3 Strengthening Financial System Stability and Effectiveness

The banking sector constitutes around 74 percent of the country's financial sector with an asset base equivalent to almost 55 percent of the country GDP. Thus the stability and buoyancy of the banking system is critically important for SBP. The SBP Vision 2020 accordingly envisions improving the financial stability regime and enhancing efficiency and effectiveness of the financial system amongst the key strategic goals of the Bank. The initiatives taken by the SBP in this direction included establishment of financial stability framework, institutionalization of deposit protection mechanism, streamlining and strengthening regulatory regime, emphasis on awareness creation and fair treatment of consumers.

3.1 Institutionalization of Financial Stability Framework

The *SBP Vision 2020* envisages designing and implementing a formal Financial Stability structure in the country. With a view to institutionalize the financial stability function in SBP, a new department namely Financial Stability Department (FSD) was established in 2016 to monitor and assess financial system wide risks and propose measures to mitigate such risks. Further, the Financial Stability Executive Committee has also been constituted under the chairmanship of the Governor to serve as an internal forum for discussions and coordination on financial system stability issues.

During FY17, SBP and Securities and Exchange Commission of Pakistan (SECP) signed a Letter of Understanding (LoU) to establish a Council of Regulators (CoR) to mitigate systemic risk covering the broader spectrum of financial sector. The Council will provide a forum for deliberating issues related to systemic risk, particularly those having cross market and stability implications. It will suggest possible arrangements for crisis preparedness and come up with a coordinated response. The formation of the Council is aligned with international practices in the post global financial crisis scenario. It will not only facilitate SBP and SECP in achieving their statutory and strategic objectives but also further enhance their collaboration for ensuring the financial system stability. Besides the CoR, work is underway for establishment of an overarching National Financial Stability Council (NFSC) comprising SBP, SECP and Ministry of Finance to discuss and resolve the systemic level issues.

3.1.1 Financial Stability Mandate in the Law

In line with international best practices, the SBP is strengthening its Financial Stability regime. Presently SBP however lacks the "explicit legal mandate for financial stability", which is inconsistent with international best practices. As per the in-house study conducted during the year, it is highly desirable for regulators/central banks to have legitimate legal powers and mandate to pursue financial system stability goal depending upon the size of economies and structure of financial markets. Most countries' central banks have explicit legal mandate for attaining financial stability by virtue of their legal framework. SBP has reviewed the legal framework *vis-à-vis* international best practices and identified some areas for explicitly covering the financial stability mandate and other related provisions in the relevant laws.

3.1.2 Deposit Protection Corporation (DPC)

The deposit insurance scheme is widely acknowledged as one of the key components of financial stability regime. It provides a variety of benefits to the financial system including i) contribute towards a stable financial system and protects financially unsophisticated depositors from the loss of their deposits, ii) create a formal protection mechanism thus removing the uncertainty about how depositors will be treated in case of bank failures, and iii) reducing the potential fiscal burden on the government. The *SBP Vision 2020* accordingly envisaged establishment of Deposit Protection Corporation (DPC) as a key milestone towards achieving the financial stability goal. The *Deposit Protection Corporation Act* was promulgated in August 2016 which has allowed for the establishment of Deposit Protection Corporation (DPC) as a wholly-owned subsidiary of SBP. In terms of Section 12 of DPA, SBP has already appointed Managing Director of DPC for the period of five years. The general superintendence, direction and management of DPC shall vest in the Board to be appointed by the Federal Government. The SBP has approached the Federal Government for nomination of the Directors on the DPC Board. The DPC would become operational after the constitution of the Board.

The membership of DPC is mandatory for all scheduled banks. The periodic premium payments to be made by the banks shall be the major source of funding for the DPC. The threshold of deposit coverage and rate of premium shall be determined by the DPC Board. The DPC will invest the premium received from the banks in secured investments (mainly government bonds) and will build-up the resource/funds base for payment to the depositors in case of failure of a bank. The DPC will also set up a separate *Shari'ah* compliant insurance scheme (*takaful*) for protection of deposits of Islamic banking Institutions.

