GOVERNMENT OF PAKISTAN
SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN
-.-.-.-

Islamabad, the 14th December, 2021

NOTIFICATION

S.R.O. 1605 (I)/2021.- In exercise of the powers conferred by sub-section (2) of section 282B of the Companies Ordinance, 1984 (XLVII of 1984), the Securities and Exchange Commission of Pakistan hereby makes the following amendments in the Non-Banking Finance Companies and Notified Entities Regulations, 2008, the same having been previously published in the official Gazette vide S.R.O 370 (I)/2021dated March 29, 2021 and vide S.R.O. 582(I)/2021 dated May 20, 2021, namely: -

AMENDMENTS

In the aforesaid Regulations,

(1) in regulation 28, 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 XIIIA;";

(2) after regulation 29, the following new Part and regulations shall be added, namely: -

"**PART III A**
Additional Requirements for NBMFC's

30. Application of this Part. - The provisions of this part shall apply to Non-Bank Micro Finance Companies and are in addition to other applicable requirements under these regulations.

31. Risk Management – Non-Bank Micro Finance Companies having a gross loan portfolio of Rs. 500 million or more, shall follow the following guidelines on risk management that provide minimum benchmark of best practices. Non-Bank Micro Finance Companies shall, -

(a) devise and implement a comprehensive risk management framework duly approved by its board to identify, assess, and prioritize risks, develop strategies to measure risk, design operational policies and procedures to mitigate risk, implement and assign responsibilities, test effectiveness, evaluate results and revise policies and procedures, where required;

(b) ensure that the risk management framework comprehensively covers all risks, including credit, operational and market risks, to which the company is exposed and encompasses the scope of risks to be managed, determine risk tolerance limits and have flexibility to accommodate any change in business activities;

(c) design risk management tools and approaches that respond to their specific clients, lending methodologies, operating environments, and financial and social performance objectives; and

(d) develop contingency plans duly approved by its board to effectively deal with stress situations. Contingency plans shall be regularly reviewed to ensure those are relevant and effective.

32. Funding and Liquidity Management - (1) A Non-Bank Micro Finance Company shall formulate and implement a comprehensive funding and liquidity management policy duly approved by its board to ensure that it has funding from well-diversified sources for its sustainability and meeting social and performance objectives.

(2) A Non-Bank Micro Finance Company shall ensure that, -

(a) its funding sources are well diversified including equity, sponsors'/donors' funding, subordinated loans, commercial finance, debt instruments issued through capital markets and other sources;

(b) its funding mix has a good balance of short term, medium term and long-term funds in line with the overall funding policy;

(c) its borrowings including subordinated debt from a single source as a percentage of total assets is not more than the following limits:

Debt to Equity Ratio	**Borrowing from a single source as % of Total Assets**
Less than 2 times	75%
2 to 3 times	70%
Higher than 3 and up to 4 times	65%
More than 4 times	60%

(d) it defines and maintains adequate minimum liquidity cushion for business as usual, as well as for stress situations, and the liquidity plans include simple stress scenarios taking into account contagion effects that may manifest in a rapid deterioration of the loan portfolio due to localized problems;

(e) where exposed to foreign exchange risk, it undertakes separate analysis for each currency individually and, where appropriate, sets and regularly reviews limits on the size of its cash flow mismatches for foreign currencies in the aggregate and for each significant individual currency;

(f) it carries out matching and forecasting of assets and liabilities for a foreseeable future to ensure that liabilities remain less then assets at all time; and

(g) a mechanism is in place for forward looking fund management for a foreseeable future to fill up any projected shortfall by arranging additional funds while complying with overall fund management policy and regulatory requirements:

Provided that the Non-Bank Micro Finance Companies, which are non-compliant with clause (c), shall ensure compliance within a year from the date these requirements come into effect.

(3) A Non-Bank Micro Finance Company shall create a special reserve fund wherein at least 5% of its after-tax profits shall be credited and the special reserve fund shall be separately disclosed in the statement of financial position as part of the equity.

