ANNEXURE-I

PRUDENTIAL REGULATIONS FOR NON-BANKING FINANCE COMPANIES UNDERTAKING THE BUSINESS OF LEASING ONLY.

For the purposes of these guidelines, a Non-Banking Finance Company (NBFC) means a NBFC engaged in the business of leasing only.

1. Creation and building up of reserve: A NBFC shall create reserve fund to which shall be credited: –

a) an amount not less than twenty per cent of its after tax profits till such time the reserve fund equals the amount of the paid up capital; and

b) thereafter, a sum not less than five per cent of its after tax profits:

Explanation.- Issuance of bonus shares shall only be made from the reserves available after appropriation created under clause (b) and since such bonus shares will increase the paid up capital, the NBFC shall transfer further amounts to the reserves in order to comply with condition of clause (a);

2. Linkage between a borrower's equity and total borrowing from NBFC: A NBFC shall ensure, while granting any facilities, that total facilities availed by any borrower or lessee from Non-Bank Financial Institutions and Banks does not exceed ten times of the equity of the borrower or lessee and obtain copy of accounts relating to the business of each of its borrower/lessee for analysis and record in the following manner, namely: -

(a) where the exposure exceeds ten million rupees	Accounts duly audited by: (i) a practicing chartered accountant;
(b) where exposure exceeds two million rupees but does not exceed ten million rupees.	Accounts duly signed by the borrower or lessee and counter signed by: (i) the internal auditor of the NBFC; or (ii) a chartered accountant; or (iii) a cost and management accountant in case of a borrower or lessee other than a public company or a private company which is a subsidiary of a public company.
(c) where the exposure exceeds one million rupees but does not exceed two million rupees	Accounts duly signed by the borrower or lessee.
(d) where the exposure does not exceed one million rupees.	Such documentary evidence of the means and investment of the borrower or lessee as may be determined by the management of the NBFC.

Explanation .- Surplus arising on revaluation of assets determined in accordance with International Accounting Standards by a firm of Chartered Accountants approved by the Commission for this purpose may be considered for the purpose of calculating the exposure limit under this regulation. The surplus on revaluation of assets so determined is required to be reflected in the balance sheet of the borrower or lessee.

3. Minimum conditions for grant of facilities: A NBFC shall ensure, while granting any facility exceeding one million rupees, that -

(a) current asset to current liabilities ratio of the borrower/lessee does not fall below 1:1: or any ratio as prescribed from time to time, however, this condition may be relaxed in case of facilities upto two million rupees by recording reasons there of.

Provided that current maturities of long term debt not yet due for payment may be excluded from the current liabilities for the purpose of calculating this ratio;

(b) long term debt equity ratio does not exceed 60:40 or any other ratio as prescribed; and

(c) due weightage is given to credit report relating to the borrower or lessee and his group obtained from Credit Information Bureau of the State Bank of Pakistan. If the credit reports indicate default, the further facilities shall be extended only after recording reasons to do so;

Explanation.- "Group" means a set of business companies or concerns under joint control or associated together or subsidiaries of a holding company.

4. Limit on exposure to a single person and grant of certain facilities: A NBFC shall not :-

(a) make exposure to a single group for more than twenty per cent of the net investment in leasing finance, however, in arriving at exposure per person under this rule, the following shall be excluded, namely :-

(i) ninety per cent of certificates of deposit and certificates of investment of the lessee under lien with the NBFC;

(ii) face value of FIBs lodged by the lessee as collateral; and

(iii) Pak rupee equivalent of the face value of Special US Dollar Bonds converted at official rate, lodged by the lessee as collateral.

(b) allow facilities to any of its directors or to individuals, firms or companies in which it or any of its director is interested as partner, director or guarantor, as the case may be, its chief executive and its major shareholders, including their spouses, parents and children or to firms and companies in which they are interested as partners, directors or major shareholders of that concern without the approval by the directors of that NBFC:

Provided that the director interested in seeking such approval shall not take part in the proceedings of the approval of the facility;

(c) allow unsecured facilities or facilities secured only by guarantees except the facilities provided against bank guarantees, the end use of which will be verified by the NBFC to be productive;

Provided that the bank providing guarantee shall have rating grade not lower than BBB;

(d) grant unsecured facilities to or allow facilities on the guarantees of its chief executive, directors and major shareholders including their spouses, parents, and children or to firms and companies in which they are interested as partners, directors or major shareholders of that concern;

(e) allow facilities for speculative purposes.

