

3 Ensuring Soundness of Financial Sector

3.1 Banking Supervision Group

3.1.1 Banking Inspection (On-Site) Department

Proactive Inspection: In pursuance of SBP's objectives, Banking Inspection (on-site) Department's (BID) mission is "to strive for soundness and stability of the financial system and to safeguard the interest of stakeholders through proactive inspections compatible with best international practices in keeping with changing global environment in financial sector".

The main function of the BID is to conduct on-site inspections of banks, besides preparing special reports on write-off cases of loans & advances and carrying out other special investigations on requests and complaints received from internal and external stakeholders and customers.

Inspection Plan: The department carried out on-site inspection of 28 banks, information system inspection of 2 banks, and examined a number of write off cases during the year. Moreover, special inspections at the request of other departments were carried out and complaints, received from different quarters, were examined by the department.

Developmental Projects: Like previous years, BID also initiated some developmental projects during this period. One of the projects regarding 'Digital Archiving of Inspection Resources' meant for availability of On-Site Inspection Manual and Checklists for various CAMELS components at a centralized place has been completed, while revision of AML Manual and preparation of its checklist is at final stage.

Capacity Building: In order to build and enhance skills of officers, the department is focusing on in-house trainings and arranged/conducted trainings in different areas including Asset Quality, Credit Risk under Basel II and Islamic Banking during the year.

3.1.2 DFIs & Exchange Companies Inspection (On-Site) Department

Under the SBP restructuring exercise carried out in FY11, DFIs & Exchange Companies Inspection (Onsite) Department (DECID) was established in April 2011, primarily to streamline and strengthen the inspection process of specialized financial institutions which include Development Finance Institutions (DFIs), Microfinance Banks (MFBs), and Exchange Companies (ECs).

Inspection Plan: After its establishment, DECID has completed all the inspections of DFIs/MFBs/ECs which were due in the inspection plan of 2010-11 prepared by BID. The first annual inspection plan of the department for the FY 2011-12 is being implemented as per schedule.

Developmental Projects: The department has proposed 6 developmental projects in its first business plan, out of which four are part of SBP strategic plan whereas two new projects regarding standardization of annexure for exchange companies and operational manual of the department are to be completed by June 2012. Moreover, two projects on revision/update of onsite inspection manuals for ECs and MFBs which were included in the annual business plan of BID were taken over by the new department and have been completed. Further, for policy input, a comprehensive document has also been prepared by the department on proposed reforms in the regulatory framework for ECs.

3.1.3 Off-Site Supervision & Enforcement Department

Developments on Supervision Front: Financial stability and soundness of banking system has intrinsic relationship with a proactive and efficient supervisory system. In its quest to make its supervisory processes robust and overarching, SBP took the following major initiative during the period under review:

Framework for Monitoring Liquidity Risk Profile of Banks/ DFIs: Among an array of risks faced by banks, liquidity risk holds paramount importance as its crystallization might trigger a chain of events, which can seriously undermine the financial health of banks not only at individual but also at systemic level. Off-Site Supervision & Enforcement Department (OSED) of the State Bank of Pakistan is undertaking a developmental project, which will culminate into a framework for monitoring liquidity risk profile of banks and DFIs on weekly basis. Besides continuing with the current practice of monitoring the banks'/DFIs' compliance with the statutory liquidity requirements, the new framework will help OSED in assessing the developing trends in the liquidity profile of individual banks through a set of newly introduced variables and ratios. The framework is targeted to be rolled out by June 30, 2012.

Effective Supervision of Exchange Companies: To further streamline and centralize the supervisory oversight over all financial institutions falling in the purview of the SBP, the functions related to monitoring, supervision, compliance & enforcement of Exchange Companies (both A & B category) have been transferred from Exchange Policy Department to OSED. Following the establishment of a dedicated division in OSED, a wide range of supervisory affairs of Exchange Companies will now be managed in a more vigorous manner.

The staff in this division is well skilled and conversant with the role, nature and business profile of Exchange Companies. Through this in-house restructuring, the supervisory framework of Exchange Companies has been made more robust and efficient by aligning it with the supervisory standards for banks and DFIs. Besides, it will help in improving coordination between the on-site and off-site & enforcement arms of the SBP as both fall in the same group. With this arrangement, it is expected that supervision related issues of Exchange Companies will be resolved in an expeditious and effective manner.

