4 Exchange Rate and Reserve Management

4.1 Debt Market

In accordance with the broad objective of improving the liquidity in the debt & capital markets, State Bank of Pakistan continued its efforts to develop the Marketable Government Securities debt market in Pakistan with special focus on broadening the investor base. In this regard, SBP has taken many initiatives for the development of debt market in Pakistan (see **Box 4.1**).

Box 4.1: SBP Initiatives to Expand the Government Securities Debt Market in Pakistan

To expand the investors' base and establish the Marketable Government Securities debt market, SBP has taken the following initiatives during FY12:

1) Marketing Campaign of GoP Securities: SBP launched a marketing campaign, in consultation with Ministry of Finance, to create awareness about government securities among the retail/small investors. Campaign was comprised of the following:

- Advertisements were published in leading newspapers of the country which explained the salient features of government securities and operational details for investment therein.
- To further augment the impact of media advertisement, State Bank of Pakistan published the investor guides for all government securities i.e. Market Treasury Bills, Pakistan Investment Bonds and GOP Ijara Sukuk. The guides are available in the main branches of Primary dealers, offices of Chamber of Commerce, offices of foreign missions abroad and SBP website. These investor guides provide complete information to the investors about features, investment procedure and benefits of investing in government securities. The Investor Guide also provides guidelines for non-resident investors on how to invest in GoP Securities.

2) Strengthening the Primary Dealer System: Under this initiative, rules governing PD system have been revised whereby PD's role and obligations towards development of government securities market have been further strengthened. Now, each PD is required to:

- Provide the complete information regarding process, methodologies, charges and forms required for investment in government securities, on their official websites.
- Keep the service charges related to IPS account activities, at reasonable level.
- Display prices of government securities in their branches.
- Quote two-way prices on Electronic Bond Trading Platform (EBND) and generate at least 50 percent of its trading volume with other PDs on this platform.

These steps will ensure that investors can invest in government securities without incurring high transaction costs. Investors will also have complete and updated information which is necessary for informed decision making about investment in government securities.

To encourage and incentivize the PDs to distribute government securities to retail investors, they will be paid commission @ 10 paisa per Rs. 100 for accepted non-competitive bids of Individuals/Employee, Provident & Pension Funds/Corporate except Asset Management Companies, Mutual Funds, Insurance, Modaraba and leasing companies.

These initiatives would further increase the share of non-bank investors in government securities. So far, SBP efforts have produced encouraging results as the non-bank holding of government securities have increased from 797.0 billion as of June 30, 2011 to 1,016.1 billion as of March 31, 2013.

Cash Reserve Requirements (CRR) and Statutory Liquidity Requirements (SLR)

In order to reduce wastages of reserves and to give more flexibility to banks in their liquidity management, the process of maintaining required reserves was rationalized the process of maintenance of Cash Reserve Requirement (CRR) was rationalized by extending the reserve maintenance period from one week to two weeks and reducing the daily CRR from 4 % to 3%.

Under the revised process, banks have been advised to maintain CRR, during the period starting from Friday and ending on Thursday of subsequent week, by taking into account the Time and Demand

Liabilities as of close of business on Friday i.e. first day of reserve maintenance period. This process has improved liquidity management of banks by providing more time to adjust their reserves thus reducing the excess reserves held by the banks and less access to SBP standing repo/reverse repo facility. For consistency purpose, similar practice has also been introduced in SLR maintenance process.

Authorized Derivative Dealers (ADD)

ADD status was given to Faysal Bank Limited during the year after detailed scrutiny of their systems, controls and capability to work as an ADD. Bank of Tokyo Mitsubishi UFJ has been given status of "Non-Market Maker Financial Institution" (NMI). However, its activities are restricted to FX Options only. With the appointment of FBL, now there are six banks in Pakistan which are working as ADD.

Currency Swap Arrangements (CSA)

State Bank of Pakistan has developed a framework of executing bilateral currency swap arrangements with the regional central banks in the respective local currencies with the objective of boosting bilateral trade and investment in local currencies.

