Pakistan: Regulatory and Supervisory Framework

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I. Introduction

1. Pakistan's financial sector has undergone a phenomenal structural change. Key elements of this change are:

(i) Privatization of banking industry which only 6 years or so back was 90% in public sector—privatization was accompanied by significant debt and labor resolution and restructuring,

(ii) Free and flexible entry of foreign banks raising foreign shareholding to almost half of the banking sector assets,

(iii) Development of a strong banking system as capital base has strengthened and the ratio of Net NPLs to Net Loans today is at an all time low of 1.8% for all banks and 1.3% for commercial banks.

(iv) Enhancement in financial depth and private credit ratio – there is however considerable room for further expansion of these indicators,

(v) Substantial credit diversification at sector levels which is helping support broad based economic activity,

(vi) Strengthening of regulatory and supervisory framework along with the stricter enforcement by a vigilant and strong central bank that is fully independent and accountable to its Board, and

(vii) Changed perception and approaches to safety net for depositors and prompt corrective actions. With most banking system now in private hands, the government's implicit guarantee for deposit no longer exists and now the owners and the Board of Directors as wells as top management of a bank are liable for their actions. Notwithstanding, central banks surveillance system plays a key role in identification of the problems, e.g. threat to capital, liquidity crisis at the earliest stage, and execution of prompt corrective action – the objective being to curb the problem at the onset, and if required appointing official liquidators for settlement of depositors' claims in a timely manner, in cases where the corrective actions result in liquidation/restructuring of the bank.

2. The trends and performance of banking sector has been influenced by a variety of factors, in particular higher and sustainable economic growth supported by effective macroeconomic management and comprehensive and sophisticated prudential regulatory and supervisory (PRS) framework. In designing PRS, central bank has been realistic and rigorous, while recognizing need for flexibility so critical given the characteristics, structure and state of financial sector and the prevailing governance and market practices. Adopted effective January 2004, the PRS has since continuously been updated substantively to respond to the emerging developments in the sector and to conform to the International standards.

3. Pakistan's PRS aims to: promote and preserve financial sector stability, encourages banks to function purely on market principles and operate in a fair and efficient manner guided by high standards of corporate governance with emphasis on complete disclosure and transparency. To ensure effectiveness of this framework, central bank has now put in place an elaborate framework of banking surveillance and supervision.

4. In setting this PRS, the main challenge has been to evolve and develop a well balanced PRS which allows for (i) an open, liberal and competitive neutrality of regulatory framework that promotes financial sector growth, diversification, and innovation, (ii) healthy competition and risk taking to ensure a sustainable and aggressive income stream, and (iii) opportunities for enhancing the franchise value of banks. On the other hand, it is critical for regulatory framework to recognize the need for augmenting more prudent behavior and ensuring effective risk management especially critical in fast expanding financial markets and also safeguarding social obligations and consumer interests. By and large Pakistan's PRS is now market friendly and all credit and lending cum deposit rate prescriptions and dictates have been withdrawn and banks are now free to operate as long as they comply with regulatory framework.

II. Regulatory Framework

5. Recognizing the ground realities, Pakistan's financial regulatory framework at this stage restricts banks from engaging in non-related commercial activities to avoid conflicts of interest between banks and diverse businesses such as securities and insurance underwriting, and real estate investment etc. This is largely done to avoid at this stage the complexities emerging from cross ownership and large conglomerates. Except in case of multilateral borrowings, banks are generally prohibited from assuming any obligation or guarantees on behalf of Non-bank Financial Institutions (NBFIs).

6. Banks and development finance institutions (DFIs) exposure to equity market is governed by a PR which disallows exposures against the security issued by the

bank itself or those by prospective borrowers themselves or provide unsecured credit to finance the floatation of securities or take exposure against non-listed securities and sponsor directors' shares. Banks investment in any single scrip is limited to 5% of their own equity with total investment in listed shares is capped at 20%. The margin requirement against the security of shares of listed companies has been set at 30%. Notwithstanding these broader restrictions banks are allowed to set up or take higher stakes in their subsidiaries that can be formed for specified purposes like asset management, brokerage, etc.. This allows banks to diversify their business interests but operating as a separate business entity.

