

3 Strengthening Financial System Stability and Effectiveness

Financial stability is essential for smooth and continued provision of financial services which is also one of the key strategic goals under SBP Vision 2020. Ensuring soundness of the financial system requires SBP to remain abreast of emerging challenges and take effective and proactive policy measures to mitigate risks. Further, SBP aims to create a uniform and formal financial stability framework to institutionalize a systematic approach towards risk assessment and mitigation for the financial sector.

With this perspective, SBP introduced further improvements in various processes and regulations to strengthen the financial stability regime during FY19. The areas include Macro prudential Policy Framework (MPPF), Risk Based Supervision (RBS), Consolidated Supervision, AML/CFT regime, inspection processes of the banking sector, risk assessment framework of Exchange Companies (ECs) and recovery plans under D-SIBs framework. Meanwhile, SBP is also striving to align the regulatory and supervisory framework with the international standards and best practices.

3.1 Institutionalization of Financial Stability Framework

3.1.1 Macroprudential Policy Framework (MPPF)

SBP is working towards formulating and implementing a comprehensive and well-structured Macroprudential Policy Framework (MPPF) to ensure system-wide stability of the financial sector. To this end, SBP has strengthened the process of assessment and communication of systemic risk. To enhance its assessment of pro-cyclical systemic risk capabilities, SBP has substantially improved its macro stress-testing regime to capture the macro-financial interlinkages. Further, a number of variables have been identified as Early Warning Indicators (EWIs) of systemic risk. For the establishment of a well-structured institutional setup for MPPF, SBP is in the final stage of forming a National Financial Stability Council (NFSC) with the coordination of Securities & Exchange Commission of Pakistan (SECP) and Finance Division.

3.1.2 Framework for Identification of Domestic Systematically Important Banks (D-SIBs)

SBP, in line with the BCBS Guidelines, issued a framework for regulation and supervision of D-SIBs in Pakistan in April 2018 and carries out its annual assessment for designation of the D-SIBs each year by end June. During FY19, three designated banks were subjected to enhanced regulatory and supervisory requirements including additional CET-1 capital requirement of 2 percent for HBL and NBP and 1 percent for UBL, which is to be complied by March 31, 2020.

To implement the enhanced supervisory framework for D-SIBs, SBP has developed a Recovery Plan framework and engaged with large banks in preparing their respective recovery plans. This framework prescribes the essential elements that banks' recovery plans should cover and provides SBP's internal criterion to assess their efficacy. Consequently, banks can timely identify potential vulnerabilities under stressed conditions and take mitigation measures for addressing the issues.

3.1.3 Strengthening of Consolidated Supervision Framework

SBP has been regularly monitoring the banking sector based on consolidated supervision. For this purpose, SBP and SECP have setup a dedicated Joint Task Force to monitor and manage the risks posed by the financial conglomerates. During the year under review, both the regulators reviewed and updated the Terms of Reference of the task force to better achieve the underlying objectives and address the changes in the dynamics of the financial system.

3.1.4 Assessment of Banks' Resilience through Stress Testing

SBP uses various stress testing approaches to assess resilience of banks against hypothetical but plausible extreme conditions which include single-factor sensitivity analysis and multi-factor dynamic macro stress tests. During FY19, the sensitivity analysis toolkit has been strengthened by inclusion of a multi-factor sensitivity analysis tool, called Stress Testing Work Box. Based on the results of these stress-testing exercises, supervisory departments of SBP engage with banks exhibiting capital shortfall. Stress testing exercise is also an integral part of SBP's annual publication, *Financial Stability Review* where resilience of banks is assessed against domestic and foreign risk factors. Stress testing framework is being regularly upgraded in line with the latest developments in the area.

3.1.5 Financial Stability Review, Half-Yearly Performance Review and Quarterly Compendium

SBP has published its premier annual report, "Financial Stability Review (FSR)" for CY18. The report covers the entire financial sector, including the banking and non-banking sectors, through in depth analysis of the latest developments. The report highlighted emerging risks and vulnerabilities and the policy actions taken to address the same. Some of the key risks include macroeconomic imbalances, weaker economic activity, tightening monetary conditions, Anti Money Laundering (AML), Combating the Financing of Terrorism (CFT) and cyber security.

