GOVERNMENT OF PAKISTAN

Securities and Exchange Commission of Pakistan

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Islamabad, the 20th May, 2021

NOTIFICATION

S.R.O.582(I)/2021.- The following draft amendments to the Non-Banking Finance Companies and Notified Entities Regulations, 2008, proposed to be made by the Securities and Exchange Commission of Pakistan, in exercise of the powers conferred by sub-section (2) of section 282B of the Companies Ordinance, 1984 (XLVII) of 1984, are hereby published for information of all persons likely to be affected thereby and notice is hereby given that comments, if any, received within fourteen days of the date of this notification will be taken into consideration, namely:-

DRAFT AMENDMENTS

In the aforesaid Regulations, in regulation 28, -

(i) in clause (a), after first proviso, for the semi-colon at the end, a colon shall be substituted and thereafter the following new proviso shall be added, namely: -

"Provided further that a Leasing Company, while calculating its investment in leasing, may include vehicle financing as part of leasing."

(ii) in clause (e), -

(a) in sub-clause (viii) the word "and" appearing at the end shall be omitted,

(b) in sub-clause (ix), after the expression "takaful companies;", the word "and" shall be inserted and thereafter a new sub-clause (x) shall be added, namely:-

"(x) implement such Minimum Housing Finance Underwriting Standards for sound housing finance underwriting and risk management practices as provided in Schedule XIV:

(iii) after Schedule XIII, a new Schedule XIV shall be inserted**,** namely**: -**

Schedule XIV

Minimum Housing Finance Underwriting Standards

Standard 1: Role of the NBFC's Board

The board of directors shall establish and oversee a housing finance underwriting policy aligned with the NBFC's risk governance framework, its risk tolerances and limits, and its overall risk appetite and strategy. The policy shall articulate the NBFC's business strategy and approach to housing finance underwriting, and shall be reviewed by the board annually.

The board shall seek periodical reporting from the NBFC's oversight functions to properly monitor and evaluate effectiveness of lending policies and procedures, risks, and to ensure that individual housing finance transactions comply with the underwriting policy and the risk tolerances. At a minimum, the board should expect semi-annual reports on the NBFC's housing finance loan portfolio including reporting on concentrations and aggregate exceptions to policy.

Standard 2: Housing finance Underwriting Policy

A NBFC's housing finance underwriting policy shall ensure that its mortgage portfolio is aligned with its risk appetite and strategy, and that its products meet the needs of its borrowers without introducing undue risk to the NBFC or over-indebtedness to its borrowers by:

- granting housing finance on the evidence of safety and soundness;
- maintaining complete documentation;
- maintaining quality data; and
- ensuring adequate oversight and regular reporting of housing finance underwriting risks.

The housing finance underwriting policy shall establish limits to the level of risk the NBFC is willing to accept in its housing finance portfolio. The policy shall take into account the NBFC's risk appetite, strategy, oversight capabilities, and the product needs of its borrowers. The policy shall be aimed at minimizing defaults and losses to the NBFC and reducing likelihood of borrower over-indebtedness, through sound underwriting practices during the underwriting process.

A housing finance underwriting policy shall document:

- housing finance product offerings;
- acceptable underwriting and acquisition standards, criteria and limits for all housing finance products (such as loan-to-value (LTV) ratios, amortization, credit scores and debt service ratios);
- risk management practices and processes;
- clearly defined roles and responsibilities for those administrating the policy;
- any loan above a policy limit as an exception to policy with clear direction on how the exception to policy is approved, monitored and reported;
- acceptable portfolio concentration limits;
- frequency of loan and collateral reviews; and
- frequency of reports to oversight functions including the board.

As part of implementation, the NBFC shall ensure that effective control and reporting systems are developed and maintained. Identification, measurement, monitoring and reporting of risks in the housing finance loan portfolio occur on an ongoing basis.

Standard 3: Prudent Underwriting Practices

In granting a housing finance, the NBFC shall assess the borrower's income, history of repayment, and the affordability of the loan to ensure there is no undue debt burden to the borrower and also to minimize risk of default to the NBFC.

A housing finance is considered safe if the risk of loss is minimal or immaterial in the event of a payment default. The soundness of a housing finance loan is determined through a thorough evaluation of the borrower's ability to repay the loan. Both safety and soundness are equally important to the underwriting process.

I. **Income Verification of the Borrower**

   A NBFC shall duly verify the identity of the borrower through biometric verification and shall meet KYC requirements. It shall verify the borrower's income including substantiation of the borrower's employment status and income history. The borrower's underlying income shall be verified through an employment letter or another reliable and documented source, and reliable and documented income history. This includes:

   - verification through independent means from a source that is difficult to falsify;
   - documentation that does not contradict other information provided during the underwriting process; and
   - documentation that matches the amount of income used by the NBFC in its assessment of the borrower's debt service capacity.

   Inconsistent incomes shall be appropriately valued and, if necessary, suitably discounted. In case of borrowers who are self-employed or who have irregular sources of income, additional due diligence through third-party verification of historical income should be carried out. For rental income, documentation shall be collected to substantiate income, such as a lease/rent agreement, rent receipts or tax assessment.