As a result, a bilateral CSA was concluded on November 1, 2011 between State Bank of Pakistan (SBP) and Central Bank of the Republic of Turkey (CBRT) in Pakistan Rupee / Turkish Lira, with size amounting to US$ 1 billion in equivalent local currencies. Similarly, a landmark CSA was signed between SBP and the People's Bank of China on December 23, 2011 amounting to Chinese Yuan (CNY) 10 billion and PKR 140 billion. Tenor of both the agreements is 3 years.

The objective of the currency swap is mainly to promote bilateral trade between the two countries in the respective local currencies. Since the CSA is a bilateral financial transaction, all terms & conditions apply equally to both countries and the pricing is based on the standard market benchmarks which are widely acceptable in the respective domestic markets.

Both the CSAs have now been implemented and SBP has issued necessary instructions to banks for its implementation after due consultations with various stakeholders and completion of operational formalities with the respective central banks.

Currency Swap Agreement between the two Central Banks gives a positive signal to the market on the availability of liquidity of other country's currency in the onshore market. The arrangement will augment the pool of liquidity available to finance bilateral trade between the two countries, supplementing the already available sources of liquidity. By virtue of this arrangement, SBP will have the ability to draw on the swap line and provide TRY of CNY to banks in Pakistan. Banks will on-lend this liquidity to importers/ exporters involved in trade denominated in TRY or CNY. At maturity, the importer/exporter will repay the foreign currency to the lending bank, which in turn will repay to the respective central bank.

GOP Ijara Sukuk

In December 2011,Government of Pakistan launched GOP Ijara Sukuk in accordance with provisions of the GoP Ijara Sukuk Rules, 2008 in which underlying asset was M-2 Motorway for sale, purchase and lease through Pakistan Domestic Sukuk Company Limited (PDSCL). The maximum value of the asset under the said program of the Ijara Sukuk was PKR 234.6 billion, out of which GOP issued Ijara Sukuk worth PKR 233.8 billion in five auctions held from December, 2011 to September, 2012. In March, 2013, Government of Pakistan launched another series of GOP Ijara Sukuk in which M-1

Motorway was identified as an underlying asset. The maximum value of the asset was PKR 43.2 billion against which Sukuk worth PKR 43.02 billion were issued by the GOP in the auction held on March 26, 2013.

Since the start of issuance of GoP Ijara Sukuk in September 2008, Sukuk worth Rs. 501.44 billion have been issued so far. As of March 31, 2013, the outstanding amount of GoP Ijara Sukuk is. PKR 459.2 billion, out of which Sukuk worth PKR 374 billion are held by Islamic Banks/Branches which is 54 percent of their DTL.

Exchange Rate

SBP's proactive approach to market regulation and management facilitated smooth functioning of the foreign exchange market and capacity building amongst the market participants. Considering the market conditions and trade volumes, SBP in its annual review during FY 12 increased the overall Foreign Exchange Exposure Limit (FEEL) of the market by 12.8 percent, enabling the market to better manage larger flows without having any undue market impact. In April 2013, the maximum cap on FEEL of an Authorized Dealer has been further increased from PKR 2,500 million to PKR 3,500 million and overall FEEL of market has been increased by 9.7 percent.

Instructions on forward cover facility against import and foreign private loans have been further strengthened. As per new instructions, maturity of forward contracts against import should coincide with the maturity of the underlying Letter of Credit (LC). In cases where the import LC has a tenor of more than 12-months, the tenor of the forward cover facility would be 12-months on rollover basis or the remaining tenor of the LC whichever less is. Minimum tenor of forward cover against loans shall be twelve months or remaining maturity of the underlying loan, whichever is lower.

