

Supervisory Regime

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State Bank of Pakistan
Off-site Supervision & Enforcement Department
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<i>Sr. No</i>	<i>Contents</i>	<i>Page No</i>
	Preface	3
1	Statutory Framework	4
2	Objectives of Supervision	4
2.1	Stability of financial system.....	4
2.2	Safe and sound financial institutions.....	4
2.3	Safe and efficient financial infrastructure.....	5
2.4	Transparent and fair-dealing financial institutions.....	5
2.5	Well-informed and empowered financial consumers...	5
3	Supervisory Process	6
3.1	Supervisory framework.....	6
3.1.1	Regulations.....	6
3.1.2	On-site Assessment.....	7
3.1.2.1	On-site Assessment methodology.....	7
3.1.3	Off-site Supervision.....	8
3.1.3.1	Surveillance.....	9
3.1.3.2	Enforcement and Resolution.....	9

PREFACE

State Bank of Pakistan (SBP), being the central bank and banking supervisor, has been entrusted, inter alia, with the responsibilities of regulating the monetary and credit system of Pakistan and to foster its growth in the best national interest with a view to securing monetary stability and fuller utilisation of the country's productive resources.

Under the prevalent legislative structure, the State Bank of Pakistan regulates Banks, Development Finance Institutions (DFIs), Microfinance Banks (MFBs), Exchange Companies (ECs), Payment Service Providers, Operators of Payment Systems or Issuers of Payment Instruments and Credit Bureaus. On the other hand, Securities and Exchange Commission of Pakistan (SECP) supervises non-bank finance companies (i.e. Leasing, Investment banking, Discount houses, Housing finance, Venture capital and Mutual funds), Insurance companies, Modarabas, Capital markets, and other corporate entities.

State Bank has an elaborate and extensive supervisory framework for the supervision and regulation of financial institutions under its domain. The objective of this communication paper is to share broad contours of the supervisory regime with the general public and other stakeholders.

1. Statutory Framework

State Bank of Pakistan regulates and supervises Banks, DFIs, MFBs, ECs, Payment Service Providers, Operators of Payment Systems or Issuers of Payment Instruments and Credit Bureaus in terms of powers conferred on it by the following statutes:-

1. State Bank of Pakistan Act, 1956
2. Banking Companies Ordinance, 1962
3. The Banks Nationalization Act, 1974
4. Microfinance Institutions Ordinance, 2001
5. Payment Systems and Electronic Fund Transfer Act, 2007
6. Foreign Exchange Regulation Act, 1947
7. Credit Bureaus Act, 2015

Latest versions of above laws are available at http://www.sbp.org.pk/1_frame/index2.asp

2. Objectives of Supervision

State Bank aims to maintain a sound and progressive financial services sector. This requires achieving i) stability of financial system, ii) safe and sound financial institutions, iii) safe and efficient financial infrastructure, iv) transparent and fair-dealing intermediaries and, v) well-informed and empowered financial consumers.

2.1 Stability of financial system

A stable financial system is described as a condition where the financial intermediation process functions in a smooth manner and public confidence exists in the operation of key financial institutions and markets. In order to achieve financial stability objective, SBP continuously evaluates safety and soundness of banking institutions, strengthen and consolidate governance and risk management standards, capital requirements and enforcement and resolution mechanism.

2.2 Safe and sound financial institutions

The prime focus of SBP's regulation and supervision is on the safety and soundness of banks, DFIs, MFBs and other regulated entities. The distress or collapse of key

financial institutions has more damaging consequences for systemic stability as such institutions transmit problems to another and consequently undermine public confidence. Moreover, depositors are usually not in a position to make fully informed judgments about the risks facing the institutions with which they enter into financial contracts.

2.3 Safe and efficient financial infrastructure

Financial infrastructure refers to the platforms that provide the services and facilities underpinning financial market activities, such as clearing houses¹, payment and settlement systems² etc. These platforms serve as important part of overall financial system. Their failure may amplify systemic risks by seizing up financial flows, undermining the fulfillment of obligations and transmitting shocks from one institution to another. State Bank envisions an enabling environment for creation of new business models and payment mechanisms in coordination with financial infrastructure providers.