II. **Borrower's History of Repayment**

   For assessment of a borrower's reliability to repay, his / her repayment history and stage in financial lifecycle should be considered.

   i) An NBFC obtains a borrower's credit information bureau report (ECIB) as one indicator of the borrower's reliability of repayment; the ECIB should not be the sole assessment tool used to determine reliability as it indicates past, not future behavior, or the borrower's current financial condition.
   ii) A borrower's financial lifecycle indicates the borrower's current and future stage of financial life. By considering the stage of the borrower's financial lifecycle, an NBFC shall assess whether the housing finance fits the current and future financial conditions of the borrower, and the probability of

repayment; doing so would assist the lender NBFC in assessing an appropriate amortization period when determining the conditions of the loan.

III. Borrower's Capacity to Repay

An NBFC shall determine the borrower's capacity to repay in order to minimize defaults and losses to the NBFC and to minimize the likelihood of borrower over-indebtedness. The NBFC and the borrower should have a clear understanding that the housing finance meets the needs and financial circumstances of the borrower. Where a loan is offered to a borrower on an exception to policy basis, the borrower shall be made aware of that.

In determining a borrower's capacity, a NBFC shall:

i) determine the borrower's debt service ratios.
   - the debt service calculations should consider any existing and ongoing financial commitments (shelter costs, debt repayments, marital and family contractual obligations). The calculations should not rely on long term access to discounted introductory rates; and
   - it must be ensured that appropriate buffers and adjustments are in place to account for potential changes in interest rates, increases in the borrower's living expenses and/or decreases in the borrower's income available to service the debt. Interest rate buffers should be regularly reviewed to ensure the current buffer is appropriate.

ii) calculate the LTV ratio with an appropriate level of down payment sourced from the borrower's own resources and identifies any other resources available as a secondary source of recovery;

iii) undertake appropriate due diligence on the guarantor or co-signor, where there is a guarantor or co-signor supporting the housing finance;

iv) determine an amortization relative to LTV ratio such that the principal portion of the monthly payments is reasonably reducing the NBFC's exposure to the underlying collateral security; and

v) document any amortization beyond the maximum tenure as an exception to policy that is approved, monitored, and reported in accordance with the requirements within the NBFC's housing finance underwriting policy.

Standard 4: Collateral Management

The NBFC shall ensure authentication of the property documents and shall conduct the verification of the property. It shall obtain legal opinion on title documents and ownership of the property. In case of housing finance for construction, opinion from construction expert on billing on quantities (BOQ) should be obtained.

In assessing the value of a property, a NBFC shall take a risk-based approach using various tools and processes, to protect against unexpected loss, and shall undertake ongoing monitoring of the collateral.

Sound collateral management and appraisal practices including a combination of valuation tools and appraisal processes shall include:

i) third party appraisal by a professional valuer that is independent from the housing finance originator, and the underwriting process (for housing units valuing upto Rs 3 million under the low cost housing scheme, in-house valuation by sufficiently trained staff may suffice);
ii) valuation tools that monitor the ongoing market value of the property;
iii) property tax assessments; and
iv) on-site inspection by a qualified employee or appraiser that determines existence, occupancy, and condition of the property.

Collateral should be protected against unexpected loss through provisions within the housing finance that includes fire and/or earthquake insurance, where required, against risk of collateral damage repairs and replacement.

Processes should be established to monitor the ongoing effectiveness of any tool used to assess the market value of the property. Controls should be in place to ensure that the tools are being used appropriately by loan officers and that risk factors that can lead to significant price corrections are continually monitored.

Finance securities documents should be complete in order to substantiate a borrower's commitment to the housing finance and to register a claim against the collateral property. A NBFC shall establish policies and procedures to ensure loan securities documents are kept safe and enforceable.

Standard 5: Documentation

The housing finance underwriting policy of a NBFC, together with complete documentation that supports a credit-granting decision, should enable an independent third party conducting a credit assessment to replicate all aspects of the underwriting criteria to arrive at the same credit decision.

The NBFC shall maintain prudent loan documentation to provide a clear record of credit-granting decision, support compliance with a NBFC's housing finance underwriting policies, and permit independent audit and/or review by a NBFC's risk oversight functions.

Complete documentation of a housing finance approval shall, inter alia, include:

(a) a description of the purpose of the loan;
(b) verification of the source of down payment;
(c) verification of income and employment status;
(d) debt service ratio calculations, including verification documents;
(e) LTV ratio and confirmation that the LTV is confirmed as the aggregate lending exposure to one collateral security;

(f) property valuation and appraisal;
(g) ECIB reports and any other credit enquiries;
(h) purchase and sale agreements, and other collateral supporting documents;
(i) an explanation of any mitigating criteria for higher credit risk factors;
(j) a clearly stated rationale for the decision (including exceptions);
(k) a record of approval for an exception; and
(l) where required, a record from the housing finance insurer validating approval to insure the housing finance.

Provided that the underwriting standards provided in sub-clause (x) shall not apply in case of the Non-Bank Micro Finance Companies."

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(Bilal Rasul)
Secretary to the Commission