

3 Strengthening Financial System Stability and Effectiveness

Strengthening the financial system stability and improving the efficiency, effectiveness, and fairness of the banking system are amongst the SBP's core strategic objectives. Presently, SBP's supervisory framework adequately complies with the internationally recognized Core Principles of effective banking supervision. The framework is reviewed on an ongoing basis to ensure its compatibility with dynamic global and local environment, to ward off any risks to the financial stability and to improve the efficiency of the system. This chapter discusses the key initiatives taken by the Bank during the year to achieve these strategic objectives.

3.1 Regulatory Initiatives for Enhancing Financial Stability and Efficiency

3.1.1 Implementation of Basel III Liquidity Standards

For measuring liquidity risk, two regulatory liquidity standards namely Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) along with a set of five risk monitoring tools were issued during the year for implementation from January, 2017. The computation of LCR & NSFR involves detailed assessment of a bank's assets, liabilities and off-balance sheet activities. The LCR measures stressed liquidity ratio on monthly basis and is aimed at promoting short-term resilience of liquidity risk profile of banks. This will ensure that banks maintain enough unencumbered high quality liquid assets (HQLA) to effectively manage total net cash outflows for the next 30 days calculated under certain assumptions. Similarly, the objective of NSFR is to reduce funding risk over a longer time horizon and is computed on quarterly basis. This requires banks to support its activities with sufficiently stable sources of funding in order to mitigate the risk of future funding problems.

3.1.2 Supervisory Review and Evaluation Process (SREP)

The banking industry is generally exposed to many risks which are not covered by the rule based capital requirements of Basel III, therefore, the same are covered under: i) Internal Capital Adequacy Assessment Process (ICAAP) and ii) Supervisory Review and Evaluation Process (SREP). While the instructions on ICAAP were already in place, SBP during the year devised a broad set of guidelines to facilitate the key stakeholders during the course of SREP. These guidelines are primarily meant for internal consumption, however, subsequently, if deemed appropriate, the same may be shared with the banking industry as supervisory expectations during the implementation of SREP. The key objectives of SREP guidelines include:

- To provide procedural guidance and a basic supervisory assessment framework to the relevant SBP staff for conducting the SREP.
- To provide prudential/supervisory measures to remove in-efficiencies in the bank's risk governance structure etc.
- To ensure that banks have sufficient capital to cover all the material risks under pillar 1 and 2.

Due to its inherent linkages and common assessment methodologies, SREP guidelines may also feed into the Risk Based Supervision (RBS) framework being developed by the Bank.

3.2 Progress towards Risk Based Supervision Framework

The project on Risk Based Supervision was conceived with the objective to graduate to the next level risk based supervision. The proposed supervisory approach would help in prioritizing our resources, improving our responses to financial stress conditions and enhancing our understanding of the risks at

the institution level. The Project among others includes development of methodology for determining the relationship between the macroeconomic indicators and business models of the financial institutions.

A concept paper was prepared during the year outlining the broad architecture of the Risk Based Supervision Framework. The concept paper sets forth steps and direction of the study, including stock taking of legal and regulatory environment of Pakistan, key supervisory frameworks prevalent around the globe and proposed supervisory framework for Pakistan. The project team has prepared proposed framework for evaluation of business model of banks. The draft methodologies for assessment of strategic risk and identification of significant banking activities have been developed. Moreover, broader parameters for assessing credit, market and liquidity risks have been identified. The development of framework is likely to be finalized by FY18.

3.2.1 Communication Paper on the SBP's Supervisory Regime

SBP has a comprehensive framework for supervision and regulation of financial institutions under its domain. The supervisory authorities and regulators particularly in advanced economies publicize their supervisory regimes to create awareness amongst the stakeholders and ensure transparency in their supervisory decisions. In line with international best practices, a communication paper on SBP's supervisory regime was prepared and placed on SBP website in May 2016. The objective of the paper is to share broad contours of the supervisory framework with the general public and other stakeholders. This will enable the stakeholders and general public to better understand and appreciate SBP's supervisory decisions.

