3 Ensuring Soundness and Efficiency of Financial System

One of the core responsibilities of the State Bank is to regulate and supervise the financial system [4] to ensure its soundness and stability for the realization of broader objective of economic growth and development. The Bank makes efforts to promote financial stability, efficiency, consumer confidence, and market discipline in the banking industry. It is important to note that the State Bank's supervisory framework adequately complies with the internationally recognized Core Principles of Effective Banking Supervision. However, the bank continually endeavors to further strengthen this framework and make it compatible with dynamic global and local environment to ward off any risks to the financial stability. In this regard, the bank took the following leading measures during FY14.

3.1 Regulatory Initiatives for Enhancing Financial Stability and Efficiency

3.1.1 Strengthening the Solvency and Liquidity Standards- Implementation of Basel-III

The Basel Committee on Banking Supervision (BCBS) issued a new capital accord commonly known as Basel III in 2010, to be implemented in a phased manner over 2013 to 2019. The salient features of the framework include changes in the capital structure, introduction of capital buffers, liquidity ratios (Net Stable Funding Ratio and Liquidity Coverage Ratio) and a leverage ratio. To align its regulatory framework with international best practices, the State Bank conducted a series of extensive Quantitative Impact Studies (QIS) and deliberations to assess the impact of new Basel Standard on Pakistani banking system. After detailed assessment, SBP issued guidelines on Basel-III in August 2013, with an implementation timeline of 2013 to 2019.

3.1.2 Revision of Prudential Regulations

During the year under review, revised prudential regulations for the corporate and commercial banking were issued to align the existing regulatory framework of the SBP with the changing business environment and the best international practices. Key objective of the revised regulations is to help the banks and DFIs to address their unique risk factors and dynamic environment in a better way by allowing them more discretion in business decisions. These regulations also identify minimum prudential benchmarks in critical risk areas to balance the consideration of financial stability vis-à-vis diversity and innovation. In line with emerging trends and risks, the revised regulations introduced prudential limits on exposures to related party, large borrowing concentration, and real estate.

3.1.3 Anti-money Laundering and Countering the Financing of Terrorism (AML/CFT)

The State Bank has been taking measures since long to prevent the use of banking channels for the purposes of money laundering (ML) and terrorist financing (TF). The AML/CFT Regulations were further strengthened to cover all important aspects of preventive measures as per international standards including customer due diligence, correspondent banking, wire transfers requirements for sending and receiving funds, reporting of suspicious transactions, keeping records of banking transactions for ten years, risk-based approach as per internal risk assessments and other requirements on internal controls, policies, compliance, audit and training.

[4] Financial system under the SBP regulation and supervision comprises banks, Development Finance Institutions (DFIs), Microfinance banks, and Exchange Companies.

3.1.4 Guidelines on Operational Risk

To facilitate the institutions in strengthening their operational risk management systems and move towards advance approaches for the measurement of operational risk, the State Bank outlined Principles for Sound Management of Operational Risk and minimum standards for operational risk/loss data collection and implementation by the banks. Banks are allowed to make enhancements in the standards in the light of their own experiences and requirements while adopting these instructions.

3.1.4 Promotion of Rating Culture in Pakistan

To promote rating culture in Pakistan and strengthen the risk management practices, risk based capital adequacy rules in respect of large unrated borrowers have been changed to encourage them for getting themselves rated. Resultantly, banks' internal credit risk assessment will be strengthened, leading to capital savings for banks and rationalization of cost of borrowing for the rated entities. In this regard, the risk weight has been increased from 100 percent to 125 percent (effective from December 31, 2014) for all unrated private sector borrowers who have aggregate outstanding exposure from financial institutions of Rs3 billion or above.

3.2 Improvements in Surveillance Framework

Since global financial crisis, several areas have been identified as crucial for increased regulatory oversight. These include consolidated supervision, stress testing, risks concentrations, and early interventions tools for resolution of distressed banks. In line with global supervisory landscape, the State Bank took the following initiatives to strengthen surveillance of the institutions under its supervisory ambit:

3.2.1 Assessment of Institutions' Resilience towards Shocks - Stress Testing

The central banks across the globe are making increasing use of macro-stress testing for the assessment of financial stability. The State Bank currently focuses on the credit risk assessment of banking industry's loan portfolio against shocks in major macro-economic risk factors. To further strengthen the framework, SBP received Technical Assistance from IMF. The mission appreciated significant progress in the overall stress testing framework of SBP. A cross cluster team has been formed for developing consistent macro scenario that involves the complex process of identifying potential risks, ascertaining possible channels of transmission and reasoning about feedback effects from the financial sector back to the real economy. The process is expected to further strengthen the SBP's macro stress testing framework.

3.2.2 Monitoring of Large Exposure

One of the key risks to financial sector stability is build up of systemic risk mainly from concentration of credit. In line with international best practices, the SBP laid down an extensive mechanism for monitoring of large exposures by clearly defining large exposures and assigning specific concentration limits on party/group, instruments (debt, equity), currency, clean exposure, related party exposure, etc.

