

## 3 Ensuring Soundness and Efficiency of Financial System

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Ensuring financial system stability is amongst the key strategic objectives of SBP and bulk of its resources, time and efforts are consumed in undertaking this important responsibility. SBP makes concerted efforts to promote financial stability, efficiency, consumer confidence and market discipline in the banking industry. It has developed an elaborate and extensive regulatory and supervisory infrastructure to ensure adequacy of risk identification, measurement and mitigation systems both at banking system and individual institution level. The SBP's regulatory and supervisory framework is largely at par with international best practices and Basel core principles of effective supervision. It continuously endeavors to strengthen this framework to cope with the challenges posed by the dynamic local and global environment. The following key developments in this area were recorded during the year.

### 3.1 Regulatory Initiatives

#### 3.1.1 Capital Adequacy Requirements

SBP issued Basel III instructions for implementation in Pakistan in August 2013 in the light of Basel III reform package introduced by the Basel Committee on Banking Supervision (BCBS). During the year, SBP introduced disclosure templates released by BCBS for capital adequacy purposes. The templates aim to enhance consistency and comparability of banks' capital related disclosures. Moreover, the regulatory capital adequacy reporting formats have been automated on Data Acquisition Portal (DAP) to improve efficiency of the supervisory process. The capital adequacy framework for Microfinance Banks (MFBs) was also revised in line with international best practices and Basel Capital Framework.

#### 3.1.2 MCR for Islamic Banking Subsidiary

To promote Islamic banking and encourage conventional banks to upscale their Islamic banking window operations into Islamic banking subsidiaries, the MCR for Islamic banking subsidiaries was revised downward to Rs 6 billion provided the subsidiary gives plans to raise its capital (net of losses) to Rs 10 billion within 5 years. The revision defines a road map for Islamic banking windows to graduate into independent subsidiaries to better serve their faith sensitive clientele. It will also be instrumental in further accelerating Islamic banking growth as the subsidiaries will significantly increase their branch network to leverage the enhanced capital base.

#### 3.1.3 Strengthening of Corporate Governance Regime

The corporate governance regime of the banking industry was further strengthened during the year to bring it at par with international standards and best practices. Following key regulations were issued for the purpose:

- Banks/DFIs were advised to conduct prior self-assessment of their prospective Directors, CEOs and Key Executives and furnish an undertaking to SBP in this regard.
- Fiduciary role of the Board members was extended to cover succession planning, compensation packages, promotion, appointment and removal of Key Executives so that a comprehensive approach could be established within the organization to achieve its business objectives with focused strategy.
- The chairmen of the Boards of banks/DFIs were made ineligible to become members of Board committees such as audit, risk management, credit, recruitment and remuneration.

- To enhance the role of independent directors, the banks/DFIs were advised that Board's audit committee would invariably be chaired by an independent director.

## 3.2 Developments in Supervision

### 3.2.1 Risk Based Supervision Framework

Regulators in many parts of the world have changed their focus from compliance based examination to risk based supervision (RBS) to better align their supervisory resources with the supervisory objectives and to institute a forward looking approach towards supervision. The main focus under RBS approach is on evaluating risks in a continuum, identifying early problems and facilitating prompt intervention/ early corrective action. Keeping in view the benefits of risk based supervision, SBP has initiated work on migrating its supervisory approach to RBS. Adoption of RBS will enable SBP to form forward looking views on the health of a financial institution by focusing on business risk and linkages with wider financial sector and impact of its failure on the banking and financial system.

### 3.2.2 Prompt Corrective Action Framework

SBP has prepared a draft report on 'Prompt Corrective Action (PCA) Framework' to further enhance and strengthen the supervisory regime. The PCA is defined as "a framework requiring the regulators to intervene well before the bank's financial health deteriorates to the point where it is classified as insolvent". The underlying objective of instituting PCA regime is to include structured and pre-specified intervention and resolution framework, triggered by objective performance measures duly disseminated to market participants.

### 3.2.3 Thematic Inspections

During H1-FY15, SBP introduced the concept of thematic inspections for focusing the areas that needed further strengthening with regard to policy and/or supervision. In first phase, industry-wide thematic inspections were conducted in two key areas of Corporate Governance and AML/CFT to comprehensively identify the core issues in these areas. In H2-FY15, thematic reviews of "Islamic banking windows in conventional banks' branches" and "agency services provided by the banks to insurance companies and Assets Management Companies" AMC's were conducted.