3.1.3 Self-Assessment of FSB's Key Attributes on Effective Resolution Regime

An effective resolution regime is essential to minimize disruptions to smooth functioning of the financial system. Such a regime helps maintain confidence and allows system to perform all its critical functions. In 2014, Financial Stability Board (FSB) issued *Key Attributes of Effective Resolution Regimes for Financial Institutions*.

SBP during the year initiated the Project "Self-Assessment of FSB's Key Attributes on Effective Resolution Regime along with policy recommendations" to assess the capacity and effectiveness of SBP Resolution Regime, identify the gaps, if any and develop recommendations to fill the gaps. The study mapped out the key attributes standard with the current legal and supervisory framework of the SBP resolution regimes for the financial institutions under its supervision. In view of the assessment, key policy recommendations on SBP's resolution regime were prepared and approved by the Governor, which include proposed changes in legal framework, development of supervisory framework and institutional arrangements.

3.1.4 Assessment of Banks' Resilience through Stress Tests

Stress testing is an integral part of the financial stability assessment toolkit of central banks around the world. SBP is also using 'stress tests' to assess the resilience of banks and the banking system against various hypothetical (extreme but plausible) macro-financial shocks. Presently, such stress tests are conducted on quarterly basis and based on the results the banks whose capital falls short of the required minimum are identified. The toolkit and the framework of stress testing are being regularly enhanced and upgraded in line with the latest developments and advancements in the area.

3.1.5 Flagship reports (Financial Stability Review)

The *Financial Stability Review (FSR)* is amongst the flagship reports being published by SBP. The FSR for the year 2016 was issued during the year, which focused more on identifying emerging risks and vulnerabilities in the financial system, assessing their impact and suggesting remedial measure where necessary. The review for the first time also covered the demand side analysis such as risks to the corporate sector and the household sector. Further, the global developments and their implications on the domestic financial sector were discussed in detail in the review[1]. Moreover, the FSR 2016 discussed the resilience of the banking system under various stress scenarios. Besides the FSR, *Quarterly Performance Reviews (QPRs)* and *Quarterly Compendium (QC) of Statistics of the Banking System* were issued during the year to apprise the general public about the latest performance and financial soundness indicators of the banking sector.

3.2 Progress toward Risk-Based Supervision Framework

In order to further strengthen its supervisory regime, SBP is developing *a "Risk Based Supervision Framework"*. Risk Based Supervision (RBS), being a forward looking approach, will upgrade SBP's supervisory methodology from the existing CAMELS/CAELS framework. The RBS model would improve risk and control assessment of financial institutions. RBS requires allocation of supervisory resources to institutions and areas which are significant in terms of riskiness or impact of failure. This approach will ultimately help prioritize supervisory resources and articulate prompt and effective response to financial stress.

Currently the project team is in the process of developing architecture of RBS framework and has developed draft methodologies for identification of significant activities, assessment of inherent risks (credit, market, liquidity, operational) and internal controls (internal audit, risk management, compliance). First Testing exercise based on the draft methodologies for assessment of various inherent risks and control functions including internal audit, compliance and risk management has been completed. Aggregation of risk and control rating in order to formulate the risk profile is under process.

3.2.1 Framework for Identification of Domestic Systemically Important Banks (D-SIBs)

Global financial crisis of 2007-08 had exposed the vulnerabilities of prevailing financial system and illustrated how failure of large institutions might lead to catastrophic consequences for the entire financial system and economy at large. In this backdrop, the FSB developed policy framework on Global Systemically Important Financial Institutions (G-SIFIs) that was endorsed by G-20 leaders at the Cannes Summit in November 2011. Later in 2012, BIS and FSB extended the G-SIFIs framework for D-SIBs. The rationale for devising enhanced framework for D-SIBs corresponds to G-SIFIs framework, that is, the prevailing regulatory regime and policies are not sufficient to address the "negative externalities" that large financial firms create.