3.2.2 Prudential Meetings with Banks' BODs

The prudential meetings with BODs and senior management of the problem banks and financial institutions, performing below the average thresholds are held to resolve supervisory concerns on strategic direction, governance, capital planning, credit portfolios, administrative costs, and control environment. During FY16, prudential meetings were held with the BODs of banks and financial institutions facing financial distress and prudential measures were suggested to ensure soundness and stability of such banks.

3.2.3 Thematic Reviews

Thematic reviews initiated last year continued during the year and the reviews of selected banks in different areas such as Anti-money laundering and combating the terrorism financing (AML/CFT), corporate governance, service quality standards, foreign trade operations, profit distribution mechanisms of Islamic banks, and out of books transactions of exchange companies were conducted. On the basis of these thematic reviews, a number of enforcement measures and policy initiatives were taken for strengthening the regulatory and supervisory framework.

3.2.4 Enhanced vigilance of Overseas Operations of Banks

Overseas operations of Pakistani banks have increased rapidly over the years. This situation entailed more stringent regulatory monitoring, thus new comprehensive formats for collection of overseas operations data on quarterly basis were introduced. This would enable SBP to assess the associated risks and take necessary preemptive measures to effectively supervise the foreign business units of the banks incorporated in Pakistan.

3.2.5 Regulation of Exchange Companies

Enforcement and compliance regime of Exchange Companies was strengthened and several measures were taken against the noncompliant companies giving a clear signal to the industry that non-

compliance of the rules and regulations shall lead to initiation of regulatory actions. This has brought visible improvement in regulatory compliance level of Exchange Companies. Moreover a program was conducted to enhance Exchange Companies understanding of SBP's regulatory and supervisory concerns.

3.2.6 Study on De-Risking in Pakistan

De-risking is a phenomenon where banks exit relationships with or close the accounts of clients considered as 'high risk'. De-risking trend has been observed toward money service businesses, nonprofit organizations, and correspondent banks, thus resulting in refusal of banking services to such customers or closure of their accounts. Reputational concerns and rising AML/CFT scrutiny contribute to de-risking. De-risking can further isolate communities from the global financial system and thus may undermine financial inclusion objectives. A qualitative study was undertaken during the year in collaboration with the Intergovernmental Group of Twenty Four and Alliance for Financial Inclusion on the potential or existing effects of de-risking on financial inclusion. The overall findings of the study revealed that globally the phenomenon of de-risking is taking place at large scale, but Pakistani banks have not been significantly affected.

3.3 Institutionalization of Financial Stability Framework

The SBP vision 2020 envisages designing and implementation of a formal Financial Stability structure in the country. With a view to institutionalize the financial stability function in SBP, a new department namely Financial Stability Department (FSD) was established during the year to monitor and assess financial system wide risks and to take measures to mitigate such risks. The Financial Stability Review for the Calendar year 2015 was also published to give an assessment of system wide stability levels, the key macro and system level risks faced by the banking industry and the risk management infrastructure in place to monitor, assess and mitigate the risks. Further, the Financial Stability Executive Committee has also been constituted under the chairmanship of the Governor to serve as an internal forum for discussions and coordination on financial system stability issues.

3.3.1 Assessment of Banks' Resilience towards Stress Tests

In line with the global regulatory and supervisory developments, SBP has increased its focus on conducting macro prudential oversight to safeguard soundness of overall financial system. Among others, the resilience analysis of the banking system is conducted under a two pronged strategy. Under the top-down approach, the resilience of the system is assessed towards both historical and hypothetical single factor/multifactor shocks to credit, market and liquidity risks. These shocks are regularly reviewed and updated keeping in view the changes taking place in the financial landscape and the risk factors. Under the bottom-up approach, banks and DFIs have been mandated to carry out quarterly stress testing exercise against various shocks provided in the revised Stress Testing Guidelines. Moreover, large banks are required to carry out advanced stress tests commensurate with their size, business, and complexity.