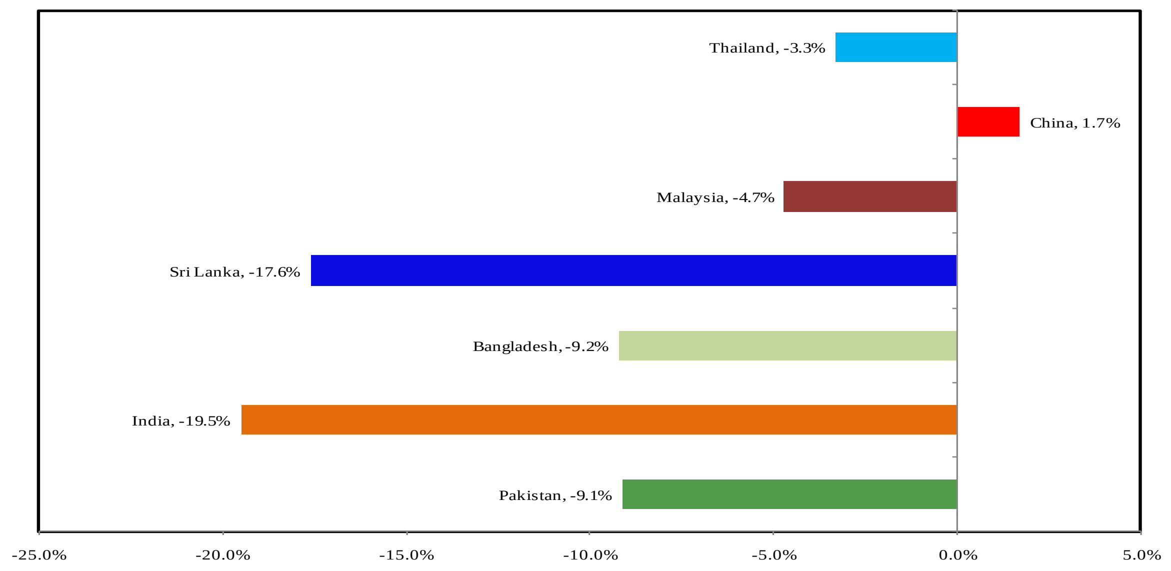
Table 4.1: Pak Rupee per US Dollar Interbank Trends

	High	Low	Close	Average	Volatility C/C[2]
FY10	85.58	81.40	85.51	83.89	3.02
FY11	86.50	83.93	85.97	85.56	2.40
FY12	94.69	85.79	94.55	89.27	2.48

[2] Reuters: Average close-to-close daily volatility (in percent)

PKR exhibited depreciation of 9.1 percent against US$ in interbank market during FY12 compared to nominal depreciation of 0.5 percent in FY11 (see **Table 4.1 & Figure 4.1**). However, the trend in

Figure 4.1: Regional Currencies Performance Against US Dollar during FY12



decline of PKR value during the year has been gradual. This exchange rate trend reflects the prevailing demand and supply conditions in the market as current account balance decreased from a nominal surplus in FY 11 to a deficit of US$4.7 billion during FY12. Most of the regional currencies remained under pressure and witnessed weakening trend. Emerging market economies were adversely affected due to bleak outlook of exports and investments as a result of concerns about economic growth prospects of the developed nations. Depreciation of several currencies vis-à-vis US Dollar remained more pronounced than that of Pak Rupee.

Foreign Exchange Reserve Management

As current account as well as overall balance of payment witnessed significant decline compared to their FY11 levels, foreign exchange reserves of the country also witnessed a declining trend in FY12 (see **Table 4.2**). Foreign exchange reserves stood at US$15.3 billion level at the end of FY12 compared to FY11 figure of US$18.2, showing a decrease of around US$3.0 billion during FY12. However, due to proactive management of SBP, the decline in the reserves during the year has been gradual that helped avoid any undue negative impact on the market sentiment.

Table 4.2: Month-wise Foreign Exchange Reserves

(in million US$)

Month end	SBP	Banks	Total
Jul-11	14,775.7	3,519.1	18,294.8
Aug-11	14,603.1	3,462.9	18,066.0
Sep-11	13,651.0	3,680.3	17,331.3
Oct-11	13,322.3	3,743.9	17,066.2
Nov-11	12,911.1	3,817.1	16,728.2
Dec-11	12,875.2	4,150.9	17,026.1
Jan-12	12,471.2	4,372.1	16,843.3
Feb-12	11,961.4	4,449.7	16,411.1
Mar-12	11,834.7	4,715.9	16,550.6
Apr-12	12,040.5	4,446.0	16,486.5
May-12	11,264.7	4,310.5	15,575.2
Jun-12	10,803.3 3	4,485.3	15,288.6

