Box 2: SBP's Initiatives to Strengthen the Stability of the Financial Sector

Post Global Financial Crises (GFC) of 2008, ensuring the stability of the financial system as a whole or, in other words, the containment of systemic risk, has emerged as one of the key priority areas of the policy makers.[19] Accordingly, various jurisdictions have established a well-defined and formal Macro Prudential Policy Framework (MPPF). Though diversity prevails across jurisdictions in terms of MPPF structure, the IMF-FSB-BIS, in a joint policy paper in August 2016, have taken stock of such structures existing around the globe. According to them, the key elements for an effective MPPF include (a) defining the objective and scope of MPP, (b) establishing an elaborate institutional structure, (c) assessing the systemic risk and identifying the policy toolkit, and (d) collaborating to contain the cross-border spillovers.[20]

Financial Stability—A Macro Perspective

The economies where banks are the key providers of financial services, the MPPF largely revolves around the banking sector (IMF-FSB-BIS, 2016). Since in Pakistan the financial sector is bank centric with 73 percent share in total assets, the primary responsibility for MPP lies with SBP.[21] This is the reason that SBP has been instrumental in making progress towards formation of a well-structured MPPF.

SBP's strategic plan "Vision 2020" envisages "Strengthening of Financial Stability Regime" as one of the key goals. Under this goal, SBP vowed to establish a comprehensive systemic stability framework consistent with FSB principles.

To formalize an institutional structure for an MPPF, SBP has made several arrangements that include formation of Financial Stability Executive Committee (FSEC) within SBP, Council of Regulators (COR) comprising SBP and SECP, and working towards establishing an overarching National Financial Stability Council (NFSC) involving SBP, SECP, and Ministry of Finance.[22]

Using these forums, SBP has initiated deliberations to assess the macro-financial risks, their probable repercussions for the stability of the financial sector and any needed remedial measures. The main themes of discussions included macroeconomic developments that may impact the financial sector, risks arising from Financial Action Task Force (FATF) evaluation of Pakistan, designing a large exposure framework to contain concentration risk, streamlining exchange of data/information between SBP and SECP etc.

In-house, SBP has strengthened the process of assessment and communication of systemic risk. To enhance its assessment of pro-cyclical systemic risk capabilities, SBP has brought in substantial improvements in its macro stress-testing regime to capture the macro-financial interlinkages.[23] Further, a suit of variables has been identified, which serve as Early Warning Indicators (EWIs) for build-up of systemic risk. These EWIs hint at possible risks

[19] Systemic risk has two dimensions i.e. Pro-cyclical (or Time dimension) and Structural (or Cross-sectional dimension).

[20] Please see "Elements of Effective Macro Prudential Policies", BIS, August 2016.

[21] Pakistan has shallow capital market (low market capitalization to GDP ratio), non-complex thin volume trading in financial markets, limited cross border exposures, almost negligible volume of mortgage financing (thus, expectedly, limited role of real estate prices), and less reliance on wholesale funding (thus, expectedly, low interconnectedness)

[22] For further detail, please see FSR 2017 Overview Box 2

[23] The macro stress testing model include univariate Auto Regressive Moving Average (ARMA), Vector Auto Regressive (VAR) model, vector error correction model (VECM) etc.

emanating from external and financial sectors and their interaction with the real sector.[24]

SBP has launched its Systemic Risk Survey (SRS) that helps to gauge the risk perceptions and confidence of the respondents in the stability of the financial system. The survey provides useful insights into the current and emerging risks (over the next six months) to guide policy actions.[25] SBP has conducted regular waves of SRS to closely monitor the industry's risk perceptions about the macroeconomy and the financial sector.

To contain structural risk, SBP has developed a framework for designation and supervision of Domestic Systemically Important Banks (D-SIBs). Under this framework, SBP has designated three large banks as D-SIBs with enhanced supervisory and regulatory requirements. Additional supervisory measures for D-SIBs include preparing comprehensive risk appetite framework, conducting macro stress tests/scenario analysis, preparing recovery plans and enhanced supervisory engagement with the top management and Board of the designated banks. Additional regulatory measures include higher loss absorbency requirement in the form of CET1 over and above the standard capital requirements.

To monitor up and down stream risks emerging from financial conglomerates (including non-financial entities), SBP is conducting Consolidated Supervision (CS) through continuous coordination with SECP. SBP has been in touch with the IMF to further strengthen its CS framework.

