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HANDOUT

BNK704

Management of Financial Institutions

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VU STUDY HANDOUT

BNK704

Management of Financial Institutions

This handout covers how financial institutions - commercial banks, central banks, Islamic banks, insurance companies, mutual funds and development finance institutions - are managed: their balance sheets, risks, regulation, and strategy, with emphasis on Pakistan's financial system and the State Bank of Pakistan.

13 lecture-wise topics | key terms | exam pointers

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UNIT 1: THE FINANCIAL SYSTEM

Lecture 1: Overview of Financial Institutions

Learning Objectives

- Classify financial institutions
- Explain financial intermediation
- Describe Pakistan's financial system structure

Key Terms & Definitions

Financial intermediation

Channeling funds from surplus units (savers) to deficit units (borrowers).

Depository institutions

Institutions that accept deposits: commercial banks, microfinance banks.

Non-bank financial institutions (NBFIs)

Institutions providing financial services without a banking license: leasing, modaraba, mutual funds.

Financial institutions (FIs) are the **circulatory system of the economy**: they mobilize savings, allocate credit, provide payment services, and manage risk. The core economic function is **intermediation** - maturity transformation (short deposits into long loans), denomination transformation, and risk transformation through diversification.

FIs are classified as **depository** (commercial banks, Islamic banks, microfinance banks - they take deposits and are tightly regulated) and **non-depository** (insurance companies, mutual funds, pension funds, investment banks). In Pakistan the system is **bank-dominated**: banks hold the bulk of financial assets, with the State Bank of Pakistan (SBP) as regulator.

Why study FI management separately from corporate finance? Because banks are **highly leveraged** (equity ~8-12% of assets), their "raw material" is money itself, they face **runs** (liquidity risk), and they operate under **prudential regulation** (capital adequacy, liquidity coverage) that shapes every decision.

- **Intermediation functions**: maturity, denomination, risk transformation; payment system operation.
- **Pakistan**: SBP regulates banks/DFIs; SECP regulates NBFIs, insurance, capital markets.
- **Bank uniqueness**: extreme leverage, demandable liabilities, systemic contagion risk.

VERY IMPORTANT — Exam Pointer

Very important: explain the three transformations of intermediation and why banks need special regulation (leverage + runs + contagion).

Section Summary

FIs intermediate savings into investment; their leverage and interconnectedness justify prudential regulation.

Lecture 2: The Balance Sheet of a Bank

Learning Objectives

- Read a bank balance sheet
- Explain asset-liability structure
- Define net interest margin

Key Terms & Definitions

Net interest margin (NIM)

(Interest income - interest expense) / earning assets; the core profitability metric.

Earning assets

Assets generating interest: loans, investments, interbank placements.

Demand liabilities

Deposits withdrawable on demand: current accounts.

A bank's balance sheet is the **mirror image of a normal firm's**: liabilities (deposits) are the raw material and loans are the product. Typical structure - Assets: cash & balances with SBP, interbank placements, investments (government securities/sukuk), advances (loans), fixed assets. Liabilities: deposits (current, saving, term), borrowings, subordinated debt; Equity: share capital plus reserves.

Profitability flows through the **income statement**: net interest income (interest earned minus interest paid) plus non-interest income (fees, commissions, forex) minus provisions (for bad loans) minus operating expenses = profit before tax. **NIM** measures spread efficiency; **cost-to-income ratio** measures operational efficiency.

Key structural facts: deposits fund ~70-80% of a Pakistani bank's assets; **CASA ratio** (current + saving accounts / total deposits) matters because current accounts pay no interest - a higher CASA means cheaper funding and wider NIM.

- **Assets**: cash, placements, investments, advances - in rising liquidity order reversed.
- **NIM = net interest income / average earning assets**; Pakistani banks typically 3-5%.
- **CASA**: cheap deposits; drives NIM; a strategic focus of branch banking.
- **Provisions** (IFRS 9 expected credit loss) are the biggest swing factor in bank earnings.