7. Consistent with normal practices, the regulatory framework for banks is all encompassing and covers a broad spectrum of elements which can be classified in six different categories defining; (i) entry requirements, (ii) risk management guidelines, (iii) corporate governance framework, (iv) industry specific guidelines, (v) operational guidelines and (iv) anti money laundering regime.

8. **Bank Entry and Licensing Requirements**. SBP has the sole authority to set criteria and approve or transfer ownership of bank licensing. Presently, banks/DFIs are required to, in a phased manner, to meet capital requirements which have reached $50 million as of December 2006 and will be doubled to $100 million by 31 December 2009. Among others, higher capital requirements are intended to accelerate the process of banking sector consolidation. Of 39 institutions, 32 banks are well on their way to meeting stipulated capital requirements with 8 banks already complying with the 2009 capital requirements. To the extent capital of banks is being enhanced through M&A process it has facilitated a degree of consolidation among convential banks.

9. SBP has now for few years invoked partial suspension of issuance of new bank licenses. After a period of liberal licensing, SBP is no longer issuing convential bank licenses in order to encourage sector consolidation. Responding to this, market has been dynamic as evident from the wave of aggressive 25 odd mergers and acquisitions some of them led by strategic foreign banks.

10. Foreign interest in Pakistani banks is driven by strong business prospects given thus far financial penetration ratio has been considerably low and there exists large potential untapped retail market as well as high profitability with return on equity close to 25%. Foreign banks can either conduct business in branch mode or set up a wholly owned locally incorporated subsidiary provided they are member of a regional group or association or if foreign banks have a global tier-1 paid up capital of US$5 billion or more. Other than these categories a foreign corporate/ body desirous of conducting banking business in Pakistan should set up local subsidiaries with a maximum of 49% share holding. Currently of the 39 banks in the country, almost 14 have foreign shareholding with few of them either fully or partially foreign owned or other smaller strategic stakes. Foreign interest in banking system has been substantial and since 2002 cumulatively has attracted foreign capital inflow of over $2 billion (including funds raised and expected to be raised from GDRs

floatation of banks in international markets). Standard Chartered Bank acquisition of mid size Union bank itself has mobilized significant proceeds. Besides, ABN-Amro, Citibank, HSBC, Saudi American Bank and Temasak all have an interest in expanding businesses and/or acquiring domestic stakes, while three banks are offering GDRs in international markets. Foreign interest in Islamic banks is quite strong with four of six banks being foreign owned.

11. Not only is entry easy through M&As in Pakistani banking sector, but license are being issued for Islamic banks as well as microfinance banks – two areas which hold phenomenal prospects for augmenting financial penetration, while serving the development needs particularly for the underserved segments of population. Thus far 6 Islamic banks and 6 microfinance banks have been allowed with former expected to constitute at least 10% of total banking sector by 2010 and microfinance reach to enhance to additional 3 million customers. Evading licensing restrictions, the Government has continued to set up bilateral government-to-government joint venture-DFIs.

12. ***Risk Management.*** Banks are allowed to take appropriate and diversified individual, group and sector risk exposures, while nurturing effective governance standards that would ultimately set the stage for a more stable and mature financial market, which can then be allowed greater flexibility. Aside from standard limits on single and group exposures (limited to 30% and 50% (including 20% and 35% fund based exposure), respectively), banks exposure on contingent liabilities cannot exceed 10 times of its own equity. Likewise, clean lending to single persons is limited to Rs0.5 million and in aggregate it cannot exceed the equity of the banks. Furthermore, Banks/DFIs exposure to a company cannot exceed 10 times of borrowing entities' equity and the entities current ratio cannot be lower than 1:1. Corporate's subordinated loans are included in their equity determination. Banks are required to obtain CIB reports for loan transaction above a limit (currently set at Rs500,000) and audited balance sheet from borrowers whose transactions value exceeds Rs10 million.