Regarding communication of financial risk assessment, SBP has been regularly publishing the yearly "Financial Stability Review", half-yearly "Performance Review of the Banking Sector", and quarterly "Compendium: Statistics of the Banking System". All these publications enhance transparency by providing detailed data including financial soundness indicators, discussion about various emerging risks and mitigating actions taken there against.

In terms of introduction and calibration of MPP tools, SBP has implemented Net Stable Funding Ratio (NSFR) and Liquidity Coverage Ratio (LCR), as prescribed under Basel III capital standards, at 100 percent for both NSFR and LCR. Further, in CY18, CAR has been increased from 11.275 percent to 11.90 percent, which is to be further raised to 12.5 percent by end of CY19. This will help in building up of the liquidity and capital buffers in the wake of recent credit expansion in the banking sector (See Chapter 3.1).

One of the key elements of MPPF is the international coordination to limit the cross-border spillovers of policy actions. Though the probability of cross-border spillovers is limited, SBP has active presence on various international forums and coordinates with multilateral agencies, national level stakeholders, and cross-border supervisory institutions.

An efficient ex-post resolution framework, including existence of credible financial safety nets, limits the spread of a system-wide contagion in a crisis. Such a framework helps maintain confidence in the system. In this regard, with the objective of compensating the small and financially unsophisticated depositors (to the extent of protected deposits), Deposit Protection Corporation (DPC) has been established as a wholly owned subsidiary of SBP (under the Deposit

---

[24] These EWIs incorporate spreads, market price indicators and their volatility, deviation from trend, and growth rates of financial and external variables.

[25] SRS is a biannual survey and its respondents include executives from commercial banks, insurance companies, exchange companies, MFBs, DFIs, , major financial market infrastructures, financial journalists, members of academia and SECP officials and think tanks.

Protection Corporation Act-2016). The Corporation commenced its business with effect from June 01, 2018[26]. Accordingly, DPC has taken following initiatives in order to initiate and implement an effective deposit protection mechanism/ framework; (a) all scheduled banks operating in Pakistan were notified as members of the Corporation, thus included in the protection framework[27], (b) DPC has rolled out deposit protection mechanism for banking companies including Islamic banks effective from July 01, 2018, in line with its statute and Core Principles for Effective Deposit Insurance Systems issued by International Association of Deposit Insurers (IADI)[28], (c) a separate deposit protection arrangement has been made for the Shariah based deposits under Shariah Compliant Deposit Protection Mechanism for depositors of Islamic Banking Institutions (IBIs)[29]and (d) all member banks have started paying the required premium contributions on quarterly basis.[30]

Financial Stability—A Micro Perspective

The presence of sound financial institutions and efficient markets is essential to ensure financial stability enabling the country to cope with the emerging risks, adapt the changing market dynamics, and ensure smooth flow of financial services. As per BIS-FSB-IMF (2016), micro prudential regulation and supervision complements the macro prudential framework. SBP—in its regulatory and supervisory domains—has taken various measures to address the emerging risks. The key focus areas include:

Foreign Exchange Policy & Operations: SBP is well cognizant of the vulnerable external sector, which has jittered the foreign exchange market **(See chapter 2)**. It is monitoring the FX flows and taking measures to limit speculative activities. It is also strengthening the operating procedures to contain the likelihood of ML/FT activities. The following SBP initiatives are worth mentioning:

To facilitate enhanced monitoring, SBP has introduced amendments in Protection of Economic Reforms Act (PERA), 1992 through Finance Act, 2018, which has allowed SBP to bind all carriers of foreign currencies of Exchange Companies (ECs) to declare cash currencies to Custom authorities **(Chapter 4.4)**. Further, another amendment in PERA, has also restricted deposit of cash foreign currency in foreign currency account to income tax returns filers only and allowed the federal government to make rules governing deposits in and withdrawals from the foreign currency accounts. [31]

In order to keep abreast with the fast changing market dynamics, SBP has made revisions in its Foreign Exchange Manual related to authorized dealers, foreign currency loans, overdrafts and guarantees, forward exchange facilities etc.[32]

Weighing the risk associated with the virtual currency (e.g. bitcoin, Litecoin, Pakcoin, OneCoin etc.) including volatility in the price and use of such currencies in illegal activities such as money laundering and the trade in illegal goods, SBP has barred ECs and ECs of 'B' category from processing, using, trading, holding, transferring value, promoting and investing in Virtual Currencies/Tokens. Further, ECs and ECs of 'B' Category have also been restricted from facilitating their customers to transact in VCs/ICO tokens. **(See Chapter 6).**[33]