Example

A bank with Rs 1000bn deposits at 8% average cost and Rs 900bn advances at 15% earns a gross spread; after 2% provisions and 3% operating costs, NIM settles near 4%.

VERY IMPORTANT — Exam Pointer

Exam pointer: be able to compute NIM from given figures and explain why CASA improves it.

Section Summary

Banks profit from the spread between asset yields and funding costs; balance-sheet structure determines both risk and return.

Lecture 3: The State Bank of Pakistan

Learning Objectives

- List SBP functions
- Explain monetary policy tools
- Describe the regulatory framework

Key Terms & Definitions

Monetary policy

SBP's management of money supply and interest rates to control inflation and support growth.

Policy (target) rate

SBP's key interest rate signaling monetary stance; transmits to KIBOR and lending rates.

Prudential regulations

SBP rules on capital, liquidity, lending limits, governance for banks/DFIs.

The **State Bank of Pakistan** (established 1948) is the central bank: issuer of currency, banker to the government, lender of last resort, regulator/supervisor of banks and DFIs, and manager of foreign exchange reserves. Its primary statutory objective is **price stability**, with growth and financial stability as supporting goals.

Monetary policy works through the **policy rate**: raising it makes credit expensive, dampening demand and inflation; cutting it stimulates activity. Transmission runs via **KIBOR** (Karachi Interbank Offered Rate) to bank lending/deposit rates, and via expectations and the exchange rate. SBP also uses **open market operations**, **cash reserve requirements (CRR)** and **statutory liquidity requirements (SLR)**.

As regulator, SBP issues **Prudential Regulations** (corporate, SME, consumer, agriculture, microfinance), enforces **Basel III** capital standards, conducts on-site inspection and off-site surveillance, operates the **credit information bureau (eCIB)**, and runs the deposit protection scheme. The **Banking Mohtasib** handles consumer complaints.

- **Functions**: currency issue, monetary policy, bank supervision, forex management, development finance.
- **Tools**: policy rate, OMO, CRR/SLR, discount window, forward guidance.
- **SBP Act amendments** strengthened autonomy with price stability as the primary objective.
- **Regulatory perimeter**: SBP = banks/DFIs/payment systems; SECP = NBFIs/insurance/securities.

VERY IMPORTANT — Exam Pointer

Very important: trace the transmission from a policy-rate hike to inflation control, naming each link.

Section Summary

SBP combines central banking (money, stability) with intensive micro-prudential supervision of banks.

UNIT 2: MANAGING BANK RISKS

Lecture 4: Credit Risk Management

Learning Objectives

- Define credit risk and its components
- Explain the 5 Cs of credit
- Describe the loan approval process

Key Terms & Definitions

Credit risk

Risk that a borrower defaults on contractual obligations.

5 Cs of credit

Character, Capacity, Capital, Collateral, Conditions - the classic appraisal framework.

NPL (Non-performing loan)

Loan overdue beyond 90 days (Substandard/Doubtful/Loss classifications).

Credit risk is the dominant risk for banks: $\text{expected loss} = \text{PD} \times \text{LGD} \times \text{EAD}$ (probability of default, loss given default, exposure at default). Management has three layers: **origination standards** (who gets loans), **portfolio management** (concentration limits by sector/borrower - SBP sets per-party and group exposure limits), and **workout/recovery** (rescheduling, litigation).

The classic appraisal uses the **5 Cs**: Character (integrity, credit history via eCIB), Capacity (cash flows to service debt - DSCR), Capital (borrower's own stake), Collateral (security: mortgage, pledge, hypothecation), Conditions (industry/economic outlook). Modern banks add **credit scoring models** and **internal ratings** (Basel IRB).

SBP classifies infected loans: **OAEM** (other assets especially mentioned), **Substandard** (90+ days), **Doubtful** (180+), **Loss** (365+), with rising provisioning requirements. **IFRS 9** moved provisioning from incurred-loss to **expected credit loss** (ECL) - banks must provision for future losses in three stages, making earnings more forward-looking and procyclical.