33. Credit Underwriting Standards - (1) A Non-Bank Micro Finance Company's board shall establish and oversee a loan underwriting policy aligned with its risk governance framework, its risk tolerances and limits, and its overall risk appetite and strategy, and the policy shall be reviewed by the board periodically. The board shall seek periodical reporting from the company's oversight functions to properly monitor and evaluate effectiveness of lending policies and procedures, risks, and to ensure that individual transactions comply with the underwriting policy and the risk tolerances.

(2) A Non-Bank Micro Finance Company shall have written manuals and policies with regard to the screening, approval, monitoring and collection of loans. The manuals and policies shall be devised taking into account the special characteristics of its lending methodology.

(3) In addition to compliance with regulation 9, a Non-Bank Micro Finance Company shall, -

(a) develop comprehensive Know Your Customer and Customer Due Diligence policies duly approved by the board and shall be communicated down the line to relevant staff. The policy shall define high risk factors which may include the description of customers, products, transaction channels and geographic distribution;

(b) deploy systems, controls and take all reasonable measures to identify existing and prospective customers and to gain a reasonable assurance that the customer is not exploiting microfinance channel for any unlawful activity;

(c) develop and implement Anti Money Laundering /Counter Financing of Terrorism policies and procedures in line with SECP's regulations, directions and guidelines and ensure meticulous compliance of the same;

(d) perform due diligence to evaluate borrowers' willingness and repayment capacity to adequately service their debt obligations, including consideration of credit history and performance on past and existing obligations;

(e) develop income assessment and evaluation procedures of borrowers that are relevant to the nature of borrowers' business to ensure that the income is reasonably estimated and the total installment of the credit extended by it commensurate with monthly income and repayment capacity of the borrower;

(f) appropriately value the inconsistent incomes and, if necessary, suitably discount it;

(g) assign due weightage to the Credit Information Bureau report in addition to their approved criteria while undertaking credit appraisal of the prospective borrower. The CIB report 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;

(h) establish minimum requirements of information and analysis upon which lending decisions are made and shall ensure that the documents, data or information collected under customer due diligence process is kept up-to-date to ensure traceability of the borrowers;

(i) in the case of secured lending, set forth procedures for collateral evaluation and lien perfection documents;

(j) develop an internal mechanism to monitor the overall exposure of their borrowers to manage credit risk and minimize the risk of borrowers' over indebtedness. At the time of granting loan, it shall obtain a written declaration on the prescribed format from the borrower disclosing details of various facilities already obtained from other microfinance banks, microfinance institutions, banks and other financial institutions and shall ensure that total exposure of their clients does not exceed their total repayment capacity as determined under the criteria laid-out in the credit policy.

(4) A Non-Bank Micro Finance Company shall have a clear policy for large loan sizes, as may be determined by its Board and shall deploy a more stringent criteria, duly approved by its board, to establish an appropriate valuation methodology and require sufficient documentation to support the collateral valuation, where applicable. A post-screening process shall be in place and shall be used in conjunction with pre-screened process to identify potentially bad loans for effectively managing those.

34. Code of Corporate Governance. - A Non-Bank Micro Finance Company shall comply with the requirements of the Code of Corporate Governance, as specified in Schedule XIIA.";

(3) after Schedule –XII, the following new Schedule shall be added, namely: -

"Schedule- XIIA

Code of Corporate Governance for Non-Bank Micro Finance Companies

See Regulation 34

[These requirements are in addition to any other applicable requirements regarding directors, CEO, composition of board etc.]

Independent and Non-Executive Directors

1. The independent directors of a Non-bank Microfinance Company (NBMFC) shall not be less than two members or one third of the total members of the board, whichever is higher.

[To be complied with by NBMFCs latest by the date of next election of directors becoming due after date of notification of the amendments to the Regulations]

Conflict of Interest

2. A director and chief executive of an NBMFC shall not be a director, consultant, advisor or an employee of any other NBMFC or institution engaged in a similar business in Pakistan.