3.2 Banking Policy and Regulation Group

The Banking Policy and Regulation Group (BPRG) performs continuous review of its legal and regulatory framework for the banking sector, and formulate policies that take into consideration the major developments both at the local as well as international fronts and the need for ongoing surveillance. This process also involves continuous dialogue with all the stakeholders that include the banking companies, public at large, trade associations and the respective government agencies. The key developments goals carried out by the BPRG over the year are summarized below:

3.2.1 Banking Surveillance

The Banking Surveillance Department over the last year remained closely involved with the banking system for ensuring its soundness and stability. In view of rising credit risks, SBP rationalized instructions on provisioning of classified advances and encouraged Banks/DFIs to reschedule/restructure small loans/advances in the flood affected areas where the possibility of recovery existed.

On the Capital Adequacy front, SBP issued clarifications on the use of ratings by the Credit Rating Agencies for calculation of Capital Adequacy Ratios (CAR) under the Basel Accord. Furthermore, in

order to improve the level of competition in the Micro Finance Sector SBP has enhanced the Capital Requirements for MFBs.

To address the risks arising from conglomeration in the financial sector, Consolidated Supervision Framework is being developed for which a formal set-up has been established. Similarly, an Annual Financial Stability Review (FSR) publication is now housed at the BSD which will be published on half-yearly basis instead of Quarterly Performance Review of the Banking System.

To promote financial inclusion and further enhance outreach of financial services, MFBs were allowed to carry out business transactions at Permanent Booths as well. In 2010, the Banks/MFBs were allowed to open 417 new branches, as a result of which the total number of bank branches in the country crossed 10,000 marks. Furthermore, the Branchless Banking Regulations were revised in order to cater to the needs of unbanked population through provision of efficient and cost effective basic banking services at the convenient places.

The SBP has also taken number of measures towards making the country's banking system more 'Pro-people'. Banks were restricted to levy service charges on regular saving accounts on the basis of maintaining minimum balance and to impose condition of maintaining a minimum balance for these accounts. Furthermore, a major policy initiative was taken by allowing banks to open dedicated Home Remittance Centers (HRCs) for making payments to home remittance beneficiaries.

Certain amendments in the Banking Companies Ordinance, 1962 were made to strengthen the regulatory scope of SBP with reference to fitness and propriety of sponsors/major shareholders of banks, increase in the capital of banks as per their risk profiles, etc. Furthermore, specific triggers for invoking corrective actions and corresponding enforcement powers have been optimized with peculiar circumstances of a bank at a particular moment of a time.

The Panel of Professional Bankers maintained under Banks (Nationalization) Act 1974, was updated to ensure adherence with the criteria approved by the Central Board of Directors of SBP and the Fit & Proper Test (FPT). Moreover, prior clearance from SBP has also been made mandatory for the Board members and President/CEO upon their re-election/re-appointment in MFBs.

During the year under review, besides four merger transactions in banking industry, two acquisitions were also managed, where control of a commercial bank and a microfinance bank was taken-over. Another transaction involving change in control of a microfinance bank is in the process of completion. Five prospective acquirers have also been granted approvals for undertaking due diligence of four microfinance banks for acquiring control/equity investment. In addition, restructuring in two local business groups, having a banking company, was allowed in order to improve the overall standing/financial position of the banking company (ies).

3.2.2 Islamic Banking

To further strengthen the Shariah compliance mechanism at Islamic Banking Institutions (IBIs), Shariah Advisers' were required to present their Shariah compliance report to their Board of Directors (BoDs) and apprise the Board about Shariah compliance levels in the IBI. This would enable the BoDs to better appreciate the Shariah non-compliance risks being faced by the IBI and their role and responsibility in designing an effective framework to manage and mitigate this risk.

In order to facilitate IBIs to develop and offer Shariah-compliant agriculture finance products for the farmers, a model product based on 'Salam' – a mode of Islamic finance has been developed.

The SBP has also been actively participating in the development of Global Islamic Finance prudential standards, guidelines etc. by the international institutions like Islamic Financial Services Board (IFSB), International Islamic Financial Market (IIFM) etc. The participation in such activities has not only enabled SBP to contribute towards development of global prudential standards but also provided an opportunity to showcase our Islamic Banking Framework and business environment to the international community.

3.2.3 Consumer Protection

During FY11 a total of 6,113 complaints were received. Analyses of these complaints revealed that banks with large consumer credit portfolios, branch & ATM networks were recipient of the greater share of the complaints. Complaints relating to internal/external frauds through cheque washing were also observed in quite a few numbers. In order to protect general public from such scams, banks/DFIs were advised to remain vigilant. Besides, public service messages were also published in widely circulated newspapers across Pakistan for awareness of consumers.

Electronic Credit Information Bureau (e-CIB)

As a part of continuous e-CIB system development and enhancement, the period defined for reporting of history for written-off loans and advances against corporate borrowers earlier meant for five years has now been increased to ten years from earlier limit of five year. This will facilitate the banks and financial institutions in making prudent lending decisions and instituting sound credit culture.