In addition, SBP has published the first issue of its Half-yearly Performance Review (HPR), replacing the Quarterly Performance Review (QPR), which addressed the performance and risk analysis of the banking sector for the period, January-June 2018. Alongside, SBP has continued to disseminate financial sector's data through regular publication of *Quarterly Compendium (QC) Statistics of the Banking System*. The Compendium includes data of commercial banks, Islamic banks, MFBs and DFIs.

3.2 Progress towards RBS Framework

To further strengthen banking supervision, SBP has initiated a cross departmental project for 'Developing Risk Based Supervisory Framework' to establish a targeted and forward looking supervision of institutions falling within its supervisory ambit. In the design phase, assistance for capacity building was envisioned through an institutional agreement with the Toronto Centre (TC) under the Long Term Country Engagement (LTCE) program for development and implementation of RBS Framework. The capacity building engagement with TC is spread over two and a half years (July 2018 – Dec 2020) consisting of seven capacity building sessions. Two capacity building sessions have been held in July 2018 and February 2019. The pilot testing of RBS framework is scheduled in the first quarter of FY20.

3.3 Strengthening Regulatory Framework

3.3.1 Issuance of Governance Framework for Banks' Overseas Operations

SBP has issued a comprehensive Governance Framework for Bank's Overseas operations in 2018 for strengthening their capacity to understand, identify and manage various risks posed by its foreign operations.

3.3.2 Issuance of Guidelines on Internal Audit Function

The detailed guidelines on internal audit function were issued by SBP for strengthening bank's internal audit functions and establishment of a robust internal audit governance structure in line with international standards and best practices.

3.3.3 Revision of Financial Statements Format for Banks/ DFIs

SBP revised the financial statement format/ disclosures of banks/ DFIs to align them with the regulatory changes and international best practices. The objective of prescribing the format of financial statements is to bring consistency in financial reporting while enhancing the transparency and quality of their disclosures.

3.3.4 IFRS 9 Readiness Assessment Exercise

IFRS 9, the new accounting standard has presented a major overhaul of financial instrument accounting by introducing an expected credit loss approach. In order to implement the standard on banks/ DFIs smoothly, SBP advised the banking industry in 2018 to carry out a 'quantitative impact assessment' of IFRS 9 implementation on their balance sheets. The purpose of this exercise was to determine the banking sector's readiness and identification of the challenges that will be faced by them during its implementation.

3.3.5 The Financial Institutions (Recovery of Finances) Rules 2018

SBP in consultation with the banking sector and legal experts drafted the Financial Institutions (Recovery of Finances) Rules, 2018. The Rules were notified by the Federal Government on August 27, 2018 under section 25 of the Financial Institutions (Recovery of Finances) Ordinance, 2001. The Rules would make the process of sale of mortgaged property by a financial institution more transparent and expedite recovery of non-performing loans.

3.3.6 Self-Assessment of BCBS Corporate Governance Principles

In order to align SBP's regulatory regime on Corporate Governance with international best standards, BPRD conducted self-assessment of BCBS Principles on corporate governance under SBP Vision 2020. The main objective was to assess the quality of SBP's regulatory framework on Corporate Governance for banks/ DFIs, identify the gaps and make recommendations for bridging the gaps. As a result of this assessment, it was found out that out of 13 BCBS Principles, SBP is compliant with 3 Principles, largely compliant with 6 Principles, materially non-compliant with 3 Principles and non-compliant with 1 Principle. BPRD is currently working to incorporate the identified gaps in existing regulatory regime of Corporate Governance where necessary.

3.3.7 Strengthening AML/CFT Regime

- To further align AML/ CFT Regulations with the Financial Action Task Force (FATF) recommendations, SBP amended various provisions of the Regulations on October 18, 2018. The introduction of these amendments were intended to provide further clarity on implementation of AML/ CFT requirements by banks/ DFIs, including customer due diligence, beneficial ownership structure, correspondent banking, wire transfers/ funds transfers and minimum documents required for opening accounts by customers.
- In accordance with the Guidelines issued by the Ministry of Foreign Affairs and National Counter Terrorism Authority under relevant UNSC Resolutions, SBP updated its Guidelines for banks/ MFBS/ DFIs.
- SBP enhanced the scope of Know Your Customer (KYC) standards and documentation requirements for Exchange Companies.
- With the view to further strengthen the measures already in place and mitigate the ML and TF risks, SBP ensured that bank accounts throughout Pakistan are verified through biometric technology. Instructions were issued for biometric verification on October 19, 2018 for banks/ DFIs. Biometric verification shall also be conducted for Branchless Banking transactions (Account to Person and Person to Account). Resultantly, 86 percent of the banking industry's customers (active) accounts have been validated by June 30, 2019 .
- SBP advised banks to accept Proof of Registration (PoR) Card held by Afghan Refugees as a valid identity document for opening of bank accounts.