2.4 Transparent and fair-dealing financial institutions

SBP expects financial institutions to adopt fair business practices and high standards of disclosure when dealing with consumers. In this regard, SBP does prescribe disclosure requirements, conduct fit and proper tests to promote honesty and integrity among financial institutions and their representatives, set competency requirements and instill fair business practices in the marketing and distribution of financial services and products.

2.5 Well-informed and empowered financial consumers

Financial consumers are expected to protect their own interests by exercising due care in the selection of financial products and service providers. However, SBP regularly issues regulations and guidelines and plays its due supervisory role in ensuring that consumers are well-informed and empowered to assume principal responsibility for their own protection.

¹ concerned with the establishment and risk management of contractual obligations

² concerned with the discharge of obligations

3. Supervisory Process

The supervisory process of State Bank of Pakistan:

- emphasizes on assessment of risks and their mitigation;
- maintains high standards in financial supervision;
- endeavors to reduce the risk and impact of failure of any institution;
- places principal responsibility for risk oversight on the institution's board and management;
- relies on timely, accurate and adequate disclosure;
- adopts a consultative approach to regulating the industry;
- emphasizes on early identification of emerging risks and system-wide issues.

3.1 Supervisory framework

In order to identify potential risks that may impact the safety and soundness of an institution and assess the suitability of various supervisory actions, SBP relies on a variety of supervisory tools to carry out this work such as Regulations, On-site Assessment, Off-site Supervision, Surveillance and Enforcement & Resolution.

3.1.1 Regulations

SBP inter alia determines different sets of rules, regulations and guidelines for the financial institutions under its domain. The prudential rules and regulations set out the high-level framework and expectations against which financial institutions are judged and serve as minimum standards to be abided by the financial institutions. Main focus of regulations however, remains on the safety and soundness of financial institutions, safeguarding the interest of depositors, risk-based capital, good corporate governance, anti money laundering and combating the financing of terrorism, and sound business conduct practices etc. State Bank's approach to regulations is mostly consultative and engagement with the financial institutions it regulates. A different array of regulations and instructions issued by various departments of the State Bank of Pakistan can be seen at <http://www.sbp.org.pk/Circulars/index.asp>

3.1.2 On-site Assessment

On-site assessment is the most critical supervisory tool employed by SBP to have a good understanding of the institution's business, identify potential risks that may impact institution's reputation, safety, and soundness and to assess the suitability of various supervisory actions. SBP's On-site assessment may be a full scope inspection, limited/ focused review or thematic. Besides that SBP also periodically assesses Information Systems and Overseas Operations of the financial institutions. Apart from these regular on-site assessments, SBP is also required, under Banking Companies Ordinance, to review cases of loans written off by the financial institutions.

3.1.2.1 On-site assessment methodology

SBP assesses the financial institutions on the basis of CAMELS methodology. This methodology involves analysis of Capital, Asset Quality, Management, Earnings, Liquidity and System & Controls broadly on the following parameters:

- **Capital:** It is evaluated in relation to SBP's capital adequacy requirements and overall financial condition of the bank.
- **Asset Quality:** This is evaluated in relation to the level, distribution, trend, severity of adverse classifications and non-performing assets; the adequacy of provisions (general and/or specific); and management's demonstrated ability to identify, monitor, administer, and collect problem advances and other such assets.
- **Management:** It is evaluated against all factors necessary to operate an institution in a safe and sound manner and thus protect depositors' funds in accordance with acceptable practices.
- **Earnings:** It is examined on basis of quantity and quality of earnings and the ability to support present and future operations; coverage of losses and build-up of adequate capital; level and trend of profits; and quality with regards to composition of core earnings and recurring nature of profits.
- **Liquidity:** This factor is examined in relation to the overall effectiveness of asset and liability management. These areas are reviewed especially with regard to compliance with cash reserve requirement and liquid asset requirement ratios as well as performance with regard to borrowings, structure and stability of deposits.

- **Systems and Controls:** The evaluation methodology of SBP includes an assessment of the adequacy of the systems and methodologies followed, the inherent degree of an institutionalized approach and an analysis of the contribution made to the control processes at various organizational levels.