13. Since consumer financing is still relatively an emerging area, SBP lays down an elaborate risk management framework for it. Although banks are allowed clean lending for personal and consumer loans within limits (Rs 500,000), these loans cannot be used for real estate purchase or subscription of IPOs. New entrants in the first and second year are not allowed to lend more than 2 and 4 times their bank equity, respectively. For subsequent years, so long as classified loans under consumer finance are 3%, banks can offer up to 10 times their equity and if these classified loans rise up to and above 10% the limit~~s~~ is scaled down to 2 times the equity of bank. Banks are expected to develop effective MIS reporting and risk management system for consumer financing. Subject to adequacy of these system and experience in consumer financing, SBP has relaxed the exposure limits on consumer financing. However, banks not meeting these requirements or illustrating poor track record of consumer financing could face restricted exposure limits. Banks have adapted well to these prudential norms and NPLs related to consumer loans

have been low (3% of total NPLs) despite the share of consumer financing in total outstanding advances has risen to about 14%.

14. These stringent PRs were instituted to ensure prudent risk behavior, however, in cases where justified, central bank can relax these exposure limits for temporary period, if financial strength of company's balance sheet is expected to improve or there is need to finance a strategic project backed by public sector guarantees. Banks are free to extend loans against hypothecation of stocks and/or receivables and to set margin financing requirements on financing facilities keeping in view risk profile of borrower.

15. Classification and provisioning for assets conforms to international norms. Loans overdue by 90 days are subject to 25% provision (up from 10%) – effective 31 December 2006 and those overdue by 180 days require 50% provisioning and those above 360 days have to be fully provisioned for.

16. ***Corporate Governance***. A recent World Bank study on South Asia "Access to Finance" ranked Pakistan corporate governance standards highest among South Asia. This is further supplemented by the 2005 ROSC assessment of corporate governance standards which have given higher points, relative to the world average, to Pakistan on majority of its principles.

17. Among other efforts, this is an outcome of effectiveness of an elaborate Corporate Governance Framework laying down specific corporate governance guidelines for banks which further has infused greater discipline among bank-finance dependent corporate sector. Besides the legislative stipulations of Banking Companies Ordinance (BCO), 1962 that provide rules for fit and proper criteria of Management and Board of Directors (BoD) as well as their appointments/dismissal, disclosure of share ownership, dividend policy, and appointments of external auditors etc., SBP has introduced a Handbook of CG for Banks which, among others, defines the role and responsibilities of BoDs; the fit and proper test criteria prescribed for Chief Executive Officers, Board members and key executives; restriction on shareholdings by the director; dealings of the banks with directors; and requirement of credit rating.

18. Furthermore SBP, in collaboration with the ICAP (the premier accounting body of the country) and the commercial banks, has facilitated adoption of International Accounting standards (IAS) by the banks. In 2006 (Feb) the reporting formats were revised to incorporate the significant regulatory developments and the modifications in the International Financial Reporting Standards (IFRS). With these changes, the quality of disclosure by banks in their annual accounts is at par with international best practices.

19. To ensure the quality of external auditors for banks SBP requires an audit firm to be approved from SBP Panel of Auditors. The firm is classified in categories A, B, and C depending on a criterion developed internally and the criteria takes into

account the number of qualified accountants, international affiliation, quality review by ICAP, and past experience. The classification also prescribe the size of the bank a firm can audit, e.g. large banks can only be audited by firms in category A.

20. ***Industry-specific PRs***. Replacing all prescribed sector ceilings or subsidized lending, SBP encourages competition amongst banks to meet the diverse set of development requirements. Given the gap in supply and demand for credit delivery, SBP has formed consultative groups to identify issues impeding the outreach of financial services for agriculture and rural sector, SME and microfinance sectors. Agriculture sector financing has more than doubled over the last few years, but remains below the overall credit requirements of the sector. Commercialization of agriculture financing, crop loan insurance program and improvements in land registration and passbook system in rural areas have been found to be more effective mechanisms to retail agriculture credit, though flow of non-farm credit has remained low.