To strengthen the stress testing regime, an assessment framework for stress testing of MFBs and Islamic Banks has been developed for conducting their periodic resilience analysis. A Workshop on Macro Stress Testing for Large Banks was also conducted to assimilate their awareness and learning and improving scenario analysis and stress testing capabilities. The SBP also disseminated stress test results on baseline and stressed scenarios for the credit risk in its Financial Stability Review of 2015.

3.3.2 Compliance with Basel Core Principles of Effective Banking Supervisions (BCPs)

The Core Principles for Effective Banking Supervision (Core Principles) are used by countries as a benchmark for assessing the quality of their supervisory systems and for identifying future work to

achieve a baseline level of sound supervisory practices. Post global financial crisis, the Basel committee on banking supervision revisited the earlier BCPs with the objective to strengthen the supervisory practices and came up with certain enhancements in their September 2012 document. The review has taken account of several key trends including systemically important banks, a macro-perspective in supervision of individual banks and banking groups, crisis management, recovery and resolution measures to reduce probability and impact of bank failure. With the revision in the BCPs, SBP has initiated Self-Assessment of Compliance with the principles. Completion of this assessment will allow SBP to initiate policy interventions and realign the supervisory and regulatory practices with international best practices.

3.3.4 Framework for Identification and Supervision of D-SIBs in Pakistan

As part of its commitment to ensure stability of financial system and further strengthen the supervisory and regulatory regime, SBP has designed assessment framework for Identification, of Domestic Systemically Important Banks (D-SIBs) in Pakistan based on BCBS methodology for constructing criteria for identifying D-SIBs. It is now working on framework for designation and supervision of D-SIBs. It is expected that identification of the D-SIBs and future work on development of regulatory and supervisory framework will go a long way in limiting systemic risks and thus ensuring financial sector stability.

3.4 Implementation of Deposit Insurance Scheme

The implementation of deposit insurance scheme is an important goal of SBP Strategic Plan 2016-2020. The SBP Act, 1956, was amended during the year to allow for creation of Deposit Protection Corporation (DPC) as a subsidiary of SBP. The DPC act 2016 is in line with International Association of Deposit Insurers (IADI) Core Principles for effective deposit insurance system. The Corporation will compensate the depositors for losses incurred by them to the extent of protected amount in the event of failure of a member Institution. All banks operative in the country shall mandatorily be the members of DPC. The annual premium to be charged to the member banks shall determined by DPC Board once established.

3.5 Strengthening of Corporate Governance Regime

The corporate governance regime for the banking industry was further strengthened during the year in line with the international standards and best practices. Major initiatives taken on this front included:

- The definition of Key Executives was revised whereby the banks/DFIs were made responsible to conduct self-assessment of their Directors, CEO and Key Executives and furnish a declaration to SBP in this regard. Further, the appointment/ removal, compensation packages and promotion of Key Executives shall be approved by the bank's Board of Directors. The banks were also advised to devise a rotation policy for meaningful succession planning for the key posts.
- Revised instructions on Board committees were issued whereby Chairman of the Board may chair and/or be a member of any one of the Board Committees except Audit and Risk Management Committees. Further, the Audit Committee of the Board shall invariably be chaired by an Independent Director.

3.5.1 FAQs on Prudential Regulations for Corporate/Commercial Banking

In order to improve the understanding about its Prudential Regulations, FAQs on Prudential Regulations for Corporate & Commercial Banking were issued during the year.

3.5.2 Debt Property Swap (DPS)

In order to minimize risks in the settlement of non-performing loans (NPLs) by the banks/DFIs through Debt Property Swap (DPS) and to set minimum standards, comprehensive Debt Property Swap regulations were issued during the year. The regulations require banks/DFIs to have in place Board of Directors (BODs) approved policy for DPS encompassing acceptable limits for the real estate exposure, procedure for valuation, documentation requirements, approving levels etc. The regulations cover the general requirements for DPS, monitoring, accounting treatment, disclosure/reporting and other relevant issues affecting the conduct of DPS transactions.