- **Expected loss** = $\text{PD} \times \text{LGD} \times \text{EAD}$ - memorize this decomposition.
- **Exposure limits**: per-party ~25% of equity; group limits prevent concentration.
- **eCIB**: SBP credit bureau; check before every facility.
- **Recovery**: negotiation, restructuring, collateral enforcement (Financial Institutions Recovery Ordinance), write-off.

Example

A textile exporter seeks Rs 500m: appraisal checks eCIB (character), export cash flows (capacity), 30% margin (capital), factory mortgage (collateral), and textile outlook (conditions).

VERY IMPORTANT — Exam Pointer

Very important: define the 5 Cs and the expected-loss formula; explain the IFRS 9 shift from incurred to expected loss.

Section Summary

Credit risk is managed across origination, portfolio limits and recovery; provisioning rules shape reported profits.

Lecture 5: Liquidity Risk and Asset-Liability Management

Learning Objectives

- Define liquidity risk
- Explain ALM and gap analysis
- Describe Basel III liquidity ratios

Key Terms & Definitions

Liquidity risk

Inability to meet obligations as they fall due without unacceptable loss.

ALM (Asset-Liability Management)

Coordinated management of balance-sheet structure to control interest-rate and liquidity risk.

LCR / NSFR

Liquidity Coverage Ratio / Net Stable Funding Ratio - Basel III liquidity standards.

Liquidity risk kills banks faster than insolvency: a solvent bank can fail if depositors run and assets cannot be sold quickly. Sources: maturity mismatch (long loans, demand deposits), wholesale funding dependence, off-balance-sheet commitments (LCs, guarantees).

ALM manages this through **maturity gap analysis**: bucket assets and liabilities by repricing/maturity dates; a negative gap (liabilities reprice first) means rising rates hurt NIM. The **ALCO** (Asset-Liability Committee) sets limits and the funding strategy. **Funds transfer pricing (FTP)** charges business units for the liquidity they consume.

Basel III imposed two ratios: **LCR** (high-quality liquid assets / 30-day net outflows $\geq 100\%$) for short-term survival, and **NSFR** (available stable funding / required stable funding $\geq 100\%$) for structural maturity matching. SBP has phased both in for Pakistani banks.

- **Gap = rate-sensitive assets - rate-sensitive liabilities** per time bucket.
- **Positive gap**: benefits from rising rates; **negative gap**: hurt by rising rates.
- **LCR $\geq 100\%$** : survive 30 days of stress; **NSFR $\geq 100\%$** : stable funding structure.
- **Contingency funding plan**: pre-arranged lines, central bank facilities, asset sale playbooks.

VERY IMPORTANT — Exam Pointer

Exam pointer: interpret a simple maturity gap table and state the effect of a rate rise under positive vs negative gaps.

Section Summary

ALM keeps the bank fundable and its margin stable across rate cycles; Basel III liquidity ratios are the hard constraints.

Lecture 6: Market Risk and Operational Risk

Learning Objectives

- Define market and operational risk
- Explain VaR
- Describe operational risk management tools

Key Terms & Definitions

Market risk

Losses from movements in interest rates, exchange rates, equity/commodity prices.

VaR (Value at Risk)

Maximum expected loss over a horizon at a confidence level, e.g. 99% 1-day VaR.

Operational risk

Loss from failed processes, people, systems or external events - including fraud and cyber.

Market risk for a Pakistani bank concentrates in the **trading book** (government securities marked to market) and **forex positions**. **VaR** summarizes it: "99% 1-day VaR of Rs 50m" means losses exceed Rs 50m on only 1% of days. VaR is computed by historical simulation, variance-covariance, or Monte Carlo; its weakness is ignoring **tail risk** beyond the confidence level (hence Expected Shortfall/stress tests).

Interest rate risk in the banking book (IRRBB) - the economic value and earnings impact of rate moves on loans/deposits - is measured by duration gap and earnings-at-risk. SBP requires banks to hold capital for market risk under Basel standardized rules.