5. Limit on NBFC's exposure against liabilities:

(a) Liabilities, excluding contingent liabilities, of a NBFC shall not exceed seven times of its equity during first two years of its operations and ten times of the equity in the subsequent years.

(b) Contingent liabilities of a NBFC shall also not exceed seven times of its equity during the first two years of its operations and ten times of the equity in the subsequent years.

6. Margin against facilities: (1) Following minimum margins shall be maintained against various facilities and all guarantees will be backed by 100% realizable securities:

(a) in case of performance bonds, the condition of 100% cover of realizable securities may be relaxed subject to minimum compulsory realizable security cover equivalent to 20% of the amount of the performance bond;

(b) in case of guarantees issued against mobilisation advance, the condition of 100% cover of realizable securities may be relaxed subject to the following conditions, namely :-

(i) guarantees issued should contain a clause that the mobilisation advance shall be released by the beneficiary through the guarantor NBFC only; and
(ii) at the time of issuing such a guarantee the beneficiary should sign an agreement with the NBFCs that releases out of mobilisation advance would be covered by realizable assets;

(c) in case of bid bonds issued on behalf of domestic consultancy firms bidding for international contracts where the consultancy fees are to be received in foreign exchange, the requirement of 100% cover by realizable securities may be waived off, and this relaxation would also be available to all suppliers of goods and services bidding against international tenders.

(2) No NBFC shall provide unsecured facilities to finance subscription towards floatation of share capital of public limited companies or allow facilities against its own shares or shares of its associated undertaking and subsidiaries thereof or shares of companies not listed on the Stock Exchange and shares of listed companies obtained as collateral shall be subject to the following minimum margins, namely :-

(a) where the current market value does not exceed the preceding twelve months average market value, 20% of the current market value;

(b) where current market value exceeds the preceding twelve months average market value but does not exceed twice the preceding twelve months average market value, 40% of the current market value; and

(c) Where the current market value exceeds twice the preceding twelve months average current market value, 50% of the current market value.

Provided that no NBFC shall hold shares in any company as pledgee or mortgagee, of an amount exceeding thirty percent of its own equity or thirty per cent of the paid-up capital of that company whichever is less.

(3) Certificates of deposit of banks with investment grade will be subject to a margin of 15% and COIs/COMs, TFCs with investment grade rating but not lower than BBB will be subject to a margin of 25% of face value or market value whichever is less.

(4) Facilities against pledge of trading stocks shall be subject to a margin of 25%.

(5) Facilities against hypothecation shall be subject to a margin of 50%.

7. Provisioning for non-performing assets:

Every NBFC shall follow prudential guidelines in the matter of classification of its assets and provisioning there against as specified below:

A. Short Term Facilities:-		
Nature Of Classification	**For Finance Lease, Operating Lease and Term Loans**	**Provisions to be made**
1. Overdue	Where rentals, profit or mark up or principal are overdue (past due) by 180 days from the due date.	No provision is to be made.
2. Substandard	Where rentals, profit or mark up or principal are overdue (past due) by 181 days but less than one year from the due date.	Provision of 20% of the difference resulting from the outstanding balance of net investment in lease finance and principal less the amount of liquid assets realizable without recourse to a Court of Law and forced sale value of leased assets as valued by valuers fulfilling prescribed eligibility criteria, in accordance with the guidelines provided in this regulation.
3. Doubtful	Where rentals, profit or mark up or principal are overdue (past due) more than one year but less than two years from due date.	Provision of 50% of the difference resulting from the outstanding balance of net investment in lease finance and principal less the amount of liquid assets realizable without recourse to a Court of Law and forced sale value of leased assets as valued by valuers fulfilling prescribed eligibility criteria, in accordance with the guidelines provided in this regulation.
4. Loss	Where rentals, profit or mark	Provision of 100% of the difference resulting from the outstanding

	up or principal are overdue (past due) beyond two years from the due date.	balance of net investment in lease finance and principal less the amount of liquid assets realisable without recourse to a Court of Law and forced sale value of leased assets as valued by valuers fulfilling prescribed eligibility criteria, in accordance with the guidelines provided in this regulation.