3.3.8 Measures to Enhance Financial Inclusion

- **Lowering of Risk Weight on Low Cost Housing Finance:** In order to facilitate availability of long-term affordable funding to low income segments (such as widows, children of Shaheed, transgender, special persons and persons in the areas severely affected by war against terrorism) in Pakistan, SBP launched a “Financing Facility for Low Cost Housing for Special Segments”. To further encourage and facilitate the banks/ DFIs to pursue low-cost housing finance in Pakistan, capital requirements on banks/ DFIs' exposure to “Low Cost Housing” has been reduced.
- **Increase in Domestic and Global Outreach of Banks / MFBS:** To enhance the outreach and provision of financial services to the general public, SBP issued new branch licenses to banks/ MFBS during FY19, which has increased the total number of branches to 16,864 from 16,066.

Similarly, Pakistani banks were allowed to further expand their overseas operations in China during FY19. Presently, nine Pakistani banks are operating in 36 countries of the world under different modes (branches, representative offices and banking subsidiaries).

- **Implementation of KPK & Balochistan Action Points:** In line with NFIS, SBP is actively engaged with banks/ MFBs to enhance their banking operations and extension of credit in rural and underserved areas of the country especially in KPK and Baluchistan provinces. Accordingly, banks/ MFBs have devised/ implementing financial inclusion plans (2018-2020).
- **Enable and Promote ADCs Of Financial Services:**
 - **Branchless Banking Regulations for Promotion of Home Remittances**
In order to facilitate banks to promote Home Remittances through Branchless Banking Channel, it was decided that the incentive of airtime be increased to Rs 2 against each USD received through M-Wallet and the entire amount of incentive to Home Remittance Account (HRA) customers would be borne by the GoP. Further, Authorized Financial Institutions were allowed to use single account for both Home Remittances and inland transactions subject to implementation of controls related to privileges/ transactions limits as per regulatory requirements.
 - **Regulations for Mobile Banking Interoperability** In order to achieve National Financial Inclusion Strategy objectives and targets, connectivity with any one Third Party Payment Services Provider for Authorized Financial Institutions and Telecom Operators was made mandatory.

3.4 Supervisory Initiatives

In line with SBP Vision 2020, SBP took following development initiatives to enhance effectiveness and operational efficiency of the inspection processes:

- **Improvement in the Inspection Process:** The project aims at bringing efficiency in the inspection process of asset quality of banks and DFIs. In this regard, SBP has developed a utility called “Red Flag System”, which will analyze banks’ advances portfolio to identify potential regulatory violations and the exposures warranting detail examination. Once implemented, the system will help the inspection teams to focus on potential risk areas thereby improving the operational efficiency.
- **Inspection Management System – Fit and Proper Test (FPT) Module:** Inspection Management System (IMS) was implemented to bring efficiency in the management, monitoring, and allocation of human resources in the inspection process. In order to bring more efficiency while reviewing cases of Fitness & Propriety of Directors and Key Executives of FIs, a new module, named FPT, was added in IMS. The process of reviewing FPT cases will become easier to manage.
- **Risk Assessment and Control Evaluation Regime for Exchange Companies:** In order to align inspection framework of Exchange Companies (ECs) with RBS framework, SBP developed an inspection framework for ECs known as “Risk Assessment and Control Evaluation Regime” (RACER) in 2016. During FY19, the framework was revised by incorporating certain risk factors especially relating to TF and made evaluation process of related controls more effective for

overall risk rating of the company. Under the revised methodology, the on-site inspection process will address all the related risks of ECs in a more structured/ detailed manner especially to address ML/ TF risk.

- **Revision of AML/CFT Penalty Scale:** The revised scale has significantly increased the penalties to dissuade and deter banks from violating AML/CFT regulations.
- **Assessing Effectiveness of Regulatory Regime**
To assess the effectiveness of SBP's instructions with respect to AML/CFT, a standardized format has been communicated to the banks to regularly report data on existence of policies and procedures on AML/CFT, oversight of senior management/ Board, name screening systems, transaction monitoring, HR strength and training imparted.
- **Supervisory Framework for Credit Bureaus:** SBP is empowered under Credit Bureaus Act, 2015 to monitor the affairs of credit bureaus through both on-site and off-site supervision. A supervisory framework highlighting the areas of supervision and monitoring has been developed. The purpose is to ensure that Credit Bureaus have best governance structure, policies and procedures in place, apply best practices in data receipt, data processing, data submission including appropriate procedures to protect consumer rights and to ensure security and confidentiality of data.