In case of Pakistan, the initial assessment suggested that given the financial industry structure, there are no G-SIFIs in Pakistan; however, some banks are systemically important, the failure of which may significantly impact the financial sector. Taking cue from benchmark BIS methodology, a framework for identification and enhanced regulations and supervision of D-SIBs is being designed. It is expected that D-SIBs framework will help in maintaining financial stability and facilitate in minimizing the cost to the economy in any episode of financial crisis.

3.2.2 Development of large exposure framework

Large exposures trigger systemic risk and thus demand supervisory attention. One of the limitations of Basel capital standards is that it does not take care of concentrated exposure with some standardized procedures but, instead, considers large number of granular exposure, by default. In order to overcome this issue, Basel Committee on Banking Supervision (BCBS) introduced "Supervisory framework for measuring and controlling large exposures" in April 2014. This framework is,

[1] The FSR-2016 may be accessed through http://www.sbp.org.pk/FSR/2016/index.htm

generally, aligned with risk based capital standards and represents a common minimum standard for measuring, aggregating and controlling concentration risk across jurisdictions.

In the light of BCBS new standards on large exposures, SBP has conducted an assessment and identified gaps between its existing rules on large exposures and those prescribed by BCBS. Based on the gap analysis, SBP prepared a set of draft guidelines on framework for large exposures and conducted a Quantitative Impact Study (QIS) involving few sample banks. SBP is now in the process of consultation with the stakeholders for revision of large exposure framework in line with BCBS guidelines.

3.3 Strengthening Regulatory Framework

3.3.1 Strengthening of Corporate Governance Regime

In line with international standards and best practices on good governance, SBP has further strengthened the corporate governance regime for banking industry. On this front, comprehensive guidelines on performance evaluation of the Board members have been issued. Further, the definition of 'Independent Director' has been revised in line with legal framework of Pakistani banking industry and emerging trends in the country's corporate culture. The minimum number of independent directors on the banks' Boards has also been increased to 33 percent from 25 percent.

3.3.2 Self Assessment on Compliance with BCBS Core Principles of Effective Banking Supervisions (BCPs)

The Core Principles for Effective Banking Supervision (Core Principles), issued by BCBS, are used by countries as a benchmark for assessing the quality of their supervisory systems and for identifying future work to achieve a baseline level of sound supervisory practices. Post global financial crisis, the BCBS revisited the earlier BCPs with the objective to strengthen the supervisory practices and came up with certain enhancements in their September 2012 document. The revised document has taken account of several key trends including systemically important banks, a macro-perspective in supervision of individual bank and banking group, crisis management, recovery and resolution measures to reduce probability and impact of bank failure.

With the revision in the BCPs, SBP has conducted Self-Assessment of Compliance with the principles. Based on the areas highlighted in the assessment, SBP has initiated work on further strengthening its regulatory and supervisory framework.

3.3.3 Guidelines and Disclosures on Governance and Remuneration Practices

The SBP issued guidelines on governance and remuneration practices in January, 2017 to provide banks/DFIs with detailed policy guidance to align remuneration practices with internationally adopted best principles and standards. These guidelines support remuneration practices by taking into consideration the ever expanding risk profiles and the direct link of risk taking behavior with remuneration. It will make the Board and senior management of Banks/DFIs more accountable and responsible, and align their compensation with risk adjusted performance in a fair, transparent and timely manner.

3.3.4 Amendments in *Financial Institutions (Recovery of Finances) Ordinance 2001*

In order to effectively deal with the issue of Non-Performing Loans, SBP in consultation with the banking industry proposed amendments in the *Financial Institutions (Recovery of Finances) Ordinance 2001 (FIRO).* The FIRO Amendment Act 2016 received the assent of the President of Pakistan on August 12, 2016. Currently, drafting of Rules under FIRO is in process. The Rules would, among others, enable banks to reduce the stock of NPLs through mechanism of non-judicial foreclosure in an effective and transparent manner. This would also help in expansion of mortgage and infrastructure financing.