Operational risk (Basel definition above) is managed via **RCSA** (risk & control self-assessment), **KRIs** (key risk indicators like failed trades, system downtime), **loss event databases**, and business continuity/disaster recovery plans. **Cyber risk** and **outsourcing risk** are the fastest-growing components; SBP's Enterprise Technology Governance regulations set expectations.

- **VaR limitations**: no tail info, procyclical, model risk - supplement with stress tests.
- **Basel III**: standardized measurement approach for operational risk capital (replaces AMA).
- **Three lines of defense**: business units, risk/compliance, internal audit.
- **Fraud prevention**: segregation of duties, maker-checker, staff rotation, whistleblowing.

VERY IMPORTANT — Exam Pointer

Very important: define VaR precisely and name two of its limitations.

Section Summary

Market risk is quantified with VaR/stress tests; operational risk is controlled through processes, indicators and continuity planning.

UNIT 3: CAPITAL, REGULATION AND PERFORMANCE

Lecture 7: Basel Accords and Capital Adequacy

Learning Objectives

- Explain the rationale for capital regulation
- Compute CAR
- Describe Basel III buffers

Key Terms & Definitions

CAR (Capital Adequacy Ratio)

(Tier 1 + Tier 2 capital) / risk-weighted assets; minimum 10% in Pakistan (SBP).

CET1

Common Equity Tier 1: the highest-quality capital - paid-up shares plus retained earnings.

Risk-weighted assets (RWA)

Assets weighted by credit risk: cash 0%, mortgages ~35-50%, corporate loans 100%.

Capital is the **shock absorber**: it absorbs unexpected losses so depositors don't. **Basel I** (1988) introduced the 8% CAR with crude risk weights; **Basel II** added operational risk, internal ratings (IRB), and three pillars (minimum capital, supervisory review, market discipline); **Basel III** (post-2008) raised quality and quantity: CET1 $\geq 4.5\%$, Tier 1 $\geq 6\%$, total $\geq 8\%$, plus buffers.

The **buffers**: capital conservation buffer (2.5% CET1 - restricts dividends if breached), countercyclical buffer (0-2.5%, built in booms), and **D-SIB surcharge** for systemically important banks. Breaching buffers triggers automatic distribution restrictions - a powerful incentive to stay capitalized.

SBP implements Basel III with a **10% minimum CAR** plus buffers (effectively ~12.5%+ for large banks). Pakistani banks are generally well-capitalized; capital planning must balance growth (RWA expansion), dividends, and buffer maintenance. **Leverage ratio** (Tier 1 / exposures $\geq 3\%$) backstops the risk-weight system.

- **CAR = eligible capital / RWA $\geq 10\%$ (SBP)**; CET1 $\geq 6\%$ incl. conservation buffer.
- **Pillar 1**: minimum capital; **Pillar 2**: supervisory review (ICAAP); **Pillar 3**: disclosure.
- **RWA** depends on asset risk: government securities ~0%, retail ~75%, corporate 100%.
- **Dividend restrictions** automatically apply when buffers are breached.

Example

A bank with Rs 120bn capital and Rs 1000bn RWA has CAR 12% - compliant with SBP's 10% minimum plus 2.5% conservation buffer effectively.

VERY IMPORTANT — Exam Pointer

Very important: write the CAR formula and list the three Basel III pillars plus the buffer structure.

Section Summary

Basel III forces banks to fund risk with real loss-absorbing capital; buffers make capital countercyclical.

Lecture 8: Measuring Bank Performance

Learning Objectives

- Compute ROE/ROA and decompose them
- Explain DuPont analysis for banks
- Use CAMELS ratings

Key Terms & Definitions

ROE / ROA

Return on equity / return on assets - headline profitability ratios.

CAMELS

Supervisory rating: Capital, Asset quality, Management, Earnings, Liquidity, Sensitivity to market risk.

Efficiency ratio

Operating expenses / operating income; lower is better.