3.4.1 On-site Inspections

The on-site inspections of Banks, DFIs, MFBs and ECs were conducted as per approved inspection plan for FY19. Areas of supervisory concerns, which, inter alia, included assessment of corporate governance, weaknesses in systems and controls, IT security, compliance with AML /CFT regime and business conduct etc. were taken up with the banks for corrective actions. Further, statutory reports on written-off loans and advances were prepared as per the requirement of section 25AA of the BCO, 1962. BIDs also carried out limited scope inspection to investigate issues or business activities requiring immediate action. Similarly, to assess safety and soundness of the overseas operations of locally incorporated banks, selected number of such branches were also inspected.

3.4.2 Thematic Inspections

Thematic inspection is a supervisory tool, which focuses on assessment of risk in a particular business activity across banking industry. On-site thematic inspections are conducted to identify inherent risks due to non-compliance with regulatory regime or adverse practices in a specific area across the industry and to facilitate issuance of direction to industry besides enforcement action against non-compliance. During FY19, following thematic inspections were carried out:

- **Assessment of Implementation of UNSC Sanctions Regime in Financial Institutions:** The objective of this exercise was to assess overall governance and robustness of systems and controls established in financial institutions to ensure compliance with the UNSC sanctions regime. The account holders' database maintained by the banks was also examined to identify accounts of proscribed entities/ individuals, which were not frozen in compliance with UNSC sanctions regime.

- **Review of High Turnover Accounts in Banks:** The inspection was carried out to review the accounts having turnover beyond a certain threshold. Similarly, selected accounts of directors, owners and key employees of exchange companies were reviewed from the perspective of ML/TF risk.
- **Assessment of Cyber Frauds in Banks:** The objective was to examine cyber frauds in alternate distribution channels i.e. Internet bank, Mobile banking and ATM card related transactions and to assess controls put in place by banks to mitigate such frauds.

3.4.3 Limited Scope Special Inspections

- **Special Inspection of Accounts in Tax Exempted Areas:** A special inspection of accounts in tax exempted areas was conducted to assess ML/TF risks.
- **Special Inspection of Suspicious Accounts:** BIDs conducted a review of a number of accounts, suspected to be fake. The accounts were mainly selected based on information received from electronic and print media, high turnover and their possible linkages with certain individuals/entities.
- **Focused Review of ML Risk of Selected Exchange Companies (ECs):** ECs are exposed to possible ML/TF risks. Consequently, a focused review was carried out pertaining to ML/TF risks inherent in money remittance/ currency exchange business and internal controls instituted by the ECs.

3.4.4 Capacity Building of Staff

To enhance the capacity of human resource, special focus was given to training. In this regard, trainings relating to technical areas such as risk management, AML/CFT, banking supervision etc. as well as soft skills were arranged. Officers were also given exposure to foreign trainings organized by multilateral agencies and central banks of foreign jurisdictions.

3.5 Enhancements in SBP's Conduct Regulation and Supervisory Regime

Enhancing SBP's conduct supervision framework and strengthening Fair Treatment of Consumers (FTC) regime are key tactical objectives under SBP Vision 2020. Some of the key conduct milestones achieved in FY19 are mentioned as under:

3.5.1 Prohibited Conduct

Issues like banks' irresponsible conduct or misconduct of banks destabilizes the industry as the same compromises FTC regime. Given the potentially large costs and possible consequences for financial stability, SBP issued guidelines on 'Prohibited Banking Conduct' in July 2019. Guidelines on prohibited conduct have been developed in line with the best international practices, which will help in bringing more clarity on regulatory expectations on business conduct besides complementing the existing SBP instructions issued from time to time.

3.5.2 Self-Assessment of the World Bank's Good Practices

The World Bank launched Good Practices for Financial Consumer Protection in 2017. Since such practices serve as a benchmark for consumer protection, SBP conducted a self-assessment of the revised good practices. The findings and recommendations of the assessment will be presented to relevant stakeholders to formulate future strategy on conduct regulation and supervision.