21. Recognizing commercialization of microfinance businesses is key to its financial and social sector sustainability; SBP has set up a regulatory regime for Microfinance banks (MFBs). Currently about 6 MFBs are governed and regulated by the MFIs Ordinance, 2001 that encourages a paradigm shift in microfinance industry, while laying foundation for systematic growth of the sector. MFBs capital requirements are set lower than commercial banks (Rs250 million) and they are required to maintain equity equivalent to at least 15% of its risk-weighted assets. Under PRs, MFBs are required to set 10% of deposit liabilities in liquid assets and transfer 20% of its annual profits after tax into reserve fund until it reaches equivalent to its capital base after which this allocation is reduced to 5%. MFBs have to set up Depositors' Protection Fund or scheme for the purpose of mitigating risk of its depositors, to which MFB/MFI shall credit not less than 5% of its annual profit after taxes. MFBs have to set aside general provision of 2% besides other stringent provision requirements. MFBs need to lend maximum loan size of Rs150, 000. SBP has further issued NGOs/Rural Support Programs/Cooperative Transformation guidelines for their upgradation to MFBs. Fit and proper criteria have been laid down for CEOs and Management of MFBs. Guidelines have been issued for commercial banks interested in engaging in microfinance business. SBP unique and rich regulatory framework offering a model of development of MF.

22. Under SBP regulatory framework, banks can offer new financing schemes and innovative products to meet the financial requirements of SMEs, while providing themselves a viable and growing lending outlet. Under PRs, banks are encouraged to extend cash flow based lending and they can take clean exposure secured only against personal guarantees of SMEs owners for up to Rs 3 million, however, clean funded exposure should not exceed Rs 2 million. For eligibility SMEs ought to declare that it has not availed clean facilities from any other bank/DFI. The maximum exposure of a bank / DFI on a single SME shall not exceed Rs 75 million. The total facilities (including leased assets) availed by a single SME from the financial

institutions should not exceed Rs 150 million provided that the facilities excluding leased assets shall not exceed Rs 100 million.

23. ***Operational Instructions***. Supplementing its PRs, SBP has issued guidelines on risk management, business continuity plan, internal controls, and stress testing. Both PRs and guidelines form the basis of our regulatory framework that enables SBP to carry out a proactive role. As the business is expanding and banks are positioning themselves to take advantage of emerging opportunities, the technology adoption becomes imperative to get a competitive edge to deliver services in an efficient and cost effective manner. Accordingly, almost all the banks in Pakistan have embarked upon major IT projects that will improve their operational efficiency and strengthen internal controls.

24. **Anti-money laundering and Combating Financing of Terrorism (AML/CFT)**. Pakistan like other jurisdiction**s** has adopted a comprehensive set of PRs to enhance its vigilance on money laundering and terrorist financing. PRs for AML require banks to ensure Know-your-customers (KYC) before establishing banking relationships, conduct due diligence on an ongoing basis, identify and provide Suspicious Transaction Reports (STRs), ensure maintenance and retention of records, and fulfill specific requirements for compliance officers and wire transfers etc. In July 2006, SBP updated and strengthened these PRs and aligned them further with FATF recommendations.

25. Under KYC-PRs banks have to: ensure true identity of prospective account holders, ascertain nature of the business, obtain introduction of account holder and determination of beneficial ownership of accounts while enhanced due diligence is carried out for high risk customers. At the same time, regulation facilitate interception of transactions, which are, prima facie, associated with money derived from illegal activities by ascertaining customer’s status and source of earnings and investigating transactions that deviate from account history. Banks are required to retain information about each account for a minimum period of five years, of all records of transactions, both domestic and international along with the records on the identification data obtained through KYC/ CDD (NIC, driving license, passport etc.) and record of STR has to be maintained for longer period and can be destroyed only with the prior permission of State Bank.

26. Banks/ DFIs are prohibited to establish correspondent banking relationship with institutions whose KYC/CDD practices are not in order or who are located in jurisdiction identified by Financial Action Task Force (FATF) as “non-cooperative countries and territories.” Banks/ DFIs have been alerted against misuse of correspondent account by third parties e.g. payable through accounts. Approval for establishing new correspondent relationship has to be taken from senior management. Banks are expected to investigate unusually large transactions and all unusual patterns of transactions to identify any suspicious transaction that is required to be reported to concerned authorities. The information to be reported by banks/ DFIs include title, type of account, numbers of accounts involved, detail of

transactions, reasons of suspicion. The employees of banks/ DFIs are strictly prohibited from disclosing the fact to any person that certain transaction has been or is being reported for investigation.