ROA (net income / assets) measures asset productivity (~1-1.5% is good for banks); **ROE** (net income / equity, 12-18% typical) measures shareholder return. The link: **ROE = ROA x leverage (assets/equity)** - banks earn modest ROA on huge leveraged balance sheets.

DuPont decomposition for banks: $ROE = (\text{net income}/\text{operating income}) \times (\text{operating income}/\text{assets}) \times (\text{assets}/\text{equity})$ - separating tax/burden effects, asset utilization (NIM + fees), and leverage. Rising ROE from leverage alone is risk, not skill.

Supervisors use **CAMELS**: Capital adequacy, Asset quality (NPL ratios, provisioning), Management quality, Earnings (sustainability, diversification), Liquidity, Sensitivity to market risk. Rating 1 (strong) to 5 (critical); weak CAMELS triggers enforcement actions.

- **ROE = ROA x equity multiplier** - always decompose before praising ROE.
- **NPL ratio** = infected loans / gross advances; **coverage ratio** = provisions / NPLs.
- **Efficiency ratio < 50%** indicates good cost control.
- **Sustainable earnings**: recurring fee income beats one-off capital gains.

VERY IMPORTANT — Exam Pointer

Exam pointer: decompose a given ROE into ROA and leverage and comment on whether it reflects efficiency or risk.

Section Summary

Bank performance analysis separates genuine efficiency (NIM, fees, costs) from leverage-driven ROE.

UNIT 4: ISLAMIC BANKING AND SPECIALIZED INSTITUTIONS

Lecture 9: Islamic Banking in Pakistan

Learning Objectives

- Explain the prohibition of riba
- Describe key Islamic contracts
- Outline SBP's Shariah framework

Key Terms & Definitions

Riba

Interest/usury - prohibited; money cannot earn a guaranteed return without risk-sharing.

Murabaha

Cost-plus sale: bank buys an asset and sells to the customer at a disclosed markup, deferred payment.

Ijarah / Musharaka / Mudaraba

Leasing / partnership / trustee partnership - core Islamic modes.

Islamic banking rests on **Shariah principles**: prohibition of **riba** (interest), **gharar** (excessive uncertainty), and haram sectors; profit must come from **trade or risk-sharing**, not money renting. Pakistan operates a **dual system**: full-fledged Islamic banks (Meezan etc.) plus Islamic windows/branches of conventional banks, all under SBP's Shariah governance framework.

Core contracts: **Murabaha** (bank purchases asset, sells at marked-up deferred price - the workhorse for trade finance), **Ijarah** (lease with ownership transfer via diminishing musharaka for home/auto finance), **Salam/Istisna** (advance purchase / manufacturing finance for agriculture/industry), **Musharaka/Mudaraba** (partnership modes for equity-like finance), **Wakala** (agency for deposits/investment accounts).

Sukuk are Shariah-compliant securities representing ownership in underlying assets (Pakistan issues GOP Ijarah sukuk). Governance: each Islamic bank has a **Shariah board**, SBP has a central Shariah board, and **Shariah non-compliance risk** (income purification/charity) is a distinct risk type auditors test.

- **Riba-free** does not mean risk-free: credit and market risks remain.
- **Murabaha** = deferred-payment sale (trade), not a loan with interest.
- **SBP essentials**: Shariah boards, profit-distribution rules, segregated funds.
- **Takaful** = Islamic insurance (contribution-based mutual guarantee).

Example

Home finance via **diminishing musharaka**: bank and customer co-own the house; customer's monthly payment buys the bank's share plus rent on the remaining share.

VERY IMPORTANT — Exam Pointer

Very important: explain murabaha mechanics and why scholars distinguish it from interest-based lending.

Section Summary

Islamic banking replaces interest with trade and partnership contracts under layered Shariah governance.

Lecture 10: Insurance Companies and Takaful

Learning Objectives

- Explain insurance economics
- Describe underwriting and actuarial basics
- Outline Pakistan's insurance sector

Key Terms & Definitions

Underwriting

Selecting and pricing risks; the underwriting cycle drives profitability.