3. The chief executive and board of an NBMFC shall disclose to stakeholders, how many family members are sitting on the board, key positions held and any other such potential conflicting interests in the organization.

4. The board of an NBMFC shall develop policy to prevent conflict of interest in their capacity as members of the board as well as for senior management and other employees as approved by the board. The conflict-of-interest policy should be reviewed at least annually. An NBMFC shall put in place a formal code of conduct that promotes ethical culture in the company.

Women Director

5. While NBMFCs are encouraged to have more female representation on their board, the board shall have at least one female director.

Orientation and Training

6. All Directors should receive orientation on the operations of the NBMFC and training on their fiduciary roles, responsibilities and liabilities as board members.
7. Board development sessions should be conducted at least once a year with a certificate awarded to the participants.

Board Meetings

8. Board shall hold regular meetings; at least once in every quarter of a year and more frequently, where required.

9. In order to strengthen and formalize decision-making process, significant issues shall be placed for the information, consideration and decision of the board of directors and/or its committees. List of significant issues is attached as **Appendix-A**.

Board Level Committees

10. NBMFCs shall establish Audit Committee, comprising at least three non-executive directors. The chairperson of the committee shall be an independent director, who shall not be the chairperson of the board. Preferably at least two members having relevant financial/banking expertise and experience must be part of the audit committee. The audit committee of the NBMFC shall meet at least once every quarter of the financial year. A meeting of the audit committee shall also be held, if requested by the external auditors, head of internal audit or by chairman of the audit committee. The board of every company shall determine the terms of reference of the audit committee.
11. There shall be a Human Resource and Remuneration (HR&R) Committee of at least three members comprising a majority of non-executive directors. The CEO may be included as a member of the committee but not as the chairperson of committee. The CEO, if member of HR&R Committee, shall not participate in the proceedings of the committee on matters that directly relate to his/her performance and compensation. The committee shall meet at least once in a financial year and may meet more often if requested by a member of the board, or committee itself or the chief executive officer and the head of human resource or any other person appointed by the board may act as the secretary of the committee. The terms of reference of committee shall be determined by the board.
12. There shall also be Risk Management Committee of the board constituted to supervise overall risk management functions of the institution. It will decide the policy and strategy for integrated risk management containing various risk exposures of the institutions. The Committee would review policies and guidelines for identification, measurement, monitoring and control for all major risk categories. The Board shall determine terms of reference of the Risk Management Committee.

Internal Audit

13. There shall be an internal audit function in every NBMFC. The NBMFC shall ensure that head of internal audit is suitably qualified, experienced and conversant with the company's policies and procedures. The head of internal audit shall functionally report to the audit committee and administratively to the chief executive officer and his performance appraisal shall be done jointly by the chairman of the audit committee and the chief executive officer.

14. No director on the Board, shall be appointed, in any capacity, in the internal audit function of the company. The Board shall ensure that the internal audit team comprises experts of relevant disciplines in order to cover all major heads of accounts maintained by the NBMFC.

15. The internal audit function, wholly or partially, may be outsourced by the NBMFC to a professional services firm or be performed by the internal audit staff of holding company and in lieu of outsourcing, the NBMFC shall appoint or designate a fulltime employee other than chief financial officer, as head of internal audit holding suitable qualification, to act as coordinator between firm providing internal audit services and the board.

16. While outsourcing the function, the NBMFC shall not appoint its existing external auditors or any of its associated company or associated undertaking, as internal auditors.

17. NBMFCs shall ensure that internal audit reports are provided for the review of external auditors. The auditors shall discuss any major findings in relation to the reports with the audit committee, which shall report matters of significance to the board.

External Auditor

18. An NBMFC shall appoint as external auditors, a firm of auditors, which has been given a satisfactory rating under the Quality Control Review program of the Institute of Chartered Accountants of Pakistan and registered with Audit Oversight Board of Pakistan under section 36I of the Securities and Exchange Commission of Pakistan Act, 1997 (XLII of 1997).