27. SBP has established an AML/CFT unit to deal with the issues of money laundering and CFT. This unit monitors and investigates STRs An AML law is under consideration and its promulgation will strengthen further the legislative and institutional framework for AML. Under the Law, SBP will house a Financial Monitoring Unit (FMU) which will be responsible for overseeing and coordinating all activities related to AML in the financial system. Oversight of AML will further benefit as linkages and information exchange among countries is enhanced.

III. Banking Supervision

28. Like other central banks and supervisory authorities, SBP conducts regular onsite inspections of all financial institutions under its jurisdiction. This involves assessment of banks overall financial health, evaluation of quality of management and role of Boards and sponsors and verification of compliance with legal and regulatory requirements. The inspections are conducted on CAMELS-S methodology whereby inspection team assesses and rates each component viz. Capital Adequacy, Assets Quality, Management, Earning, Liquidity, Sensitivity to Other Risks and Systems and Controls. Increase in size and complexity of financial sector and introduction of new and innovative financial products, has required SBP to enhance the sophistication of approach and methodology of its inspections. Capacity building is being launched to develop SBP skills in risk management, Islamic Banking, treasury, foreign exchange, IT etc. In addition, work is underway to strengthen further its capacities for oversight of Basel 2.

29. ***Off-site Supervision & Surveillance***. In response to changing realities, lessons learnt and peculiar financial conditions, the off-site monitoring system at SBP has undergone substantive changes since its introduction in 1997. The off-site monitoring system (i) monitors the overall and individual banks financial health, (ii) helps in early problems detection for appropriate corrective action, and (iii) focuses on-site supervisory resources to high risk areas or activities. Off-site monitoring is conducted based on periodical returns of banks. On line submission of the Report of Chart of Accounts will enhance efficiency and quality of offsite supervision. SBP is to start building capacities for more integrated supervision where industrial groups and NBFIs relationship with banks is growing. At this stage, SBP is coordinating with the Securities and Exchange Commission of Pakistan (capital market supervisory agency) for exchange of information of transactions that cut across sectors and involve both banks and NBFIs.

30. ***Institutional Risk Assessment Framework***. Driving inspiration mainly from the Supervisory Framework Rating Assessment criteria of the Office of the Superintendent of Financial Institutions (OSFI) of Canada, SBP has introduced an Institutional Risk Assessment Framework (IRAF) to enhance its supervisory

vigilance by integrating and consolidating the information collated through its regular supervisory and surveillance mechanisms. IRAF engenders a risk rating taking into consideration the information available regarding a bank from various sources. It not only embraces the offsite and onsite feedback, it also takes management of banks on board, to establish their rating regarding their compliance with standards, codes and guidelines issued by SBP. To make the supervisory process an all-inclusive exercise, market information regarding the health of banks has also been incorporated in the framework.

31. The supervisory process of onsite inspection, offsite surveillance and IRAF culminates into enforcement actions. The enforcement actions that can be taken by SBP range from imposition of pecuniary penalties to removal of management, board of directors and cancellation of banking license. The results of stringent enforcement actions taken have been encouraging as majority of the banks have displayed extraordinary operational performance over the past five years.

V. Emerging Challenges and Issues

32. The increasing growth and complexity in banking sector have now given rise to new issues and challenges. While initially preoccupied with their own primary business of banking, the banks have now cross ownership where industrial and brokerage companies own banks and banks own subsidiaries and associate companies that handle asset management, brokerage, insurance, housing and telecommunications businesses. These close linkages and cross ownership structure among corporate and FIs expose the banks to related party transactions risks. At the same time, growing foreign acquisition and entry of new regional and global players as well as growing domestic banks presence oversees requires SBP to deal with home and host regulator issues. Responding to these structural changes in financial sector, SBP is positioning and equipping its inspection and supervision department to deal more effectively with the emerging supervisory challenges.