Combined ratio

$(\text{Claims} + \text{expenses}) / \text{premiums}$; <100% means underwriting profit.

Reinsurance

Insurance for insurers - transfers catastrophic/large risks.

Insurance pools **independent risks**: by the law of large numbers, aggregate claims become predictable. Insurers earn from **underwriting profit** (premiums minus claims/expenses) and **investment income** (float invested in securities). Life insurance adds a savings/mortality mix; general insurance covers motor, health, property, marine.

Actuarial science prices policies from mortality/morbidity tables and loss distributions; **reserving** (IBNR - incurred but not reported) is the critical liability estimate. **Reinsurance** (treaty/facultative) caps tail risk - essential in Pakistan for flood/earthquake exposure.

Pakistan's sector (regulated by **SECP**) is small relative to GDP (low penetration ~0.7%) but growing, led by life insurers and health takaful. **Takaful** operators run participant funds on wakala/mudaraba models with Shariah boards; retakaful provides Shariah-compliant reinsurance.

- **Combined ratio < 100%** = underwriting profit; investment income adds the rest.
- **Solvency margin**: capital vs liabilities - the regulator's key metric.
- **Bancassurance**: banks distributing insurance - major growth channel in Pakistan.
- **Microinsurance/takaful**: serving low-income segments; regulatory push via SECP.

VERY IMPORTANT — Exam Pointer

Exam pointer: define combined ratio and explain the two profit sources of an insurer.

Section Summary

Insurers manage pooled risk and invest the float; reinsurance and reserving discipline determine survival.

Lecture 11: Mutual Funds, DFIs and Microfinance

Learning Objectives

- Explain mutual fund mechanics and NAV

- Describe DFIs' role
- Outline microfinance in Pakistan

Key Terms & Definitions

NAV (Net Asset Value)

Fund assets minus liabilities per unit; the redemption price.

DFI (Development Finance Institution)

State-backed lenders for long-term industrial/agricultural finance.

Microfinance

Small loans/savings for low-income clients without conventional collateral.

Mutual funds pool investor money into diversified portfolios: open-end funds issue/redeem units at daily **NAV**; categories include money market, income, stock, and Shariah-compliant funds. Pakistan's asset management industry (regulated by SECP) grows via investor education and digital platforms; fund managers earn management fees (~1-2%).

DFIs (e.g. in Pakistan: industrial/agricultural development institutions) fill the **long-term finance gap** banks avoid - project finance, infrastructure - often with government/IFI backing. Their management challenge: development mandate vs commercial viability, and political interference risk.

Microfinance (Khushhali, FINCA, Akhuwat's interest-free model) uses **group lending/social collateral** to serve the unbanked; SBP's microfinance framework licenses Microfinance Banks. Digital branchless banking (Easypaisa, JazzCash) has scaled outreach dramatically - a global case study in financial inclusion.

- **NAV** computed daily; entry/exit loads regulated.
- **DFI risk**: long tenors, lumpy exposures - needs strong project appraisal.
- **Group lending**: joint liability substitutes for collateral.
- **Branchless banking regulations** enabled Pakistan's mobile-money scale-up.

VERY IMPORTANT — Exam Pointer

Very important: explain NAV and how group lending solves the collateral problem.

Section Summary

Funds, DFIs and microfinance extend the financial system beyond commercial banks to investors, industry and the poor.

UNIT 5: STRATEGY, TECHNOLOGY AND THE FUTURE

Lecture 12: Bank Strategy and Competition

Learning Objectives

- Analyze competitive forces in banking

- Explain digital disruption
- Describe M&A rationale

Key Terms & Definitions

Five forces (banking)

Rivalry, new entrants (fintech), substitutes, buyer/supplier power - applied to banks.

Fintech

Technology firms unbundling banking services: payments, lending, wealth.

Economies of scale

Falling average cost with size - drives bank consolidation.

