriculture communities, banking industry (both conventional and Islamic) are being arranged.
Sensitizing the Academia (the students' faculty) about the emerging Islamic banking industry would not only create demand for IB related courses/certificate/degree programs in educational institutions but would also significantly improve Islamic banking literacy. Thus, the academia is a key segment of the awareness campaign; linkages with the reputed educational institutions across the country are being developed through SBP (SBC) for the purpose.

- **Other Measures**
- **Exposure Draft on Accounting standard for PLS depositors**

The department worked closely with ICAP to develop Exposure Draft (ED) on Accounting Standard for PLS depositors. The Exposure Draft has been prepared and currently it is circulated for the comments of the respective stakeholders. The ED will be reviewed /finalized in the light of feedback from the industry to finalize the same as Accounting Standard.

3.5 Vigilant Supervisory System

3.5.1 Online Submission of Returns

State Bank of Pakistan continued to improve its various supervisory processes and took the following initiatives during the review year:

1. Quarterly Data File Structure (DFS) for Micro Finance Banks (MFBs) covering both hard copies of Quarterly Report of Condition and e- Quarterly Report of Condition was automated under Reporting Chart of Accounts (RCOA) from Sep-09 quarter reporting. This has helped in relieving the paper based reporting and has saved considerable time of both the reporting institutions and SBP officials.

2. To ensure timely dissemination of data to all concerned stakeholders, SBP decided to further shorten deadline for submission of quarterly DFS under RCOA w.e.f. December 31, 2009. The Banks/ DFIs are now required to upload their quarterly data through Data Acquisition Gateway (DAG) Portal within 18 working days from the end of each calendar quarter instead of 30 days. This shortened deadline has helped all the relevant departments in generating various MIS reports and dissemination of the relevant information to external stakeholders in a timely and efficient manner.

3.5.2 Revised Off-Site Rating Structure for Microfinance Banks (MFBs)

1. State Bank of Pakistan, in its endeavor to further improve offsite supervision mechanism for Microfinance Banks, took initiative to review the offsite rating framework of MFBs developed by International Consulting Consortium INC in 2006. A thorough study of the existing system was carried out which identified various areas for improvement. Comprehensive analysis of all the identified areas was done and improvements were suggested.
2. Review of literature of United Nations Development Programme (UNDP), Asian Development Bank Institute (ADBI), Consultative Group to Assist the Poor (CGAP), and Microfinance Information Exchange (MIX) was carried out. After review of the literature, some common analytical tools were identified for assessment of financial and non-financial areas of the MFBs. Analytical tools already in use were also aligned as per definitions.
3. Finally, a revised Off-Site Rating Framework was developed featuring comprehensive assessment mechanism, uniform and multidimensional data presentation, availability of CAELS ratings for all quarters and easier sharing of data with other stakeholders. The objective and subjective assessment mechanism is largely based on system generated data, new ratios with realistic benchmarks and peer analysis.

3.6 Proactive Inspection

Banking Inspection (on-site) Department (BID) operates with the mission ‘to strive for soundness and stability of the financial system and to safeguard the interest of stakeholders through proactive inspections compatible with best international practices in keeping with changing global environment in financial sector.

Main functions of the BID are to conduct on-site inspections of financial institutions, i.e., Banks, Development Finance Institutions (DFIs), Micro Finance Institutions (MFIs), and Exchange Companies. BID also prepares special reports on write-off cases of loans & advances and carries out other special investigations on requests and complaints received from internal and external stakeholders and customers.

3.6.1 Inspection Plan

Banks

The inspection plans were carried out from July 1, 2009 to June 30, 2010. The department completed on-site inspection of 35 banks/joint ventures/specialized institutions during the year.

Exchange Companies

The exchange companies division of the department completed on site inspection of 40 exchange companies during the year.

Complaints

The department received a total of 68 complaints during the year. Out of the total complaints received, 50 complaints were disposed off during the year.

3.6.2 Developmental Projects

The department initiated a number of developmental projects as well as updated the existing inspection documents which are at the final stages. The following are some of the major developments:

- The department has been conducting Information System (IS) inspections of the banks and Exchange companies. The IS and exchange companies manuals have been prepared to further streamline the inspections.
- The department prepared checklists for foreign exchange inspections.
- Updation of checklists for various components of the CAMELS inspection system.