19. An NBMFC shall not appoint as external auditors, a firm of auditors, which or a partner of which is non-compliant with the International Federation of Accountants' Guidelines on Code of Ethics, as adopted by the Institute of Chartered Accountants of Pakistan.

20. No NBMFC shall appoint its external auditors to provide services in addition to audit except in accordance with the applicable laws or any other regulatory requirement and shall require the auditors to observe and confirm compliance with the applicable International Federation of Accountants guidelines in this regard.

21. An NBMFC shall ensure that the auditors do not perform management functions or make management decisions, responsibility for which remains with the Board and management of the company.

22. No NBMFC shall appoint a person as an external auditor who is a close relative (spouse, parents, dependents and non-dependent children) of the chief executive officer, the chief financial officer, the head of internal audit, the company secretary or a director of the NBMFC. It shall also be ensured that no person involved in the audit of the NBMFC is a close relative of these office holders of the NBMFC.

23. A NBMFC shall require the external auditors to furnish a management letter to its board and any matter deemed significant by the external auditor shall be communicated in writing to the board prior to the approval of the audited accounts/ financial statements by the board.

24. An NBMFC shall change its external auditors every five years.

Related Party Transactions

25. The details of all related party transactions shall be placed periodically before the Audit Committee of the company and upon recommendations of the audit committee the same shall be placed before the board for review and approval.

Appendix-A to Schedule XIIA

i. Annual business plan, cash flow projections, forecasts and strategic plan;
ii. Budgets including capital, manpower and overhead budgets, along with variance analyses;
iii. Matters recommended and/or reported by the committees of the board;
iv. Update on the conflict of interest policy and issues arisen in relation thereof;
v. Quarterly operating results of the organization as a whole and in terms of its operating divisions or business segments;
vi. Internal audit reports, including cases of fraud, bribery, corruption, or irregularities of a material nature, management letter issued by the external auditors;
vii. Policies or amendment to policies such as Credit Policy, Risk Management, Human Resource Management, Procurement of goods and services, Environment and Social Management etc., rule or regulation, enforcement of an accounting standard having material effect and such other matters as may have a material effect on the NBMFC;
viii. Status and implications of any law suit or proceedings of material nature, filed by or against the NBMFC;
ix. Any show cause, demand or prosecution notice received from revenue or regulatory authorities;
x. Failure to recover material amounts of loans, advances, and deposits made by NBMFC, if such a failure to recover for a single transaction or in aggregate has a material impact on the NBMFC;
xi. Any significant accidents, dangerous occurrences and instances of pollution and environmental problems involving the NBMFC;
xii. Significant public or product liability claims made or likely to be made against the NBMFC, including any adverse judgment or order made on the conduct of the NBMFC or of another organization that may have a material negative bearing on NBMFC.
xiii. Report on governance, risk management and compliance issues. Risks considered shall include reputational risk and shall address risk analysis, risk management and risk communication;
xiv. Review of specific Social Performance impact to analyze fulfillment of social targets and to ensure that social performance issues are identified as components of the NBMFC's strategic and business plans.
xv. The CEO shall immediately bring before the board, as soon as it is foreseen that the organization will not be in a position of meeting its obligations on any loans (including penalties on late payments and other dues, to a creditor,

bank or financial institution or default in payment of any liability) or any other debt instrument. Full details of the failure to meet obligations shall be provided in the NBMFC's quarterly and annual financial statements.

(4) after Schedule –XIII, the following new Schedule shall be added, namely: -

"Schedule- XIIIA
Minimum Housing Finance Underwriting Standards for Housing Finance
See Regulation 28(e)(x)

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 behaviour, 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 this Schedule shall not apply in case of the Non-Bank Micro Finance Companies.".

[File No. SCD/NBFC/NBFCR/2021]

(Bilal Rasul)
Secretary to the Commission