3.3.5 Enterprise Technology Governance and Risks Management Framework
AS envisaged in its *Vision 2020,* SBP has issued *Technology Governance and Risk Management Framework for Financial Institutions (FIs)*. The framework is based on international standards and recognized practices for technology governance and risk management and shall serve as SBP's baseline requirement for all FIs. It aims to provide enabling regulatory environment for managing risks associated with the use of technology. The instructions are focused on strengthening the proactive and reactive environments in FIs to various facets and dimensions of the information technology i.e. security, operations, audit and related domains. They are also aimed to ensure that technology operations in FIs are safe and secure.

The framework shall apply to all FIs which includes commercial banks, Islamic Banks, Development Finance Institutions (DFIs) and Microfinance Banks (MFBs). The framework is not "one-size-fits-all" and implementation of the same needs to be risk-based and commensurate with size, nature and types of products and services and complexity of technology operations of the individual FI. The FIs shall assess and conduct a gap analysis between their current status and this framework and draw a time-bound action plan to address the gaps and comply with the guidelines provided in this framework.

3.3.6 Framework for Outsourcing Risk Management in Financial Institutions
Keeping in view the importance of outsourcing of activities by financial institutions; SBP initiated review of its existing guidelines on outsourcing arrangements with a view to identify the gaps between the guidelines *vis-à-vis* market practices. The revised regulatory instructions titled *Framework for Risk Management in Outsourcing Arrangements by Financial Institutions* have been issued which cover the new areas like governance of outsourcing arrangements, risk management in outsourcing arrangements, in-sourcing of services, group outsourcing, and outsourcing by foreign branches of banks and collaboration by FIs with Fintechs (Financial Technologies). The framework shall help in coverage and mitigation of the risks like strategic risk in terms of roles and responsibilities of Board and senior management of FIs, technology risk and legal risk related to the outsourcing arrangements by FIs.

3.3.7 Step towards Enhancing Efficiencies in Regulatory Reporting
SBP has been fully cognizant of utilizing information technology as a tool for enhancing its operational efficiencies. SBP’s Data Acquisition Portal is vital in acquiring quantitative and qualitative returns in electronic form from reporting entities. Quarterly Reporting Chart of Accounts (RCOA) is the most comprehensive return containing several thousand data elements being acquired through DAP4. In order to further improve efficiencies, timeline for submission of quarterly RCOA by reporting entities was reduced from 14 working days to 12 working days. These timelines shall be considered for further reduction after assessment of quality of reported data and the banks’ capacity to report error-free data.

3.3.8 Strengthening of Consumer Financing Regulations
SBP periodically reviews its regulatory framework in order to align it with changing business environment and international best practices. The Prudential Regulations for Consumer Financing were revised during the year to promote consumer financing in sustainable and fair manner while ensuring financial stability of the banks/DFIs. The revised regulations provide more discretion to

banks/DFIs in decision making in line with their dynamic business environment. Under these regulations, amongst others, banks/DFIs were advised:

- To develop common glossary of important terms. The development of common nomenclature of Important Terms facilitate the general public to have better understanding of the banks' products and services and terms and conditions thereof enabling them to make meaningful comparison between the financing products offered by different banks.

- To initiate assessments for introduction of differentiated loan pricing in all consumer financing products, which *interalia* should be sensitive to loan product characteristics, borrowers' risk assessment, timely regular repayments and exemplary behavior.

- To maintain general provision against performing loans on tiered basis linked with gross non performing loan ratio (GNPLR) of the banks/DFIs. The regulation aims to incentivize banks/DFIs which have lower GNPLR and promote better risk management practices.