3.6.3 BASEL-II unit

The BASEL-II unit, established in the department in 2007 to oversee the implementation of capital accord, carried out activities which helped financial institutions in understanding the mechanics of the accord as well as overseeing their transition to more advanced approaches. The unit prepared and performed the following activities assisting its onsite inspectors:

- Checklists for capital adequacy chapter
- Guidelines for capital charge on ‘credit risk in standardized approach’
- Pre-inspection memo templates, specifically, for writing capital adequacy chapter
- Guidelines for calculating Horizontal and Vertical disallowance under Market Risk charge
- Providing continuous back end support to on site teams
- Conducting on site inspection with regard to capital adequacy

Besides, the unit developed and conducted training on ‘Inspection of Capital Charge for Credit Risk under Basel II Standardized Approach.

3.7 Consumer Protection

Maintaining Financial Stability and Confidence

In the past decade, a conscious effort has been made at the policymaking level to follow incremental approach to reorganize fiscal and regulatory regimes relating to consumer financing. This policy shift in market segmentation regarding delivery of credit by banks, lending mainly to government and public sector, trade financing, and corporate sector, has helped create a better environment for consumer financing by banks. Thus, consumer financing in the form of mortgage financing, auto financing, credit cards, personal loans, and consumer durable loans expanded exponentially. Given its commitment to increase access to financial services for the underserved, consumer and small business finance is of great significance to SBP. Growing consumer and SME lending have led to rising financial disputes between the banks and their borrowers/customers. There was a need to create a well defined complaint and dispute resolution mechanism to enhance public confidence in banking system. Towards this end, a dedicated Consumer Protection Department (CPD) has been established in SBP for speedy resolution of public grievances against banks. Further, in terms of Section 82(E) of the Banking Companies Ordinance, 1962, CPD is also mandated to decide the appeals filed against the decisions of Banking Mohtasib Pakistan (BMP). The CPD at SBP is moving from reactive to proactive approach in protecting consumers' rights in the context of:

Table 3.3: Complaint Handling
in number

Category Name	Complaints
ATM/debit cards	77
Auto finance	87
Credit card irregularities	291
Delay in remittances/collection/clearing	72
Fraud & forgeries	161
Mortgage finance	5
Loans/advances	530
Misbehavior/misconduct	247
Operation of PLS/deposit account	288
Pension problems	67
Personal loan	23
Service charges	81
Staff matters	148
Miscellaneous	3,063
Total	**5,140**

- effectively dealing with public grievances against Banks/DFIs.
- promoting culture of social responsibility in financial institutions for amicably resolving disputes.
- formulating and reviewing consumer protection policies and guidelines.
- assist financial institutions in credit risk management through providing online access to Electronic Credit Information Bureau (eCIB) database.
- educating consumers to deal proactively with financial matters.

During the year 2009-10, more than 5,000 complaints were received and handled. These related to ATM/Debit Cards, auto finance, credit cards, fraud and forgeries, mortgage finance, loan and advances, misbehavior/misconduct, operation of PLS/deposit account pension problems, service charges, staff matters, etc. Further, 46 appeals against the decision of Banking Mohtasib Pakistan were received out of which 19 were disposed off during the year, while 27 are still under investigation.

Promoting Public Understanding

The department is also embarking upon a mass consumer awareness program. As per roadmap developed for the purpose, an exclusive webpage containing information relating to deposit and loan product, handling and safe keeping of ATM/Debit/Credit Cards, Glossary of banking terminology and Identity theft and tips to avoid internet frauds and electronic scams will be made part of SBP website. Further, complaint filing and handling procedure, consumer help desk and Frequently Asked Questions (FAQs) will also be found on this webpage. A consumer awareness campaign will be launched in print media. Consumer protection related instructions will be published in print media for creating awareness among general public.

Electronic Credit Information Bureau (eCIB)

SBP's role is also very critical in assisting the banks and financial institutions in instituting strong credit risk management systems. Having access to eCIB database, all banks and member financial institutions have now been able to achieve higher accuracy in risk prediction, fraud and loss prevention thereby promoting strong credit culture. Since its inception in 1991, eCIB has been continuously improving its operations in line with best international credit sharing practices and growing business requirements. The eCIB at SBP has now evolved itself into a very sophisticated and hi-tech entity, using state-of the-art technology to perform its crucial functions more efficiently. The strengthened capacity and improved operational efficiency has enabled the Credit Information Bureau to capture more than 5 million borrowers' records, irrespective of any loan limit, of its 101 member financial institutions. During the year 2009-10, about 1.4 million enquiries were made by the member financial institutions and about 2,857 complaints/disputes relating to eCIB data reporting were taken up with the reporting financial institutions and were resolved.

As a part of continued system development and enhancing the scope of reported information, eCIB started gathering information on corporate borrowers' facility rating and individual borrowers' rating. The incorporation of two additional fields in eCIB system software is meant to strengthening the risk management functions in banks/DFIs. The importance of such mechanism necessitates that all financial institutions should have carefully designed risk rating systems to strengthen their overall risk management framework.