### 3.2.4 Resolution of Problem Banks

During FY15, SBP successfully managed resolution of problem bank. The bank was put under moratorium on November 14, 2014 for six months to safeguard interest of the bank's depositors and prevent any systemic risk. Under the moratorium, the depositors were allowed to withdraw up to PKR 300,000, which fully served the 92.3 percent of the deposit accounts. The liquidity stress faced by some of the small banks was tactically managed while rumor mongering about the stability of the banking sector was curbed through effective and measured communication in print and electronic media.

On the advice of Federal Government, a scheme of amalgamation of under section 47 of the *Banking Companies Ordinance, 1962*, was also devised which led to its merger and amalgamation with an Islamic bank. After the merger, the moratorium on withdrawal of deposits was also lifted. The SBP not only ensured smooth functioning of the bank during the moratorium period but also made effective arrangements that all deposit withdrawals claims are timely honored after lifting of the moratorium. The ample availability of liquidity ensured by SBP in all branches of the defunct bank (since merged and amalgamated in BIPL) across the country played a key role in giving comfort to the depositors and preventing any run on the bank.

### **3.2.5 Enforcement Support System (ESS)**

SBP has developed an in-house Enforcement Support System (ESS). Primarily, it is an electronic record keeping of enforcement actions taken by SBP, however, real benefit comes out of its ability of providing references to past enforcement related matters and issue tracking across the entire banking industry. It will enhance efficacy of supervisory response by calibrating decisions on the basis of various patterns made observable through ESS and will help ensure consistency in regulatory responses and enforcement actions.

## **3.3 Financial Consumer Protection and Responsible Banking Conduct**

SBP promotes responsible banking through effective market conduct regulations and supervisory tools. Major developments in the area of consumer protection during FY15 are briefly elaborated below:

### **3.3.1 Enactment of *Credit Bureau Act-2015***

To provide for incorporation, functioning, regulation and supervision of existing and new credit bureaus, the SBP proposed for enactment of the *Credit Bureaus Act (CBA)* and the same has been approved by the Parliament. The establishment of credit bureaus under the new law is expected to bring efficiency and better credit risk management for banks and financial institutions. It will also attract foreign collaboration, enabling the core players to benefit from the expertise of reputed credit bureaus operating in advanced economies. Also, the improved credit risk culture is expected to reduce risks of default and increase flow of credit to new segments of borrowers and thus will be instrumental in improving financial inclusion.

### **3.3.2 Improving Efficiency and Fairness in Banking Services**

SBP has issued guidelines on “*Fair Treatment of Customer*”. The objective is to instill the idea that Consumer Protection is not merely a compliance issue rather it is an indispensable ingredient of sustainable success for banks. These guidelines will enable banks to inculcate culture wherein customers are treated fairly and equitably. Further, to rationalize service charges, SBP has issued nine overarching guiding principles of fairness to be followed by banks while devising fees and service charges on banking products/services.

### **3.3.3 Enhancing Conduct Requirement for Banks**

SBP has issued a set of “*Guidelines for Conduct of Business in Banks*”. The objective of these guidelines is to promote good banking practices by setting out minimum standards in dealings with customers and increasing transparency in the provision of banking services. These will also enhance understanding of customers regarding the services provided by banks. To alleviate the difficulties being faced by visually impaired/blind persons in availing banking facilities, SBP has issued related guidelines to banks/MFBs to treat such persons in dignified manner.

### **3.3.4 Consumer Awareness Initiatives**

SBP has intensified its efforts for educating consumers and launched awareness campaign for various segments of society through mass media. Information relating to complaint redressal mechanism, role of SBP in resolving disputes vis-à-vis role and functions of Banking Mohtasib Pakistan (BMP) were disseminated. The campaign also covered basic but necessary information relating to debt collection and recovery guidelines, precautionary measures for using ATMs, debit and credit cards, cheque handling, to identity theft, skimming frauds, understanding e-CIB functions and its implications for debtors.