Based on the assessment of above components, an overall assessment of the financial institution is made and shared with the concerned financial institution and necessary enforcement measures are taken. Financial institutions are required to place SBP's On-site assessment before their Board of Directors for review and necessary actions.

State Bank's On-site assessment of the financial institutions is an "un-published record" and thus cannot be disclosed publically.

3.1.3 Off-site Supervision

Off-site supervision is another important and critical supervisory tool of the State Bank of Pakistan and is also used to reinforce the on-site assessment. It is continuous supervision process wherein regular meetings with the institutions are held, audit reports on the institutions and regulatory returns are reviewed and key financial indicators and business developments are monitored. The off-site assessment is primarily based on the quarterly data submitted on-line by banks/DFIs through SBP's Data Acquisition Portal under Reporting Chart of Accounts. In addition, non-financial data such as minutes of Board meetings are also analyzed. Based on available financial and non-financial data, a quarterly off-site assessment of the financial institutions is made. This assessment is used for supervisory and surveillance purposes.

Off-site assessments are made under CAELS (Capital, Asset Quality, Earnings, Liquidity, and Sensitivity to other risks) framework and takes into account financial institution's performance in comparison with its peer groups. Peer groups are comprised of Top-6 banks, Mid-8 banks, Small banks (based on total assets size), Branches of foreign banks, Specialized banks (owned by Federal Government) and Islamic banks. Besides that, State Bank's Off-site supervisory framework also reviews performance of overseas operations of Pakistani banks.

3.1.3.1 Surveillance

SBP's Off-site supervisory framework also monitors liquidity positions of the financial institutions and conducts stress-testing.

Financial institutions under State Bank's mandates are required to maintain a prescribed level of Cash Reserve and Liquid Assets against their demand and time liabilities in local currency. Moreover, banks which maintain foreign currency deposits are also required to keep a prescribed level in Cash Reserve Account and Special Cash Reserves Account with State Bank. Failure to maintain the required amount of reserves attract penalty under provision of law/regulations.

SBP has advised the banks/DFIs to conduct stress tests³ on quarterly basis based on their credit, market, and liquidity risk using sensitivity analysis⁴. In accordance with supervisory purposes, SBP also conducts Macro Stress Testing for identifying potential impact of extreme yet plausible events or movements on the capital adequacy of the banks.

3.1.3.2 Enforcement and Resolution

SBP is empowered to take regulatory actions against those institutions that breach rules, regulations or instructions issued by it under various statutes. These actions may range from imposition of penalties, administrative & financial sanctions and reference to concerned law enforcement/prosecution agencies.

SBP also imposes monetary penalties under the relevant provisions of law. Other enforcement actions depend upon the nature, severity and continuity of regulatory breaches and risks posed to the institution and may range from mild to severe. The nature of intervention or corrective actions also takes into consideration behavior and ability of the institution's management and sponsors, and the previous record of dealing with deficiencies.

³ Stress Testing is a risk management tool that helps identify the potential impact of extreme yet plausible events or movements on the value of a portfolio.

⁴ Sensitivity Analysis typically examines the short-term impact of change in some variable(s) (e.g. interest rate, equity prices or a combination of both) on the value of a portfolio/financial position.

Mild supervisory and regulatory enforcement actions generally include meetings with the relevant Key Executives, Chief Executive or Board of Directors of the institutions by SBP's enforcement team. Meetings levels are escalated depending upon the severity of the concerns or the compliance levels with already committed targets. In the mild supervisory and enforcement actions, SBP advises the institution to submit Commitment Letter, Board Resolutions / Undertaking in which management/Board of the institution resolves to correct the identified deficiencies or weaknesses within a given time.

The failure to implement mild corrective actions by the institutions leads to initiation of severe corrective measures. Severe actions may require the institution to, inter alia:

- follow any particular policy in relation to advances, deposits etc
- maintain higher level of liquid assets
- increase the capital level by a specified amount
- remove any key executive/ board of directors
- reconstruct/amalgamate the institution
- cancel the license
- wind up the institution through High Court

State Bank of Pakistan continuously endeavors to review its supervisory framework to align it with developments in the local business practices, technology and international supervisory and regulatory standards.