3.4 Supervisory Initiatives

The on-site inspections of banks, DFIs, microfinance banks and exchange companies were conducted as per approved inspection plan FY17. Based on the inspection findings, major areas of supervisory concerns and violations of regulatory instructions pertaining to corporate governance, risk management, internal audit and compliance, AML/CFT, IT risk, service quality, settlement risk, etc. were taken up with the banks' BoDs and senior management for corrective actions. In addition, statutory reports on written-off loan and advances were prepared as per requirement of section 25AA of the *BCO 1962*. Further, inspections of selected overseas branches of locally incorporated Pakistani banks were also conducted in order to assess their soundness and stability.

3.4.1 Thematic Inspections

Thematic inspection is a supervisory tool, which focuses on the assessment of specific risk areas, business activities, processes and practices across the industry. The cross-institutional approach creates a benchmark for further policy improvement, corrective actions across industry and guidance to strengthen controls in financial institutions. SBP's approach of thematic inspections is also a step towards more focused risk based supervision of the financial institutions. During FY17, thematic inspections were carried out in the areas of internal credit risk rating systems of banks, customers' risk profiling, transaction monitoring systems of banks, human resource practices in banks, business model and credit risk of DFIs and ML risk management in exchange companies.

3.4.2 Special Investigations

The SBP conducts special investigations/ inspections on issues/complaints received from internal or external stakeholders. During the year various special investigations were carried out including mis-utilization of export proceeds, Meat Export (under invoicing), AML aspect in the withdrawal / remittance from foreign currency accounts, misappropriation of funds in Abandoned Properties Organization, assessment of impact of higher bank charges and interest rates on consumer credit and various special inspections of Exchange Companies on the request of internal stakeholders.

3.4.3 Inspection Framework for Exchange Companies

During FY17, SBP successfully carried out parallel test run of its revised risk-based framework for inspection of Exchange Companies. The Risk Assessment and Control Evaluation Regime (RACER) provides a more objective basis for assessment and risk profiling of the exchange companies and would help supervisory staff to focus on important business activities of the companies. The resultant inspection findings would help Exchange Companies improve their risk management practices, governance frameworks and process level controls.

3.5 Enhancements in SBP's Conduct Regulation and Supervision Regime

Fair Treatment of Consumers (FTC) being a crucial prerequisite for inclusive yet sustainable financial growth is amongst the important regulatory objectives of SBP. The *"Fair Treatment of Consumers (FTC) regime*" is one of the key tactical objectives under the strategic goal for improving efficiency, effectiveness and fairness of the banking system. With the strategically enhanced focus on business conduct of banks, MFBs and DFIs, SBP envisions to gradually step back from direct handling of complaints while enhancing its conduct regulation and supervision regime. The key initiatives and achievements in conduct regulation and supervision during the year include:

- **Conduct Assessment Framework (CAF):** The Conduct Assessment Framework (CAF) has been issued to demonstrate SBP resolve to ensure Fair Treatment of Consumers by banks, DFIs and MFBs. CAF was issued after a successful pilot run, which besides institutionalizing the conduct assessment would help banks to diagnose the conduct risk area (s) and develop the necessary capacity to manage such risks. Under the framework the banks will make self assessment of their business conduct and share the findings with SBP on annual basis for revalidation. CAF will also serve as conduct monitoring tool for SBP to gather conduct related data, address the gaps and maintain risk profiles of the banks.

- **Banks' Capacity Building in Consumers' Fair Treatment:** In order to inculcate the customer service orientation and create better understanding of CAF amongst the banks a three day training module was developed and conducted through Institute of Bankers Pakistan (IBP). Further, engagement sessions on large scale with higher management of banks, MFBs and DFIs are often undertaken to sensitize them about FTC and responsible banking conduct.

- **Enhanced Conduct Supervision:** In order to strengthen the FTC regime, SBP has to adopt effective conduct monitoring tools to collect market data, highlight malpractices, analyze the root causes and recommend corrective actions. Accordingly, thematic off-site examinations have been carried out to review efficiency of call centers and complaint handling procedures of banks, MFBs and DFIs through questionnaires, surveys and mystery shopping through telephone calls. The general findings and the regulatory expectations regarding the complaint handling procedures have been placed on SBP website whereas the sector specific findings along with recommendations have been shared with respective banks, MFBs and DFIs for exclusive guidance to bridge the gaps. Further, on the basis of review of efficiency of call centers, areas have been identified for issuance of guidelines to improve their efficiency, which will be issued after receipt of feedback from Pakistan Banks Association.