3.5.3 Report on Training Assessment in Banks

The SBP, in addition to strengthening its legal, regulatory and supervisory oversight has also been taking initiatives to address the capacity issues in banks to improve the quality of their staff. A quantitative study was completed during the year to investigate the training and development needs of banking industry. Keeping in view the banks' responses and assessment, a number of initiatives have been recommended in the report to strengthen the function of training and development in the country's banking industry.

3.6 Improvement in AML/CFT Framework

3.6.1 Amendments in AML Act 2010

The AML Act, 2010 was amended during the year after the parliamentary approval to streamline the existing AML law with international standards prescribed by FATF and also to bring consistency and clarity in the enforcement provisions. The amended act brought fiscal offences under the purview of AML Act. The SBP played a key role in finalization of the amendment Bill approved by both houses of the parliament.

3.6.2 National Risk assessment

As a part of the National Risk Assessment (NRA) of Pakistan, SBP conducted Pakistan's banking sector assessment on ML/TF as per agreed mechanism at national level. The results and recommendations of the NRA will help towards effective risk based supervision of financial institutions.

3.7 On-Site Inspections

The on-site inspection of banks, financial institutions and exchange companies as per approved inspection plan is a regular function of SBP. The inspection of banks and financial institution were conducted during the year as per approved inspection plan. Based on the inspection findings, major areas of supervisory concerns and violations of regulatory instructions were taken up with the banks' BODs and senior management for corrective actions. In addition, statutory reports on written-off loans, mark-up and other dues were prepared. Further, keeping in view the huge risks originating from information systems, specialized human resources were hired to enhance SBP's capacity to review banks' IT systems and assess the risks associated with these systems and the banks' capacity to manage/mitigate such risks.

3.8 Strengthening of Regime for Fair Treatment to Consumers (FTC)

As per SBP Vision-2020, SBP would gradually step back from direct consumer complaint handling and focus more on regulating and overseeing the conduct of banks to ensure fair treatment and deals to Consumers. Accordingly, the name of Consumer Protection Department (CPD) was changed to Banking Conduct & Consumer Protection Department (BC&CPD) with effect from November 30, 2015 along with requisite enhancement in its mandate to regulate the conduct of banks in their service

delivery. This section discusses the key initiatives taken during the year to ensure fair treatment to consumer.

3.8.1 Guiding principles on Fairness of Service Charges

To ensure fairness and transparency in service charges, 'Guiding Principles on fairness of service charges' were issued during the year. While being non-prescriptive, the principles have not only significantly brought down the number of complaints against service charges but have also helped in inculcating the culture of responsible pricing within the banks.

3.8.2 Consumer Grievance Handling Mechanism

The vision 2020, envisages banks to serve as the first forum of redressal for consumer complaints. Accordingly, comprehensive guidelines on complaint handling mechanism were issued during the year requiring banks to setup effective complaints/disputes redressal/resolution mechanism that should include a problem solving approach, comforting attitude of dealing staff, appropriate turnaround time (TATs), record retention policy, annual disclosures and regulatory returns.

3.8.3 Effective Disclosures

In order to improve transparency and ensure truth in lending and savings products of banks, standardized Product Disclosure Requirements (PDRs) were introduced for all types of Personal, Housing and Auto Finance products being offered and marketed by banks. Moreover, the banks were advised to provide a Product Key Fact Statement (PKFS) to the banking consumers who have availed or are planning to avail consumer finance products from banks. This will significantly enhance transparency and disclosure in the financial products.

3.8.4 Legal and Regulatory framework for Credit Bureaus

A credit Information agency plays an important role in promoting financial discipline, better credit risk management and making prudent lending decisions. The Credit Information Bureau under the aegis of SBP has been providing reliable credit information to member financial institutions. However, private sector credit bureaus have also been operating for quite some time but without any formal regulatory framework. In order to have an effective and enabling legal and regulatory framework for the credit bureaus in private sector, the Credit Bureaus Act, 2015 (CBA) was enacted on August 25, 2015. Under the Act the power to grant license, issue regulation and on-going supervision of private Credit Bureaus has been vested with SBP. By virtue of the Act a bureau can procure financial information of a person from member institutions. Besides, it empowers general public to access their credit information from a bureau. SBP has also notified regulatory framework which sets forth minimum standards with respect to Governance, Operational efficiency, Data integrity & Security and Dispute Resolution to ensure smooth functioning of credit bureaus.

