Box 3.2: Supervisory and Crisis Management framework of SBP – recent initiatives to strengthen the financial stability

Financial stability is one of the key public policy objectives as it is essential for sustainable economic growth and public welfare, with a predominant role of central bank. In terms of the recent amendments, section 4B of the SBP Act, 1956[76] has explicitly delineated the stability of the financial system of Pakistan as one of the objectives of SBP. Further, section 4C of the Act, among others, empowers SBP to use necessary macro-prudential tools for this purpose.

Effectiveness of central bank's role in financial stability reflects in effectiveness of its supervisory framework; and well-designed safety nets as a part of the crisis management framework.

SBP strives to continuously improve and update its supervisory and safety nets framework

To this end, the overall supervisory framework and financial safety nets of SBP adequately complies with internationally accepted best principles and standards. Effective management of different crises and contribution to stability of the financial system over the years corroborate the effectiveness of the safety nets available at disposal of the SBP. Incidentally, SBP regularly reviews and updates its supervisory framework in light of emerging best practices and changing dynamics of the market. In this regard, SBP took various measures in recent years to strengthen its safety, which are discussed below.

Risk Based Supervisory framework as the primary safety net against financial fragility

SBP has adequate supervisory powers to issue regulations and directions as well as to supervise banks and take corrective measures for redressing any supervisory concerns and orderly resolving failing institutions. Accordingly, SBP has issued necessary guidelines and prudential regulations to banks to provide guidance and minimum standards of prudence on different key areas **(**see **Table 3.2.1).**

Table 3.2.1: Supervisory regime and financial safety nets
• Risk-Based Supervision and Corrective Action Regime • Problem Bank Management • Lender of Last Resort • Deposit Protection Corporation
Legal Framework and Powers (SBP Act 1956, BCO 1962 and DPC Act 2016)

SBP has instituted a comprehensive surveillance mechanism which is based on the premise of *Risk-Based Supervisory (**RBS**) Framework* in 2021.[77] This framework provides more future-oriented and comprehensive assessments of financial institutions and help in optimum utilization of supervisory resources. Under the framework, SBP continuously supervises the regulated institutions and takes corrective measures e.g. direction to improve their governance and controls, imposes penalties in case of breach, removes a bank's management where its conduct is detrimental for the bank and its depositors, etc. SBP also has legal powers and institutional arrangements to take resolution measures for the rehabilitation and reorganization of problem bank that cannot

[76] The State Bank of Pakistan Act, 1956

[77] Risk Based Supervisory Framework. The CAMELS based supervisory system was replaced by the RBS framework replaced in 2021.

continue as going concern entity and thus can cause losses to general depositors and lead to loss of public confidence in the banking system and system wide crisis. For this purpose, SBP can also impose moratorium on a failing bank with the approval of federal government to avoid run on bank and consequent value destruction, and prepare scheme of reconstruction for the bank. Under this scheme, any losses can be imposed on the shareholders and creditors of the bank.

For dealing with a crisis situation, SBP has formulated contingency planning process which comprises crisis binder to guide and formalize the role of different departments in a crisis scenario, identification of Domestic Systemically Important Banks (**D-SIBs**) and subject them to additional capital requirement and enhanced supervision including the requirement to prepare recovery plan, communication strategies for dealing with crisis events, etc.[78]

To strengthen the contingency planning process, SBP is working to improve resolution-planning process for D-SIBs and plans to conduct a simulation exercise to test its abilities to handle a situation of financial crisis.

With a view to strengthen its resolution regime, SBP is contemplating certain changes in its legal and supervisory framework to align with emerging best practices on banks' resolution.

Safety nets have been instituted to provide financing to banks in crisis and protection to depositors

In the recent years, SBP has taken a number of measures to further improve the safety nets. For instance, regulations for the provision of *Lender of Last Resort* (***LOLR***) facility have been formulated under section 17G of the SBP Act, 1956[79]. Under this section SBP can extend financing to a bank for improving the liquidity position so that an interim liquidity shortage may not lead to the failure of a bank. Unlike standard financing facilities which are provided against the security of federal government papers, LOLR facility can be extended against a wide variety of adequate collaterals. The facility can be extended under both conventional and the Shariah-compliant modes.

Moreover, **Deposit Protection Corporation (DPC)** was established and operationalized in 2018 under the Deposit Protection Corporation Act, 2016 as an explicit deposit insurance system in Pakistan. DPC plays a pivotal role in promoting financial stability and preserving the general confidence in the banking system. It aims to compensate the small and financially unsophisticated depositors to the extent of protected deposits in the event of a bank failure. All scheduled banks are member institutions of the DPC. They pay prescribed premium to DPC which compensate the depositors of a failing bank up to the protected amount.[80]

Macro-prudential supervision framework focus on the systemic risks and cross sectional dynamics

The regulatory regime of SBP is based on the principle of proportionality and comprises both rule and principle based instruction. It duly addresses the emerging systemic risks as well as any peculiarities arising from the interconnectedness and other dynamics of the

[78] D-SIBs are identified on the basis of their size, interconnectedness, substitutability and complexity. Please refer BPRD Circular No. 04 of 2018

[79] SBP issued LOLR Regulation in January 2022. These regulations cover modes of financing, types of collaterals, pricing of facility, tenor, minimum eligibility criteria, documentation requirements, etc. Moreover, banks have been advised to appropriately incorporate the issued regulations in their operational processes to access LOLR facility in case of exceptional liquidity stress.

[80] In order to further enhance depositors' confidence and support financial stability, DPC has recently enhanced the level of protected deposit from PKR 250,000 to PKR500,000 per depositor-per bank

financial market. In order to continuously monitor the **macro prudential risks and take timely measures,** the SBP carries out various macro prudential surveillance assessments including scenario analysis (macro stress testing) to estimate projected solvency position of bank over a protracted period of time, assessment and designation of D-SIBs, preparation and publication of financial stability review, detailed statistics on banks, Microfinance Banks (**MFBs**) and DFIs, financial soundness indicators, and special studies. Moreover, consolidated surveillance of banks and financial conglomerates is carried in coordination with SECP. To facilitate the coordination between key stakeholders for timely policy actions, SBP has instituted a number of high-level forums both within the institution as well as with other agencies like SECP and Ministry of Finance.