Governor's Review

I am honored to present the SBP Performance Review for FY17, during which the economy witnessed numerous positives and some key challenges particularly in the external sector. The growth momentum further strengthened during the year with the growth rate surpassing 5 percent mark (5.3 percent) for the first time in last 10 years. The investment to GDP ratio improved to15.8 percent; the credit off take by the private sector registered strong growth of over 67 percent, inflation at 4.2 percent remained well below the target of 6 percent. The external sector however remained under stress with imports surpassing USD 50 billion for the first time, exports and remittances registering negative growth and trade and current account deficit increasing to USD 32 billion and USD 12 billion respectively. The SBP kept a close watch on these developments and took measures and policy actions to help the economy maintain the growth momentum while ensuring price stability.

The low inflation environment enabled us to continue with the accommodative monetary policy stance and keep the policy rate unchanged at 5.75 percent. The accommodative monetary policy coupled with improvement in overall business environment and energy availability and upswing in CPEC projects, etc fueled credit demand, causing credit off take by the private sector to grow by over 67 percent. The improvement in the growth of deposits and relatively lesser government borrowing from banks also contributed in the private sector credit growth. The country's financial markets also exhibited stability during the year with the overnight interest rate hovering around the policy rate and KIBOR averaging around 6.1 percent. The SBP closely monitored the liquidity and interest rate movements in the market and intervened as and when needed to implement its monetary policy stance. The constitution of an independent Monetary Policy Committee (MPC) in 2015 has enhanced the independence and credibility of the monetary policy formulation process. During the year, we also started publishing the minutes of the MPC meetings, which has further improved transparency and credibility of the process besides enabling the market to better appreciate SBP's stance on the country's overall economic conditions generally and the monetary policy particularly.

On the external front, while exports declined by 1.6 percent to USD 20.4 billion, imports grew by 18.7 percent to USD 53 billion. The import growth however, can be significantly attributed to machinery imports both for CPEC and non CPEC energy and infrastructure projects as well as for BMR projects in textile sector. The completion of these projects in the short to medium term will further augment the growth momentum besides generating export surpluses. The Home remittances declined marginally to USD 19.3 billion from USD 19.9 billion last year, which can largely be attributed to the continued weakening of economies of Saudi Arabia, Middle East and UAE in the wake of sharp decline in oil prices during last 3 years. It can also partly be attributed to increased disclosure requirements in the US with resultant increase in compliance costs and sharp depreciation of the British Pound against the US Dollar after *Brexit*. The decline in remittances was contained due to the proactive role of PRI in facilitating expats in remitting funds back home to their families.

The challenges faced on the external front resulted in decline of about USD 2 billion in our foreign exchange (FX) reserves, which reduced to USD 21 billion at the close of the year. The SBP owns about three fourth of the country's FX reserves whereas one fourth are owned by commercial banks.

A large bulk of the SBP's reserves is being managed in house whereas a small portion is with external fund managers. Keeping in view the developments in international financial markets particularly the US market, SBP gradually increased its allocation to short term US treasuries as yields on US treasuries improved. Further, to diversify the investment portfolio and improve yields without increasing the investment risk, the investment in Islamic *Sukuks* was enhanced. The yield on the FX portfolio increased to 0.85 percent in FY17 as compared to 0.79 percent in FY16 while maintaining the overall risk profile of the portfolio i.e. low risk (mostly against AAA rated sovereigns) and highly liquid.

The *SBP vision 2020* envisages strengthening of the financial stability regime and improving the efficiency and effectiveness of the financial system. The passage of the Deposit Protection Act by parliament during the year plugged a major gap in our financial stability framework. This has paved the way for the establishment of a Deposit Protection Corporation (DPC) as an SBP subsidiary. The SBP Board has also approved an initial investment of Rs500 million in the DPC equity. The DPC will commence its operations in FY18 after constitution of its Board by the Federal Government. To further strengthen the financial stability regime, the SBP signed a Letter of Understanding (LoU) with the Securities and Exchange Commission of Pakistan (SECP) to establish a Council of Regulators to mitigate systemic risk covering the broader spectrum of the financial sector. The Council will provide a forum for deliberating issues related to systemic risk, particularly those having cross market and stability implications, and will suggest arrangements necessary for a coordinated response against the crisis. Besides the Council of Regulators, work is also underway for the establishment of an overarching National Financial Stability Council (NFSC) comprising SBP, SECP and Ministry of Finance to discuss and resolve systemic issues.