3.8.5 Guidelines of Business Conduct

In order to exert self-discipline on the banks with respect to responsible banking and promote healthy competition and ethical practices, SBP has issued Guidelines of Business Conduct for Banks. These Guidelines will promote good banking practices, increase transparency in the provision of banking services, ensure compliance of prudential Regulations/laws by the banks and enhance customers' confidence in banking system.

3.8.6 Conduct Assessment Framework (CAF)

To ensure that banks treat their customers fairly and justly, the banks must have a formal conduct policy and a mechanism to monitor the conduct in a systematic way to avoid Conduct Risk i.e. such behaviors/practices that are detrimental to the bank's repute and relationship with the customers. To

help ensure banks to have a reliable mechanism to assess their conduct with their customers, SBP developed a Conduct Assessment Framework (CAF) to be used by banks themselves. A pilot run of the framework was also conducted and the same will soon be formally rolled out. CAF will also serve as conduct monitoring tool for SBP whereby the data on the conduct of banks would be collected and analyzed to identify the gaps, if any, in the banks' conduct and to address the gaps/issues through different regulatory interventions.

3.8.7 Consumer Awareness

Consumer awareness and understanding about different products and services being offered by banks is not only important for improving financial inclusion but also to improve banks' conduct and promote prudent and ethical banking practices. A rigorous Consumer Awareness campaign has been launched wherein awareness seminars/session are being held with a cross section of stakeholders including Chambers of Commerce, Trade Bodies, Market Committees, Academia across the country.

3.9 International Cooperation in Banking Supervision

3.9.1 FSB Regional Consultative Group for Asia (FSB RCG ASIA)

SBP is a member of Financial Stability Board (FSB)-Regional Consultative Group of Asia (RCG-Asia) since its inception in 2011. The purpose of the RCG is to bring together financial authorities from FSB member and non-member countries to exchange views on vulnerabilities affecting financial systems, policy initiatives to promote financial stability and implementation of these initiatives. The Governor SBP became co-chair of RCG Asia from July 1, 2015 for two years. During the year, FSB RCG Asia conducted two meetings; 9th meeting of RCG in Hong Kong in November, 2015 and 10th meeting in Kuala Lumpur, Malaysia in May, 2016.

3.9.2 Workshop on Financial Technology and Cyber Security

FSB-RCG-Asia conducted a Workshop on Financial Technology and Cyber Security on May 19, 2016 in Hong Kong. The workshop was co-Chaired by SBP and HKMA. It covered an overview of the latest global developments of financial technology, its potential benefits and possible risks to the financial sector and implications for financial stability. The workshop also discussed cyber threats to the banking sector and ways to mitigate those risks including enhancing the IT risk management within financial institutions. The outcomes of the workshop were shared in the 10th FSB-RCG Asia meeting held in Kuala Lumpur, Malaysia.

3.9.3 Correspondent Banking Coordination Group (CBCG)

The FSB established Correspondent Banking Coordination Group (CBCG) to assess and address the decline in correspondent banking. The FSB also created four work streams (WSs) of technical experts to coordinate at a more detailed level the work pertaining to (i) Data collection and analysis(WS-1), (ii) Clarifying regulatory expectations(WS-2), (iii) Domestic capacity-building in jurisdictions that are home to affected respondent banks(WS-3), and (iv) Strengthening tools for due diligence by correspondent banks(WS-4). SBP also has representation in this group.

3.9.3 Memorandum of Understanding

An MOU was signed between the Central Bank of Jordan and SBP during the year to increase bilateral cooperation in the field of banking and finance between the countries. The process for signing Memorandum of Understanding with the Central Bank of Belarus was also initiated during the year.