3.2.3 Consolidated Supervision Framework

Over the last couple of years, the State Bank has established a framework for consolidated supervision of banks and financial conglomerates. Under this framework, the State Bank identifies the group structures of banking groups and constantly monitors them to identify and manage the risks posed by the conglomeration. For this purpose, a joint task force of the State Bank and the Securities and Exchange Commission of Pakistan (SECP) has also been formed to share information and coordinate their supervisory efforts. Besides surveillance of banking groups during the year, the supervisory system and coordination mechanism with the SECP was further strengthened by developing early warning signals for the monitoring of financial conglomerates.

3.2.4. Strengthening of Supervisory Processes

To further improve supervisory processes, following major improvements in on-site inspection and off-site supervision processes were made during the year:

- Operations and Foreign Exchange & Treasury Inspection manuals have been revised with extended scope to cover financial derivatives.
- A separate off-site surveillance framework for exchange companies has been formulated. This framework comprises six components namely; corporate governance(C), Operations (O), System and controls (S), AML/CFT measures and approach (A), Returns and statements (R) and Financial statements (F). This framework will enhance the effectiveness of supervision of exchange companies.
- The rating parameters were realigned to ensure uniformity in assessment of CAELS and CAMELS assessments.

3.3 Developments in Supervision

The State Bank's supervision system comprises both on-site and off-site supervision of its regulated entities. The on-site supervision of banks, DFIs and MFBs is based on CAMELS framework (Capital, Asset Quality, Management, Earnings, Liquidity, and System & Controls) while off-site surveillance is based on CAELS (Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Other Risks) framework. The supervisory process focuses on the overall risk assessment of institutions and effectiveness of their policies and procedures, control environment, and compliance with laws, regulations and supervisory directives. Necessary enforcement actions and follow up are conducted to alleviate the regulatory concerns as observed during the supervisory process.

During FY14, SBP carried out inspection of a number of Banks, DFIs, MFBs and Exchange Companies. The inspection teams recorded observations on different regulatory issues that were highlighted in the inspection reports for corrective action and followed up by the State Bank for the enforcement of these actions. Besides the regular supervision, a number of special investigations and thematic inspections were conducted to address specific issues and risks.

3.3.1 The State Bank's Representation on FSB-RCG-Asia

Being a member of Financial Stability Board's Regional Consultative Group for Asia, the State Bank has effectively participated and contributed in the deliberations of the forum. FSB-RCG Asia formed two working groups for conducting studies on *Impact of the SIFI Framework on the Asian Region and Measures in Response* and *Shadow Baking in Asia.* The SBP provided its detailed input to these working groups. The reports of both these groups were published by FSB in August 2014. The bank also participated in an informal study group on *Long-Term Investment (LTI)*, to assess the current state of long-term investment finance and identify important factors for promoting supply of long-term investment and financial stability in Asian context.

3.4 Increase in Domestic and Global Outreach of banks/MFBs:

3.4.1 Opening of New Branches: Banks/MFBs were allowed to open 791 new branches[5] which included 485 conventional banking branches, 245 Islamic banking branches and 61 microfinance branches. Accordingly, total number of bank branches in the country rose to 12,465 in June 2014.

3.4.2 Overseas Expansion: Presently, eight Pakistani banks are operating in 37 countries of the world in different modes (branches, representative offices and subsidiaries). During FY14, SBP allowed Pakistani banks to further expand their overseas operations in Ireland, Sri Lanka, United Arab Emirates, Bangladesh, Kenya, Malaysia and Seychelles.

3.5 Facilitation of Government Initiatives

3.5.1 Promotion of Social Welfare Initiatives

The State Bank has been facilitating the Government of Pakistan (GoP) in its various initiatives for social welfare. Necessary regulatory instructions and guidelines were issued to support the disbursement of financial assistance to affectees of natural disasters and Internally Displaced Persons (IDPs) due to war on terror. During FY14, the bank continued its support by facilitating Benazir Income Support Program for disbursement of funds to the beneficiaries through smart cards.

3.5.2 Privatization of Public Sector Shareholding in a Bank

The State Bank extended required support to Privatization Commission for divestment of 19.8 percent shareholding in United Bank Ltd. The said privatization transaction generated a gross proceed of Rs38.2 billion (around US$ 387 million, including foreign portfolio investment of US$310 million) 81.4 percent of which was subscribed by foreign investors.

3.6 Consumer Protection

The State Bank has been endeavoring to inculcate a culture of treating customers fairly and strengthen the Conduct Supervision. The regulated institutions are advised to improve their consumer grievance redressal mechanisms. The Consumer Protection Department (CPD) redressed a total of 4,830 instant issues during FY14. Moreover, a total of 5,676 e-CIB related complaints were resolved mostly within three to seven days.

In order to strengthen consumer protection regime, the CPD took a number of initiatives during FY14 including: a)- Introduction of 'Enhanced Security Features for Cheques', b)- Development of 'Accessible Banking Infrastructure for Special Persons', c)- Introduction of Credit Card Summary Box to secure the financial consumers from unfair sale practices and to clarify terms and conditions to consumers d)- Grievances of the age pensioners were alleviated by developing on-site surveillance for effective monitoring of pensions disbursement and provision of "Direct Credit of Pensions in the Account" facility, e)- holding consumer education and awareness programs for different segments of the society and dissemination of consumer protection related information and instructions through print media.

[5] Include sub-branches as well.