### **3.4 Financial Stability Framework**

Strengthening the financial stability regime is a key strategic goal of SBP. To achieve this goal, SBP has embarked upon developing financial stability framework in line with international best practices. The framework includes design and implementation of institutional set-up, development of crisis management framework, deposit insurance scheme and strengthening of supporting legal and regulatory framework. During the year under review, a number of initiatives were taken and projects started for pursuing this goal; some of which are elaborated below:

#### **3.4.1 Strengthening of Financial Stability (FS) Framework at SBP**

The global financial crisis (2007-08) revealed that financial authorities' approach to seek price stability and micro-prudential surveillance was not sufficient to ensure financial stability. Hence, in the post crisis era, increased focus was laid on institutionalizing framework for maintaining financial stability under the Financial Stability Board (FSB) principles. Drawing from the country experiences and based on an internal assessment of existing arrangements, SBP has initiated work on designing and implementing a formal structure of FS for Pakistan encompassing the establishment of: i) National Financial System Stability Council (NFSSC), ii) Financial Stability Executive Committee (FSEC) at SBP and iii) Financial Stability Department (FSD) in SBP.

#### **3.4.2 Assessment of Banks' Resilience towards Stress Tests**

In line with the global regulatory and supervisory developments, SBP has increased its focus on conducting macro prudential oversight to safeguard soundness of overall financial system. Among others, SBP performs resilience analysis of the banking system for which it has adopted two pronged strategy. Under the top-down approach, the SBP assesses resilience of the system towards both historical and hypothetical single factor/multifactor shocks to credit, market and liquidity risks. These shocks are regularly reviewed and updated keeping in view the changes taking place in the financial landscape and the risk factors. Under the bottom-up approach, banks and DFIs have been mandated to carry out quarterly stress testing exercise against various shocks provided in the revised *Stress Testing Guidelines*. Moreover, large banks are required to carry out advanced stress tests commensurate with their size, business, and complexity.

Recently, sensitivity tests on concentration of borrowers have been revised in line with Basel Committee on Banking Supervision (BCBS) guidelines on large exposures. Moreover, liquidity shocks have been applied using the Basel III liquidity standards to assess resilience of system and individual financial institutions towards stressed liquidity withdrawals. SBP is in the process of strengthening its stress testing framework and for this purpose it has sought Technical Assistance from IMF.

#### **3.4.3 Framework for Identification and Supervision of D-SIBs in Pakistan**

As part of its commitment to ensure stability of financial system and further strengthen the supervisory and regulatory regime, SBP has designed and published a paper on "*Identification, Regulation/ Supervision of Domestic Systemically Important Banks (D-SIBs) in Pakistan*". To better manage build up of systemic exposures, the policy paper adopted the benchmark BCBS methodology for constructing criteria for identifying D-SIBs in Pakistan. Further, the framework touches upon the matter of possible regulatory, monitoring, and disclosure requirements to maintain financial stability and reduce the probability of direct support and implicit Government guarantee for managing D-SIBs during crisis. It is expected that identification of the D-SIBs and future work on development of regulatory and supervisory framework will go a long way in limiting systemic risk and ensuring financial sector stability.

#### **3.4.4 Encouraged Financial Soundness Indicators (FSIs)**

After successful development of core Financial Soundness Indicators (FSIs) – which are being published regularly by SBP and IMF on quarterly basis, SBP initiated work on enhancing the scope of FSIs through preparation of “*Encouraged FSIs*”. In addition to coverage of deposit taking institutions, the Encouraged FSIs covers other financial corporations, non-financial corporations, households, market liquidity and real estate markets which have systemic implications owing to their linkages with banking sector. SBP has initiated publishing the quarterly encouraged FSIs on its website, while IMF is expected to publish the same on its website shortly.

#### **3.4.5 Developments related to Financial Stability Board – Regional Consultative Group for Asia (FSB-RCGA)**

SBP is a member of FSB-RCGA since its inception in 2011 and Governor SBP represents Pakistan on the forum. SBP has remained an active participant in FSB-RCG Asia and effectively contributed in discussion on the financial sectors reform agenda.

#### **3.4.6 Quarterly Performance Review (QPR) of Banking Sector**

To keep the stakeholders apprised with latest developments related to banking sector, SBP commenced publishing of Quarterly Performance Review (QPR) of the banking sector. The QPR for October-December 2014 quarter was the first in this series. The report provides a comprehensive analysis related to banking trends including asset structure, performance and solvency position of the banking system.