3.5.3 Capacity Building on Conduct Supervision and Regulation

In view of the globally growing focus on Financial Consumer Protection and Conduct Supervision, the related role of regulators has been largely revitalized. Resonating with the enhanced role to promote FTC and responsible banking conduct, SBP hosted workshops on Market Conduct Supervision in collaboration with the World Bank and Toronto Center. Two iterations were held, first in February 2019 and second in April 2019. Officers from banking cluster of SBP, SECP and Pakistan Microfinance Network attended the workshops.

3.5.4 Industry Engagements

SBP organized a knowledge sharing session on Conduct Risk Management in coordination with Standard Chartered Bank (Pakistan) Limited at SBP in March 2019. It was emphasized during the session that ring-fencing consumer protection or responsible banking conduct within the compliance function could not render real/ fair outcomes. Instead, the entire bank, right from the Board to the frontline managers, need to be responsive to this objective.

3.5.5 Regulatory Enhancements in Private Credit Bureaus

- **Issuance of License- Credit Bureaus:** Under Credit Bureaus Act, 2015, SBP issued licenses to two credit bureaus i.e. M/s Aequitas Information Services Limited and M/s Data Check Limited.
- **Initiative on reporting of non-traditional data:** Efforts were made by SBP to allow the institutions other than financial institutions to become part of the Credit Reporting System. In this regard, a number of meetings were held with the respective utility companies to discuss their membership and issues of data sharing with the Credit Bureaus. At the initial stage, telecom companies have to share their data. Necessary notification in this regard, has been issued by the Federal Government.

3.6 International Cooperation in Banking Supervision

3.6.1 Financial Stability Board 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. During the year, two RCG Asia meetings were held which were attended by SBP's senior management. The meetings covered areas including banking sector stress testing, cyber security in the financial sector, role of FinTechs for financial inclusion, crisis preparedness, non-bank financial intermediation, climate-related financial risk, amongst others.

3.6.2 FSB Correspondent Banking Coordination Group (CBCG)

The FSB established CBCG to assess and address the decline in correspondent banking in light of the four-point action plan outlined in a FSB Report (on correspondent banking) to the G20. Since the

action plan is more or less in place, the members have streamlined the four technical work streams of CBCG. The Deputy Governor (Banking & FMRM) represents SBP on the CBCG forum.

3.6.3 Surveys on Macroprudential Policies & Tools, Regulations and Supervision

IMF started Macroprudential Policy Survey since 2017 to form a global database of Macroprudential policy measures taken by the member countries after the global financial crisis of 2008. The survey covers questions related to (a) Institutional aspects of Macroprudential Framework, (b) Broad-based tools applied to the Banking Sector, (c) Household & Corporate Sector tools, (d) Liquidity tools applied to the Banking Sector, (e) Tools to address systemic Liquidity Risk and Fire Sale Risk in Non-bank Sector, (f) Tools to address risks from SIFIs and Interconnectedness within Financial System and (g) Tools to address other sources of Systemic Risks. Pakistan's consolidated response was shared with the IMF in 2017 and 2018 after coordination with the relevant stakeholders.

Additionally, SBP completed the World Bank's "Bank Regulation and Supervision Survey (BRSS) 2017" and addressed subsequent queries for the period 2011 to 2016. This survey covered questions related to (a) banking, (b) capital and liquidity requirements, (c) governance, (d) accounting standards/ disclosures, (e) supervision, (f) deposit insurance and (g) Islamic banking. The survey was intended to provide comparable data on how banks are regulated and supervised around the globe.

3.7 Other Initiatives

3.7.1 Ease of Doing Business (EODB) Index of World Bank

Since 2017, SBP is leading the reform efforts for improving Pakistan's ranking in the "Getting Credit" indicator of Ease of Doing Business Index. SBP has been actively collaborating with federal agencies, the World Bank and private stakeholders including commercial banks, private law firms, accountancy firms and corporate sector for implementation of the reforms. Further, SBP has continued to focus on awareness and dissemination of relevant information amongst the stakeholders. In collaboration with World Bank and Board of Investment, SBP conducted two awareness sessions with participation from commercial and MFIs, government agencies, law firms, accountancy firms and private companies etc. The awareness sessions were aimed at informing the participants and survey contributors of the recent reforms that are being undertaken and encouraged potential contributors to submit the Getting Credit Survey to the World Bank.