- **Consumer Awareness and Empowerment:** SBP has been running the Consumer Awareness campaigns since the recent past to enhance consumers' understanding and awareness about their rights through seminars across the country and through print and electronic media. In FY17 a *"Know Your Rights and Responsibility Booklet"* was prepared which comprehensively covers rights and responsibilities of the banking consumers.

3.6 International Cooperation in Banking Supervision

3.6.1 FSB Regional Consultative Group for Asia (FSB-RCG ASIA)

SBP is a member of Financial Stability Board (FSB) - Regional Consultative Group of Asia (RCG Asia) since its inception in 2011. The purpose of the RCGs is to bring together financial authorities from FSB member and non-member countries to exchange views on vulnerabilities affecting financial systems, policy initiatives underway and planned to promote financial stability and the implementation of these initiatives. Governor SBP remained co-chair of RCG Asia for about two years effective from July 1, 2015. During SBP's tenure, the RCG Asia held 3 RCG meetings and workshop on Fintech and Cyber security in Hong Kong in May 2016. SBP and Hong Kong Monetary Authority co-chaired the 11th meeting on December 2, 2016 in Hong Kong where SBP called for effective implementation of Macro-prudential Policy Framework to mitigate systemic risks. In the latest (12th) RCG Asia meeting held in Bangkok in June 2017, RCG Asia members discussed (i) Cyber security regulatory approaches and intelligence sharing; (ii) Crisis Preparedness and Resolution Regimes; (iii) Addressing misconduct in light of governance and corporate culture; among other financial stability issues.

3.6.2 Correspondent Banking Coordination Group (CBCG)

The FSB established Correspondent Banking Coordination Group (CBCG) to assess and address the decline in correspondent banking in light of the four-point action plan outlined in a FSB Report (on correspondent banking) to the G20. The FSB also created four Work Streams (WSs) of technical experts to coordinate the work pertaining to the action plan at a more detailed level: (i) Data collection and analysis (WS-1), (ii) Clarifying regulatory expectations (WS-2), (iii) Domestic capacity-building in jurisdictions that are home to affected respondent banks (WS-3) and (iv) Strengthening tools for due diligence by correspondent banks (WS-4). The Deputy Governor (Banking & FMRM) represents SBP on the CBCG, while SBP is also represented on WS-2 and WS-4. Lately, the CBCG has formed the Remittance Task Force (RTF) to coordinate work on identifying and addressing issues relating to remittance providers' access to banking services. SBP is an active member of the task force.

3.6.3 SAARCFINANCE Seminar on "Financial Stability"

SBP conducted a seminar on "Financial Stability" under SAARCFINANCE Forum on March 27-28, 2017 at NIBAF, Islamabad. The representatives from five SAARC Central Bank members participated in the Seminar. The seminar covered broad topics related to financial stability including (i) the Financial Stability Frameworks, (ii) Bank Resolution and Crisis Management; (iii) banking sector perspective on Financial Stability; (iv) Systemic Risk Management in the Securities and Capital Market; and (v) Opportunities and Challenges provided by Fintech.

3.6.4 National Risk Assessment

Pakistan carried out National Risk Assessment (NRA) with the assistance of World Bank. DG-FMU was the National Coordinator of the project. NRA is mandatory for all countries as per revised Financial Action Task Force (FATF) recommendations. Working Groups of stakeholders, consisting officers from SBP were formed to prepare reports of their respective disciplines. The SBP actively contributed in development and carrying out the assessment of following modules/areas:

- Banking Sector vulnerability
- Financial Inclusion
- Other Financial Institutions