4.2 Foreign Exchange Reserve Management

Global Economic Overview

FY12 was another eventful year for the global economy. The downgrade of United States sovereign paper by Standard and Poor's, escalation of Euro zone debt crises as well as rising political tensions in the Gulf remained dominant themes and kept market participants in a state of risk aversion. The Euro zone sovereign debt crises gathered momentum by further engulfing Italy and Spain - two of the core countries forming the EMU. Oil prices also began an upward journey on account of rising political tensions in the Gulf region. Markets became optimistic for a brief period in the second half amidst some encouraging economic releases coming from the United States, however, the improvements proved short lived and unable to overcome the hindrances facing developed economies for the past two years. While many expected emerging economies to anchor global growth, their own trade dynamics deteriorated - through dwindling demand from developed economies - reducing the value added to global output. Central banks, globally, maintained their accommodative stance and quantitative easing programs, resulting in another year of near zero interest rates.

Performance of Reserves

In light of the global economic conditions, the balance of payments weakened further in FY12 as compared to the previous year. The trade deficit remained high as imports reached US$ 40 billion on account of higher international crude and commodity prices, and exports remained lackluster under US$ 25 billion due to reduced demand from developed economies. While the record remittances of US$13.2 billion partially mitigated the side effects of running the high trade deficit, the current account balance widened significantly. Consequently, forex reserves were utilized to offset the balance of payment account deficits as well as for making IMF loan repayments during the year. At the end of FY12, the country's forex reserves stood equal to 19.8 weeks of imports coverage compared with 26.5 weeks of imports at the end of FY11.

Reserve Strategy Outlook

The foreign exchange reserves of the country are allocated to achieve optimal returns given mandated investment parameters and risk exposures. The reserve management team continues to deploy assets strategically, taking into consideration; changing global economic conditions, size of reserves, and flow of funds to and from the economy. In accordance with its mandate, the reserve management team at State Bank of Pakistan focused on minimizing market and credit risk exposures emanating from European sovereign debt crisis. Going forward, any adjustments to the reserve management strategy and subsequent update of asset allocation will continue to be guided by the broad investment parameters of security, liquidity and optimal returns, formulated by the Central Board of SBP.

4.3 Changes in Foreign Exchange Regime during FY12

In order to streamline the trade loan under FE-25 Scheme, the Authorized Dealers (banks) have been allowed to open foreign currency accounts and extend trade loans under FE-25 Scheme in US Dollar (USD), Pound Sterling (GBP), Euro (EUR), Japanese Yen (JPY), Canadian Dollar (CAD), UAE Dirham (AED), Saudi Riyal (SAR), Chinese Yuan (CNY), Swiss Franc (CHF) and Turkish Lira (TRY). Further, the interbank placements and interbank SWAPs or any other source of foreign currency liquidity that is permitted under SBP Rules / Regulations can be used to extend trade loans in the above foreign currencies. However, currency of the trade loan should be the same as that of the underlying LC/ Firm Trade Contract.

The Authorized Dealers (banks) have been advised to ensure that the forward cover facility provided by them against imports is being availed for genuine import transaction and that the importers do not hedge more than the underlying exposure. The maturity of forward contracts against import should coincide with the maturity of underlying Letter of Credit (L/C). All forward contracts against which the underlying L/Cs are cancelled are required to be closed out on maturity at prevailing exchange rates and differential is settled between the importer and the bank. Similarly, they have also been advised to ensure that the forward cover facility provided by them against Foreign Private Loans is being availed for genuine transactions and that the customers do not hedge more than the underlying exposure. The minimum tenor of forward cover against such loans shall be twelve months or remaining maturity of the underlying foreign private loan, whichever is lower. Forward cover already provided to customers prior to the effective date of this circular shall remain effective till their maturity.