---

[26] DPC Circular No. 02 dated May 31, 2018

[27] DPC Circular No. 03 dated June 22, 2018

[28] DPC Circular No. 04 dated June 22, 2018

[29] This mechanism has been developed in accordance with the requirements of Section 7(3) of the Act, to comply with the Shariah requirements of such protection arrangement

[30] The protected amount has been determined by the Corporation to be PKR 250,000 per depositor per bank, which is 1.46 times of GDP per capita.

[31] EPD Circular Letter No. 05 of 2018

[32] FE Circular No. 14 of 2018

[33] FE Circular No. 03 of 2018

AML/CFT: SBP has taken several initiatives to strengthen AML/CFT regime. These include a) amendments in AML/CFT regulations to bring about clarity on various terminologies, b) guidance on compliance of SROs and notifications issued by GoP under UNSC resolutions, and c) enhancement in scope of KYC requirements.

Overseas Operations: The overseas operations contribute around 5 percent share in the assets of the banking sector. In response to challenges emerging for the banking sector in the overseas markets, SBP has issued a comprehensive Governance Framework for banks' overseas operations in 2018. The framework is aimed at strengthening banks' capacity to understand, identify and manage various risks posed by its foreign operations. Banks are required to strengthen their governance, risk management & compliance practices for their overseas branch & subsidiary operations.[34]

Quality of Disclosures: SBP has revised the financial statement format/disclosures of banks/DFIs to align them with the regulatory changes and international best practices. The objective is to bring consistency in financial reporting among the banking industry while enhancing the transparency and quality of their disclosures. [35] [36]

Dynamic Provisioning: IFRS 9, the new accounting standard has presented a major overhaul of financial instruments accounting by introducing an expected credit loss approach based on probability of default. SBP has advised the banking industry in 2018 to carry out a 'Quantitative Impact Assessment' of IFRS 9 implementation on their balance sheets. The purpose of this exercise was to determine the banking sector's readiness and identification of the challenges expected during its implementation. This step is expected to complement the MPPF later as IFRS 9 encourages dynamic provisioning.

Risk Based Supervision: SBP has made major strides in the development of Risk Based Supervision (RBS) framework by entering into a Long Term Country Engagement (LTCE) program with Toronto Centre (TC) for capacity building of SBP officials. LTCE program spreads over two and a half years (July 2018 – Dec 2020). During this time, the RBS framework will be developed, tested and refined.

IT Inspection: For comprehensive assessment of IT systems of the supervised financial institutions, Information Systems' Inspection Framework (ISIF) has been developed. ISIF would form part of overall RBS framework, which is presently in development phase. ISIF assess the risk in core IT functions i.e. IT operations, IT value delivery, Alternate delivery channels, Project management and IT procurement & Service Level Agreement (SLA) management, while controls and governance aspects are also assessed.

Banking Conduct and Consumer Protection: SBP considers Financial Consumer Protection or Responsible Banking Conduct crucial for stability and inclusive growth of the sector. In this connection, some of the most eminent conduct milestones achieved by SBP in CY18 include:

- SBP has issued guidelines on 'Prohibited Banking Conduct. These guidelines will enable banks to exhibit responsible conduct by ensuring the inclusion of adequate and preemptive controls in their Fair Treatment of Consumers (FTC) frameworks.[37]

[34] BPRD Circular No. 06 of 2018

[35] BPRD Circular No. 02 0f 2018

[36] Few changes include as (a) movement of revaluation surplus/deficit under equity head, (b) separate line for intangible assets, (c) single line presentation for provision against NPLs and investment, (d) addition of new line for income from derivative, (e) addition of state of comprehensive income, and (f) few changes in the notes of financial statements.

[37] BC&CPD Circular No. 02 of 2018

- In order to strengthen the FTC regime, SBP has embraced effective conduct monitoring tools to collect market data, highlight malpractices, analyze the root causes and recommend corrective actions. Accordingly, SBP has recently conducted off-site thematic examination on "Marketing Disclosures for Individual Lending Products" by banks.

