State Bank of Pakistan's Approach to Resolution[i]

Banks play a central role in the financial system, serving as intermediaries for mobilization of savings and provision of credit and operators of payment system. Since disorderly failure of a bank can have ramifications for the stability of other financial institutions, depositors, and overall economic activities, therefore, banks are subjected to prudential supervision and oversight to ensure their resilience to stress and overall financial soundness, thereby, reducing the likelihood of failure.

However, prudential supervisory frameworks are not designed to reduce risk of stress to zero or to prevent bank failures. The banks' business model inherently hardwires credit and liquidity risk which means a bank can fail due to multiple economic, environmental and business factors even in the presence of an effective regulatory and supervisory framework. Therefore, an effective resolution regime is essential to orderly deal with failed banks that cannot be placed into liquidation and Deposit Protection Corporation's (DPC) payout. Resolution of banks, which are systemic in failure, aims to ensure overall financial stability, continuity of depositors' access to their funds and other critical banking services and minimizing the risk to public funds by ensuring the banks' shareholders and creditors are exposed to losses.

As per section 42A of the Banking Companies Ordinance, 1962 (BCO), the State Bank of Pakistan (SBP) has been designated as a resolution authority for banks and other financial institutions (referred as "banks"). The law empowers the SBP to take necessary steps to ensure orderly resolution of a failed bank, in line with the statutory resolution objectives and provides the SBP with a range of resolution tools and powers in this regard.

To undertake its statutory function as a resolution authority, SBP has instituted a comprehensive framework for conducting resolution planning, preparing institution specific resolution plans and implementing the resolution tools in the event a bank meets the conditions for entry into resolution. The following paragraphs provide guidance on the way SBP carries out its statutory responsibilities for managing the failure of a bank.

I. Objectives of Resolution:

In line with its statutory mandate, SBP's resolution objective aims to contribute to the stability of financial system of Pakistan and to protect the interest of the depositors.

II. Governance and Institutional Arrangements:

Governance arrangement and operational setup has been institutionalized in SBP to implement an effective resolution regime. A dedicated 'Financial Institutions Resolution Department' (FIRD) has been established to implement effective resolution regime which is operationally independent from prudential supervision function. In this regard, policies and procedures are in place that define key trigger points for activating the resolution action, roles of different departments and stakeholders, and other allied matters. To ensure both objectivity in the decision making process and optimization of objectives, cross functional and executive level committees have been formed to assess and decide on the resolution actions.

Accordingly, the Executive Committee (EC) of SBP is designated as apex forum for taking key decisions related to resolution, to ensure objectivity and consistency in decision making. Furthermore, senior level committee is constituted with the purpose of enhancing coordination across different functions of SBP and other relevant external stakeholders to make preparation for crisis and to implement crisis management actions including resolution.

III. Assessing when a bank meets the conditions for entry into resolution

SBP regularly monitors banks and takes corrective actions proportionate to the level of stress and supervisory concerns to ensure that banks operate in safe and sound manner. Generally, banks may be categorized in any of the three stages, i.e., supervision phase, recovery phase and resolution phase, based on the supervisory assessments and financial soundness indicators. During the supervision phase, banks do not pose serious supervisory concerns. However, once a bank starts facing financial distress and pose serious supervisory concerns, SBP enhances its supervisory engagement. If a bank is unable to recover from the financial distress, then SBP decides whether to take a bank into resolution or liquidation based on Resolution Conditions Assessments (RCAs). The decisions are made after due review and collegial decision making process to ensure objectivity and effective balancing of different objectives.

IV. Resolution Tools and Safeguards:

The law provides SBP, a range of tools to ensure that a failed bank is resolved in an orderly manner. These resolution powers allow SBP to take necessary actions so as to preserve the financial stability and protect the interest of the depositors. In this regard, following are the main tools:

a. Bail-in - Reduce or extinguish the interest or rights of the shareholders, creditors, and depositors;
b. Reconstruction - restoring the capital of the banking company to the required level;
c. Amalgamation - Amalgamate the failed bank fully or in part with any other bank;
d. Bridge bank - Transfer in full or in part the business, assets and liabilities of the banking company to a bridge bank;
e. Liquidation - The bank's license is cancelled and the bank is put into liquidation as per law.

The law empowers SBP to change or amend the claims and rights of shareholders and creditors to ensure resolution of a bank; however, the law also provides certain safeguards to ensure objectivity in the SBP's actions to preserve wider public interest and financial stability.

V. SBP's Approach to Loss Distribution and Recapitalization in Resolution

If a bank fails and enters into resolution, SBP uses its resolution tools to ensure that the equity capital and any other subordinated capital instruments of the failed bank are written down. In case, these funds are not sufficient to absorb all the losses of the failed bank or recapitalize it to desirable level, the funding support from DPC may be sought subject to certain safeguards and conditions to meet the costs of resolving the bank. Reliance on public funds to ensure orderly resolution is a last-resort option. However, in case, where the government provides funds to support the resolution, the law provides for the recovery of any costs incurred by the government from the market.

VI. Resolution Coordination Arrangements

In order to achieve overarching objective of resolution, SBP has put in place special coordination arrangements amongst relevant functions of SBP, DPC and Federal Government (FG) relating to execution of resolution actions and financing requirements where needed. The SBP, as a resolution authority, will coordinate with the FG in case the sources are insufficient to cover losses and/or recapitalize the bank to the desired level.

SBP has arrangements with other central banks, domestic and foreign regulatory and resolution authorities for the purpose of sharing the public and non-public confidential information relevant to the regulatory and resolution actions subject to reciprocity and certain safeguards. These safeguards require SBP to recognize foreign resolution measures which contribute towards SBP's overall resolution objective and have no fiscal implication for Pakistan and does not contravene any public policy objective of the country. Further, it ensures that creditors and bank branches of Pakistan must be treated equitably under the respective resolution regime.

VII. Resolution planning and resolvability assessment

As part of resolution planning process, SBP prepares resolution plans. The resolution plan inter-alia determines the preferred resolution strategy and choice of resolution tool for ensuring orderly resolution of a bank. SBP also carries out resolvability assessments to evaluate the preferred resolution strategies for the banks. Based on this assessment, SBP may direct a bank to remove any significant barriers/ impediments to orderly resolution through changes to its functions and activities or organizational structure.

SBP regularly reviews and updates its resolution framework in the light of changing market dynamics and emerging best practices to ensure that resolution objectives are achieved in an effective and prudent manner.

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[i] This document is for the purpose of public guidance only, and may not be construed as legal binding obligation on SBP. For further guidance and details, please refer to the relevant laws.