4.4 Exchange Companies (EC)

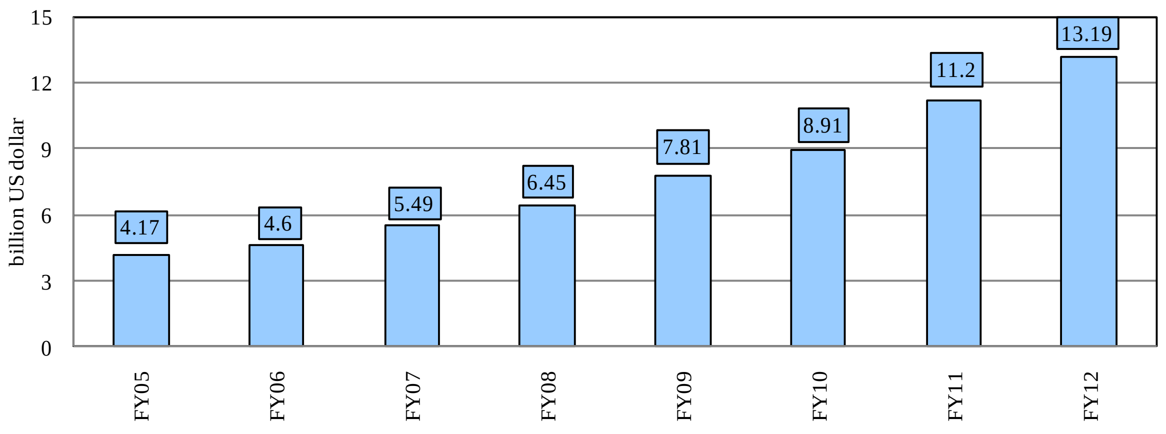
In order to address the compliance of the regulatory & legal requirements of Anti-Money Laundering (AML)/Countering Financing of Terrorism(CFT) regime, Exchange Companies were advised for reporting of Suspicious Transaction Reports (STRs)/Currency Transaction Reports (CTRs) to Financial Monitoring Unit (FMU) under AML Act, 2010. Revised policy for renewal of licenses of Exchange Companies was introduced which was purely based upon compliance status of the Exchange Companies.

With a view to preserve the integrity and safety of the financial system, guidelines for combating money laundering and terrorist financing were issued. In terms of the guidelines, EC were advised regarding documentation of transactions, Know Your Customer (KYC) & Customer Due Diligence (CDD), beneficial ownership, record keeping, Compliance of Legal and Regulatory Framework etc. They were further advised to review and submit their policy for combating money laundering and terrorist financing each year, duly approved by Board of Directors.

4.5 Pakistan Remittance Initiative (PRI)

In order to provide an ownership structure in Pakistan for remittance facilitation, State Bank of Pakistan, Ministry of Overseas Pakistanis and Ministry of Finance launched a joint initiative, called Pakistan Remittance Initiative (PRI), in April 2009. This initiative has been taken to achieve the objectives of: (a) facilitating and supporting efficient flow of remittances and (b) to provide investment opportunities in Pakistan for overseas Pakistanis. The establishment of PRI has contributed positively in enhancing the flow of remittances to Pakistan, which has noticeable upward trend (see **Figure 4.2**).

Figure 4.2: Remittances Trends in Pakistan



PRI has formulated a comprehensive strategy aimed at greater commitment of financial sector towards remittance services and resultant inculcation of remittance culture, transparency of remittance market with adequate consumer protection, efficiency of payment system infrastructure, and incentives for the remitters, beneficiaries and overseas entities.

Through a consultative process, the number of financial institutions involved in remittance services has increased significantly. The realization of business cases in remittances by additional financial institutions has not only facilitated the larger strata of remittance beneficiaries but also resulted in creating a competitive environment.

PRI is encouraging financial institutions in Pakistan to enhance their outreach worldwide through new remittance- specific related arrangements. Around 400 new arrangements have been finalized by banks in Pakistan with their overseas correspondents since the inception of PRI.

PRI is encouraging banks to issue PRI co-branded Pardes Cards (a PRI generic name for remittance cards) offering beneficiary with the ease of withdrawing their funds 24x7 from any ATM across the country or use the same at POS terminals. The cards can only be fed through home remittances from aboard and used locally. Once the card is issued to a beneficiary after due process, remittance received from abroad is automatically transferred to the card. These cards shall not only bring wide array of people under mainstream of banking, but also help to reduce the COC payments. Two of the large size banks, namely UBL and HBL, have already launched their respective Pardes Cards while others are in pipeline.