- In view of digital transformation, the functional importance and allied conduct risks of call centers, SBP undertook a diagnostic review of "Call Center Management at banks". Based on the thematic review, detail guidelines on the Call Center management, eliciting the related bare minimums, have been issued for the banks and MFBs.[38]

- SBP has granted the certificate of commencement of business to Aequitas Information Service Limited, first private credit bureau in Pakistan, and license to another credit bureau viz. Data Check Limited in the year 2018.

Financial Market Infrastructure (See Chapter 5): Pakistan Real Time Interbank Settlement Mechanism (PRISM) is the payment system of systemic importance facilitating large scale transactions. Keeping in view that significant developments have taken placed in terms of scope and operational efficiency of PRISM, SBP has updated PRISM Operating Rules (PORs) which are in line with international standards and offer directions related to PRISM (RTGS) business operations.[39]

Electronic Fund Transfers (EFTs) enable customers to access their bank accounts electronically for fund transfers and account management using different channels like ATMs, internet and mobile banking etc. SBP has issued Regulations for EFTs with the purpose to promote, ensure consumer protection and payments transparency by standardizing EFTs as broadly outlined in Payment System & Electronic Fund Transfer (PS&EFT) Act 2007[40]. These regulations identify the minimum information of originator and beneficiary required to initiate/process an EFT, highlight the responsibilities of originator, Payment System Operators (PSOs) /Payment Service Providers (PSPs) and beneficiary compensation policy for unauthorized and / or delayed EFTs, disclosure requirements and dispute resolution process etc.

To safeguard banks/MFBs and their customers from potential losses due to cyber-crimes and online banking frauds, SBP has issued a comprehensive set of instructions – advising banks to take pre-emptive measures and ensure security of card data.[41]

SBP has issued guidelines to broaden the scope of payment services as well as enhance the operational efficiency of financial transactions. Such initiatives include allowing NBFIs to offer ATM services (called White Label ATM Operator)[42], advising banks to enable customers' credit card payments through alternate delivery channels (internet banking, mobile banking, ATMs etc.)[43], assigning 1Link and National Clearing Corporation of Pakistan Limited (NCCPL) as Special Participants of PRISM to bring in further efficiency in the clearing process and limit the settlement risk etc.[44,45]

Financial Stability—Financial Inclusion Perspective

A vast literature has established that, besides supporting poverty reduction and economic growth, the financial inclusion also promotes financial stability.[46] In fact, providing greater access and better

[38] BC&CPD Circular No. 01 of 2018

[39] PSD Circular No. 02 of 2018

[40] PSD Circular No. 03 of 2018

[41] PSD Circular No. 09 of 2018

[42] PSD Circular No. 05 of 2018

[43] PSD Circular letter No. 02 of 2018

[44] PSD Circular No. 04 of 2018

[45] PSD Circular No. 01 of 2018

[46] **Indicators used to proxy financial inclusion** (e.g. share of credit provided to SMEs, number of bank branches per 1000 population, number of ATMs per 1000 population, number of

uses of financial services to a vast under-privileged section of the society strengthens the financial stability, given the country has already implemented financial infrastructure and skilled supervision (Okpara 2011; Prasad 2010; Cull et al. 2012). Morgan and Pontines (2014) highlighted that increased share of lending to small and medium-sized enterprises (SMEs) aids financial stability, mainly by reducing non-performing loans (NPLs) and the probability of default by financial institutions. Han and Melecky (2013) observed that financial inclusion, measured by wider access to and use of deposits, can build the banks' deposit base stronger in period of financial trauma, which ultimately promotes financial stability of countries, especially the middle income countries. On the other hand, greater financial access may lead to financial risks if driven by rapid credit growth or the expansion of relatively unregulated parts of the financial system (BIS Quarterly Review, March 2015).

SBP has long been promoting the development finance including microfinance, SME finance, Agriculture finance, Infrastructure and Housing finance and Islamic Banking. Increasing financial inclusion is one of the key strategic goals of SBP Vision 2020. The developments in this regard are as under:

National Financial Inclusion Strategy (NFIS): To promote financial inclusion, government launched NFIS in 2015. With the ultimate objective of enhancing inclusion, the federal government has published new policy directions for its implementation during the next five years. [47,48] The policy offers a national framework, definite action plan and targets for achieving universal financial inclusion. The updated policy contributes headline targets and specific tasks for their accomplishment, assigned to the relevant institutions, with given timeline and Key Performance Indicators (KPIs) for implementation until 2023.[49] These targets focus on broad areas, such as;