Banking competition in Pakistan: large banks compete on **CASA franchise and digital channels**; mid-sized banks on niche corporate/SME relationships; Islamic banks on Shariah differentiation. **Porter's five forces**: intense rivalry, fintech entrants, customer bargaining power rising via comparison apps, low supplier power, substitutes (capital markets for large corporates).

Digital transformation is the strategic imperative: mobile apps, digital onboarding (eKYC), instant payments (**Raast** - Pakistan's instant payment system), and API banking. Branch networks shrink to advisory hubs; **cost-to-income** improvement funds tech investment.

Mergers seek scale economies, CASA base acquisition, and geographic fill-in; SBP encourages consolidation of weak banks. **Neobanks/digital banks**: SBP's digital bank licensing framework admits branchless full banks - branchless incumbents (Easypaisa/JazzCash banks) are the template.

- **Raast**: SBP's instant payment rail - free P2P transfers disrupting fee income.
- **Digital banks**: SBP framework; branchless, tech-first, financial-inclusion mandate.
- **M&A drivers**: scale, CASA deposits, NPL cleanup via stronger acquirer.
- **Platform strategy**: banking-as-a-service APIs embed finance in commerce.

VERY IMPORTANT — Exam Pointer

Exam pointer: name three strategic responses of Pakistani banks to fintech competition.

Section Summary

Strategy in banking is now digital-first: scale, cheap deposits and technology decide winners.

Lecture 13: Risk Governance, Ethics and Emerging Issues

Learning Objectives

- Describe the risk governance architecture
- Explain conduct and ethics requirements
- Discuss ESG and climate risk

Key Terms & Definitions

Risk appetite

Board-approved level of risk the bank will take to achieve objectives.

Conduct risk

Risk of unfair customer treatment - mis-selling, hidden fees.

Climate risk

Physical and transition risks of climate change to loan portfolios.

Risk governance: the board approves **risk appetite** and strategy; the **risk committee** oversees; the **CRO** (Chief Risk Officer) runs an independent risk function; the **three lines of defense** (business, risk/compliance, audit) separate risk-taking from control. SBP's corporate governance regulations mandate board composition, fit-and-proper tests, and related-party limits.

Ethics and conduct: mis-selling (bancassurance without consent), hidden charges, and aggressive recovery damage trust and invite the Banking Mohtasib/regulator. **AML/CFT** (anti-money-laundering) is a board-level obligation: KYC, transaction monitoring, STR reporting to FMU - failures bring heavy SBP penalties.

Emerging: ESG/climate risk - SBP's green banking guidelines push environmental risk assessment in lending (flood-exposed agriculture, carbon-intensive industry); **cyber resilience** testing; **AI** in credit scoring (with fairness/PDPA data-protection concerns); **CBDC** exploration (SBP studying a digital rupee).

- **Risk appetite statement:** quantitative limits per risk type, board-owned.
- **AML/CFT:** KYC + monitoring + STRs; personal liability for directors on failures.
- **Green banking:** SBP guidelines on environmental risk management and green finance.
- **Consumer protection:** SBP conduct regulations; Banking Mohtasib redress.

Example

A bank financing a coal plant must now assess transition risk (carbon regulation stranding the asset) under evolving SBP climate guidance - a decade ago this was not on the credit checklist.

VERY IMPORTANT — Exam Pointer

Very important: describe the three lines of defense and give one example each of credit, conduct and climate risk.

Section Summary

Modern FI management integrates risk governance, ethical conduct and emerging ESG/climate obligations.

Glossary of Key Terms

Intermediation — Channeling saver funds to borrowers with maturity/risk transformation.

NIM — Net interest margin: core spread profitability metric.

CAR — Capital adequacy ratio: capital / risk-weighted assets.

LCR / NSFR — Basel III short-term and structural liquidity ratios.

VaR — Value at Risk: quantile-based market risk measure.

Murabaha — Shariah-compliant cost-plus deferred sale contract.

NAV — Net asset value per mutual fund unit.

CAMELS — Supervisory rating framework for banks.