Reliable and efficient payment systems are vital to facilitate delivery of home remittances securely and efficiently and State Bank of Pakistan has already taken number of steps to develop related Payment Systems Architecture of the country such as:

- Utilization of PRISM (RTGS) to transfer and settle inter-bank Home Remittance transactions. This has enabled banks to transfer inter-bank transactions into beneficiaries' accounts on the same day.
- Apart from RTGS, through ATM Switch, instant A/C credit facility is also available for beneficiaries through Inter Bank Fund Transfer (IBFT). This has reduced turnaround time considerably.

Keeping in view the rising trend in Home Remittances and the importance of same for the economy, SBP has allowed banks to open dedicated Home Remittance payment centers. Payments can be made to beneficiaries via cash, demand drafts and pay orders. In addition, such Home Remittance Payment Centers would also be allowed to perform the functions of Sales & Service Centers.

A call centre has been established by PRI to provide a reliable and immediate contact point (24 hours, 7 days a week). All overseas Pakistanis and their families back home can inquire about the remittance services of banks and lodge their complaints with the call centre (0092-21-111-222-774). There are toll free numbers for overseas Pakistanis residing in 12 countries/ regions of the world. Further, PRI has its own website http://www.pri.gov.pk for related purposes.

With a view to encourage overseas Pakistanis and others to use banking channels for home remittances, and to protect the remitters / beneficiaries from any losses that they may incur due to unwarranted delays in receipts of funds in the beneficiaries' accounts, a mechanism has been put in place whereby in case the amount of remittance is not credited/ paid to the beneficiary as per stipulated instruction, the beneficiary shall be entitled to a return of sixty five (65) paisa per thousand rupees per day from the concerned bank for the number of days credit/payment on account of remittance was delayed.

PRI have organized various training programs related to different facets of remittances services, ranging from strategic framework for remittance services to policy level initiatives. PRI also awarded appreciation certificates to top performer branch managers of banks, in recognition of their services for the national cause. Governor, SBP distributed the awards amongst banks' officials in different areas relating to home remittances, including remittances services at branch level both in Pakistan and overseas, processing at centralized Home Remittance Cells and IT support for swift remittance delivery. Forty-five officials from a number of banks also received individual performance awards for facilitating remittances into Pakistan.

4.6 Risk Management and Compliance

As a part of Foreign Exchange Reserve Management, Risk Management and Compliance Department (RMCD) acts as the middle-office and performs the critical functions of risk management through timely identification, assessment and quantification of credit, market, and operational risks. During the year, RMCD continued its drive to bring its functions and operations in-line with the best international practices. Some of the major developmental work was:

- RMCD strengthened its risk assessment framework through introducing real time early warning system for timely identification of key market and credit risk factors that may pose financial risks to the reserve management activities. Due to volatility in the financial markets and to meet the diversification needs of the reserve management program, RMCD reviewed its existing risk management policies and aligned them with the changing dynamics of the financial markets and associated risks.

- In order to proactively manage operational risks, RMCD took several initiatives to streamline operations of reserve management function in coordination with relevant stakeholders (TOD and IMID) and ISTD. Some of the key tasks that were completed during the year included the following:
    - Consolidation of refined Risk factor related data.
    - Harmonization of internal and external data sources of in-house and outsourced portfolios to address issues related to data validation and authenticity.
    - Deployment of automated real time alerts to ensure compliance of RMCD guidelines and policy limits.

4.7 Treasury Operations

During the year under review, the treasury operations (back-office) witnessed significant technological improvements, better internal controls and enhanced capacity building that jointly played pivotal role in boosting the operational efficiency of the department and making it more aligned with international best practices. In this regard following initiatives were successfully completed:

- Automation of Reserve Security Accounting Entries in Globus and Oracle in banking books.
- Development of SWIFT messages relating to international payments area through Globus system and integration with SWIFT system.
- Centralization and rationalization of Bank-wide outsourced corporate services including technological platforms and hiring of external experts.
- Acquisition and custody of all the agreements related to reserve management functions for better control.
- Streamlining of operational activities by complete revamping of functions and administrative hierarchy of the department.
- Capacity building in the area of reserve management, particularly for providing operations support for new treasury products including currency swap agreements and in-house arrangements for purchase of CNY bonds and treasury bills.