- Enhancing usage of digital payments (65 million transaction accounts including 20 million share of women)
- Increasing deposit base to 55.0 percent of GDP[50]
- Promoting SME finance (achieve 17 percent of private sector credit and increase borrowers to 700,000)[51]
- Increasing agricultural finance (target annual disbursement of PKR 1.8 trillion and cater to 6 million farmers digitally), enhancing low-cost housing, increasing share of Islamic banking (to 25 percent of banking industry and attain 30 percent share in overall branch network)

Microfinance: In order to address funding constraints of the microfinance sector, SBP has established a Line of Credit (LoC) Fund for Microfinance Banks (MFBs)

SME borrowers, number of accounts at formal institutions, and financial inclusion index etc.)

Indicators used to proxy financial stability (bank Altman's Z-score, stock market volatility, provision for non-performing loan, standard deviation of deposit, financial stability index etc.)

[47] Publication "NFIS Government's 100 day Agenda" (retrieved from http://www.finance.gov.pk/NFIS.pdf)

[48] In 2015, Government of Pakistan (Ministry of Finance (MoF)) and SBP introduced the National Financial Inclusion Strategy (NFIS) per implementation plan until 2020.

[49] With regard to the implementation framework, a central monitoring and coordination system has been realized through the creation of "Transformation Office" at PM office. The ultimate responsibility for the implementation rests with the assigned institution.

[50] According to World Bank, the deposit to GDP ratio was 32.0 percent in 2016 (https://fred.stlouisfed.org/series/DDOI02PKA156NWDB)

[51] As of December 30 2018, the credit to SME sector as percent of Pvt. Sector financing was 8.46 percent and SME borrowers were 180,704. (Source: Annual SME Finance Review, 2018: http://www.sbp.org.pk/sme/PDF/DFG/2018/QSMEF-Dec-2018.pdf)

and Non-Bank Microfinance Companies (NBMFCs) for onward lending to microfinance borrowers. This has been carried out with the funding support of GoP under WB's Financial Inclusion and Infrastructure project.[52]

SME Financing: To promote SMEs, SBP's following initiatives are noteworthy:

- The scope of current Credit Guarantee Scheme (CGS) has been extended through inclusion of low-end medium enterprises under this scheme.
- To enable un-incorporated SMEs to use[53] moveable assets as collateral, SBP is facilitating establishment of an electronic registry under Financial Institutions (Secured Transaction) Act, 2016.
- In consideration of the fact that majority of the SMEs lack expertise to professionally manage financial, technological, marketing and human resource aspects of their businesses, banks have been advised to adopt Non-Financial Advisory Services (NFAS) in their SME banking to better serve their existing and potential SME clients. [54]
- SBP introduced the modus operandi for the Refinance Scheme for Working Capital Financing of Small and Low-End Medium Enterprises in selected economic sectors.[55] Similarly, in an effort to improve financing access for women entrepreneurs, the coverage under 'Refinance and Credit Guarantee Scheme for Women Entrepreneurs in Underserved Areas' has been extended by increasing the number of eligible districts.[56]

Housing Finance: The housing finance has a meager share in Pakistan (0.5 percent of GDP). In order to promote housing finance, Pakistan Mortgage Refinance Company (PMRC), established with the equity contributions from Financial Institutions (FIs) and the Government of Pakistan (GoP), has been granted permission to commence business. PMRC is mandated to provide long term funding to Primary Mortgage Lenders (PMLs) and will also contribute to the development of bond market.

Islamic Finance: In order to provide Shariah compliant alternative of conventional Long Term Financing Facility (LTFF), SBP has issued Mudarabah based Islamic Long Term Financing Facility (ILTFF) to facilitate export industries for purchase of imported or locally manufactured new plant and machinery.[57]

SBP has revised 'Shariah Governance Framework for Islamic Banking Institutions'. The framework covers the roles of various organs of Islamic. Also, IBIs have been advised to undertake enhanced measures for training and capacity building of their staff.

[52] AC&MFD Circular No. 01 0f 2018

[53] IH&SMEFD Circular Letter No. 01 of 2018

[54] IH&SMEFD Circular No. 10 of 2017

[55] This scheme was introduced in December 2017 (IH&SMEFD Circular No. 11 of 2017)

[56] IH&SMEFD Circular Letter No. 02 of 2018

[57] IH&SMEFD Circular No. 01 of 2018