In order to optimally utilize supervisory resources, we are moving towards Risk Based Supervision (RBS), which is a forward looking approach for assessment of risks and control functions in financial institutions. The development of the requisite architecture for RBS is under process; draft methodologies for identification of significant risks and assessment of control functions have been developed, which are being currently tested for assessing their effectiveness. The thematic inspections initiated since 2015 are part of the drive to move towards risk based supervision system. During the year, the Bank carried out thematic inspections of internal credit risk rating systems of banks, customers' risk profiling, transaction monitoring systems, human resource practices, business model and credit risk assessment of DFIs and the Exchange Companies' systems and capacity to manage the risk of money laundering. These reviews/inspections have enabled the Bank to better assess industry wide risks in these areas and effective requisite controls in place to mitigate risks.

On the regulatory front, to improve corporate governance in banks/DFIs, comprehensive guidelines on performance evaluation of the Board members were issued in line with international standards and best practices on corporate governance. The Bank also issued guidelines on governance and remuneration practices of the Boards and senior management of banks/DFIs to make them more accountable and responsible and align their compensation with risk adjusted performance in a fair and transparent manner. Similarly, to provide an enabling regulatory environment for managing risks associated with the use of technology, instructions for technology governance and risk management in financial institutions were issued. Further to ensure *Fair Treatment of Consumers* by the banks, Conduct Assessment Framework (CAF), a self assessment conduct monitoring tool for banks, MFBs and DFIs was issued. CAF will also serve as a conduct monitoring tool for SBP to gather conduct related data, address the gaps and maintain risk profiles of the banks.

Improving financial inclusion has been the hall mark of the SBP's financial system deepening and broadening strategy. Under the National Financial Inclusion Strategy (NFIS) launched in 2015, the *Asaan* Mobile Account (AMA) Scheme was initiated which provides an integrated platform to digital financial service providers to open digital transaction account of any person having a basic mobile phone. The Branchless Banking (BB) regulations were also amended allowing opening of accounts through biometric devices. The initiative has been a huge success with over 87 percent increase in Branchless Banking Accounts during the year. We also launched *the National Financial Literacy Program* (NFLP) to enhance financial literacy of the target groups i.e. farmers, MSEs (Micro and Small Enterprises), students, etc. Agriculture Finance, which is the major pillar of SBP's financial inclusion strategy, continued expanding with disbursements to the sector crossing Rs 700 billion mark for the first time in the country's history. Encouragingly, the outreach of agricultural finance also increased to 3.27 million farmers during the year from 2.40 million last year. The expansion of agriculture finance outreach during the year could among others also be attributed to Government of Punjab E-Credit scheme for the farmers, which was designed and implemented with our active support and facilitation.

The SBP has been playing a leading role in the promotion and development of the Islamic finance industry in the country. The Bank's efforts and contributions in the development of the industry has national and international recognition. In a major development during the year, the Federal Government accepted SBP's long outstanding recommendation and provided tax neutrality to Islamic banking institutions (IBIs) and their customers through Finance Bill 2017. This will ensure a level playing field for both conventional and Islamic finance banks and their clients; earlier it was skewed more in favor of conventional finance which was one of the key issues that had constrained its growth in the past. The Bank is also working with the industry and the Government to ensure regular issuance of *Sukuks*. It has also been absorbing some of the liquidity of IBIs through *Bai Muajjal (credit sale) of Government Ijarah Sukuk;* during the year Rs 24.6 billion was absorbed through this mode. Further, to encourage risk sharing modes of financing (*Musharakah*, *Mudarabah* and *Wakalah*), the Bank during the year exempted IBIs from the requirement of using KIBOR as a benchmark rate in the pricing of such products.

The development of a robust Payments System is amongst the strategic objectives envisaged in the SBP vision 2020. While the work is underway for the development of a National Payment System Strategy, the Bank during the year signed an agreement with the World Bank to seek its technical and financial support for the development of a National Payments Gateway (NPG). The Bank is also working actively with Federal and Provincial Governments to automate Government payments and receipts, which constitute a significant part of the country's payment system. Last year, the Bank had facilitated the Punjab Government in launching its flagship E-Stamping project, whereas during the current year necessary support was extended to the Sindh Revenue Board to initiate online collection of taxes. Similarly, the Bank has partnered with the FBR to initiate online collection of FBR taxes and customs duty. The project is at an advanced stage and is most likely to be operational by December 2017. Further to automate the Government payments and gradually eliminate cheques from the government payments, the Bank is working with AGPR and CGA to directly credit funds in the beneficiaries' accounts through RTGS. The pilot for this project is expected to be completed during FY18 in Islamabad after which it will be gradually rolled out across the country.