33. **Consolidated and cross border supervision.** Besides developing in-house capacities for joint conglomeration and consolidated supervision, SBP is developing greater interface with other central banks and has signed about 15 Memorandum of Understandings (MoUs) with various central banks/supervisors. These MoUs have a wide variation in scope, ranging from provisions for exchange of information to sharing license criteria, on-site inspection, supervisory cooperation, combating money laundering, nature of action to be taken in case of any irregularity etc. Even where MoUs are not in existence, SBP shares information with the host country supervisors as and when necessary. However, there is scope for greater effective relationship among regulators.

34. **Complexities of implementing effective risk management.** SBP's elaborate risk management framework has helped contain effectively all sources and types of risks. To monitor resilience of banking system towards shocks to risk

factors, SBP calibrates alternate scenarios subject the overall banking system and individual banks to different degrees of credit, market and liquidity shocks. This stress testing is conducted every quarter. Based on September 2006 data, all banks were generally found to be resilient to credit risks and after shock capital adequacy ratio was found to remain above 11%. For one bank, capital adequacy would decline below these levels if either benefit of forced sale value is withdrawn due to banks exposure to mortgage collateral and for couple of banks shocks to credit quality of consumer portfolio may increase consumer sector NPLs and impact capital adequacy. Banks were equally resilient to interest rate shocks for movement upto 200bp and equity price movements in the range of 20%. Liquidity coverage ratio would come down in case of 10% decline in liabilities. In case of exchange rate depreciation banks are found to actually gain as their foreign currency assets are in excess of foreign currency liabilities.

35. While stress testing results offer broader comfort about banking sector strengths, there is need to recognize that there remain some areas of concerns. For example, banks do face (i) maturity mismatches, of special concern in the rising interest rate scenario; (ii) potential risk of loan defaults in the backdrop of rising consumer finance portfolios and equity markets exposure of the banking system; and (iii) risks posed by weaknesses in internal control system and lack of effective mechanism for containing operational risks. Commercial banks are launching substantive efforts to address these problems and adoption of technological solutions and connectivity of all branches with headquarters of banks will help in this area.

36. **Implementation of Basel II Accord**. Pakistan adopted a road map for implementation of Basel II Accord. Under this, banks will be adopting the standardized approach from January 2008 based on the spade work conducted since July 2006. There are number of issues in adoption of standardized approach. First, only a small proportion of corporate sector is rated by the rating agencies. In absence of the rating of borrowers, banks may end up allocating more capital than warranted. To ensure coordinated approach to Basel II implementation, SBP has set up a Working Group under the guidance of SBP to remove obstacles in its smooth implementation. Effective preparation for Basel II requires development of allied and support infrastructure that facilitates need for strengthening and enhancing role of credit rating agencies and development of internal controls and IT systems. In absence of credit rating agencies, Pakistan is developing further role of private sector Credit Information Bureaus, and independent debt/financial advisories etc. The gaps in the rating agencies are of particular concerns for SBP, given its heavy reliance of Standardized approach under Basel II. SBP has to further upgrade its capacity for supervisory review (Pillar II) and a core group of supervisors will be trained in this shortly.

37. **Lastly, there is need for more intensive capacity building of industry and SBP**. Greater international cooperation in strengthening the capacities of developing markets in risk management and emerging supervisory approaches

would be key to enhancing effectiveness of vigilance and oversight both at bank and central bank level.

38. **Conclusion**. Being autonomous and effectively empowered under the Banking Companies Ordinance, 1962 SBP has adopted a rigorous but flexible regulatory framework which helps to keep banks exposure within tolerable range, while allowing them opportunities to enhance and diversify their businesses. Banking sector has played a key role in supporting real sector development whose performance and macroeconomic stability have together re-inforced banking sector performance. All time high profitability and structural transformation of banking sector has attracted substantial foreign capital in banks which given its innovations and practices will augur well for strengthening and sustaining banking sector performance. Proper enforcement of regulatory framework has been helped by a strong SBP's independent supervisory and surveillance mechanism and validation process of the external auditors. Effective oversight has induced banks to enhance their corporate governance and compliance with laws and regulations that also follow international accounting and disclosure standards. Despite these achievements, both central bank and banks have to continue with broadening and deepening of structural reforms to help enhance financial services penetration and address the outstanding vulnerabilities in the system, while facilitating industry smooth adoption of risk measurement and management systems advocated under Basle II.