Despite the speedy growth being witnessed in the digitization of payment and settlement systems, cash transactions are going to stay in the foreseeable future, particularly in a cash denominated economy like ours. We have thus actively pursued automation of the cash processing functions both in the Central Bank and the banking industry to ensure issuance of machine authenticated cash to the public. The first phase of Currency Management Strategy launched in 2015, was implemented during the year whereby banks started disbursing machine authenticated banknotes (Rs500 and above) in 30 big cities. These cities host 73 percent of banks' branches, 71 percent of ATMs and 88 percent of deposits. In the second phase from January 2018, the banks shall issue machine authenticated banknotes of Rs 100 and above through their branches and ATMS across the country. The SBP during the year also started issuing higher denomination banknotes (Rs500 and above) with enhanced security features and improved look and feel. Further, during the year the old design banknotes of Rs 10, 50, 100 and 1000 were demonetized after approval by the Federal Government. These banknotes ceased to be legal tender with effect from December 1, 2016. However, the SBP-BSC offices will continue to exchange these banknotes till December 31, 2021. The Bank during the year also acquired the banknote and prize bonds printing business of Pakistan Security Printing Corporation from the Federal Government. The acquisition has enabled us to have effective and enhanced control over the full spectrum of banknote printing function, which was necessary considering the critical and strategic importance of banknotes for the Bank.

We are also investing heavily in our HR and IT systems to enhance the HR skills mix and improve the technological infrastructure as envisaged in *Vision 2020*. Training and development has been a key element of our strategy to hire and maintain a suitably trained and motivated workforce. During the year, over 1000 officers were imparted training in functional, managerial and leadership areas at NIBAF and reputed training institutes and business schools in the country including LUMS, IBA, and PIMS. We have also started sending our middle and senior management officials to Federal Government Training Programs for civil servants in Lahore and Karachi. Further, 224 officers were sent on foreign training in different funded and unfunded programs to give them exposure to the developments being made in central banking policies, practices, systems, etc. The workforce rationalization project has also been initiated to objectively assess the manpower needs for undertaking the assigned functions and strategic goals.

In order to strengthen the IT infrastructure, several initiatives have been taken including up-gradation of application software and IT systems, automation of business process and implementation of security protocols / policies. While the up-gradation of RTGS and Globus currency was successfully completed during the year, the upgrade of Globus Banking is in process and will be completed in the near future. The Bank has well defined institutional arrangements for Business Continuation Plans (BCP), which are periodically tested to assess their capacity and readiness to respond to the crisis situations. Similarly a robust and state of the art DR site is functional to continue the time sensitive critical functions in case of disasters. A comprehensive assessment of IT security was made and changes in IT governance and access control systems, etc were made where necessary.

The development of a robust Enterprise Risk Management (ERM) Framework is also at an advanced stage, which would enable the Bank to assess, measure and mitigate the risks associated with its mandate and functions. The Board has approved the ERM Framework, which would align risk assessment process with modern techniques and make it more objective. To foster the risk culture and enhance capacity of the Bank's employees in ERM, multiple training sessions on ERM were arranged. Further, two rounds of *Risk Control and Self Assessment* (RCSA) exercises were completed through bottom up approach for risk identification, analysis, prioritization and mitigation in the Bank and its subsidiaries. An *Incident Reporting Policy* has also been introduced and enforced across the organization for prompt reporting of control weaknesses to trigger remedial actions.

Lastly, I wish to express my thanks and gratitude to my predecessor Mr. Ashraf Mahmood Wathra and SBP Board of Directors under whose leadership the Bank made remarkable progress towards achieving its strategic goals. I would also like to express my deepest appreciation of the senior management team and the staff of SBP who worked tirelessly to realize the organizational goals. The institutional capacity and a culture of professionalism built over the years give me optimism for even more improvement in the Bank's performance in the years to come.

Tariq Bajwa
Governor/Chairman

October 30, 2017