B- Long Term Facilities:-		
Nature Of Classification	**For Finance Lease, Operating Lease and Term Loans**	**Provisions to be made**
1. Overdue	Where rentals, profit or mark up or principal are overdue (past due) for one year from the due date.	No provision is to be made.
2. Substandard	Where rentals, profit or mark up or principal are overdue (past due) by one year but less than two years from the due date.	Provision of 20% of the difference resulting from the outstanding balance of net investment in lease finance and principal less the amount of liquid assets realizable without recourse to a Court of Law and forced sale value of leased assets as valued by valuers fulfilling prescribed eligibility criteria, in accordance with the guidelines provided in this regulation.
3. Doubtful	Where rentals, profit or mark up or principal are overdue (past due) by more than two years but less than three years.	Provision of 50% of the difference resulting from the outstanding balance of net investment in lease finance and principal less the amount of liquid assets realisable without recourse to a Court of Law and forced sale value of leased assets as valued by valuers fulfilling prescribed eligibility criteria, in accordance with the guidelines provided in this regulation.
4. Loss	Where rentals, profit or mark up or principal are overdue (past due) beyond three years from the due date.	Provision of 100% of the difference resulting from the outstanding balance of net investment in lease finance and principal less the amount of liquid assets realisable without recourse to a Court of Law and forced sale value of leased assets as valued by valuers fulfilling prescribed eligibility criteria, in accordance with the guidelines provided in this regulation.

Notes.-

1. Where profit is overdue (past due) by one hundred and eighty days or more from the due date, unrealised profit shall be put in a Suspense Account and shall not be credited to Income Account.

2. Liquid assets mean realizable amount of bank deposits, certificates of deposit, government securities, shares of listed companies, NIT units, certificates of mutual funds, gold ornaments, inventories pledged to NBFCs with possession with 'perfected lien' duly supported with flawless documentation.

3. Subjective evaluation of performing and non-performing lease portfolio shall be made for risk assessment and where considered necessary the category of classification determined on the basis of time based criteria shall be further downgraded. Such evaluation shall be carried out on the basis of adequacy of security inclusive of its realizable value, cash flow of lessee, his operation in the account, documentation covering advances and credit worthiness of the lessee, etc.

4. The rescheduling or restructuring of non-performing lease facilities shall not change the status classification of lease facilities etc, unless the terms and conditions of

rescheduling/restructuring are fully met for a period of at least one year (excluding grace period, if any) from the date of such rescheduling / restructuring. Accordingly, NBFCs are directed to ensure that status of classification as well as provisioning is not changed in relevant reports merely because of the fact that a lease facility has been restructured or rescheduled. However, while reporting to the CIB, such lease facilities may be shown as "rescheduled/restructured" instead of "default".

5. NBFCs shall continue to classify their lease facilities portfolio and make provision there against in accordance with the time based criteria prescribed above. However, where a NBFC wishes to avail of the benefit of collaterals held against lease facilities, they can consider the realizable value of mortgaged or pledged assets for deduction from the outstanding principal amount of lease rentals against which such assets are mortgaged/pledged, before making any provisions. The realizable value shall be the value that could currently be obtained by selling the mortgaged or pledged assets in a forced/distressed sale conditions. Accordingly, NBFCs shall take into account only forced sale value into consideration while determining the required provisions. Lease rentals against which securities are not available, or which have not been valued according to these guidelines and verified by the external auditors, shall continue to be classified and provided for according to the time-based criteria. NBFCs shall follow the following uniform criteria, for determining the realizable value of mortgaged, pledged or leased assets, namely:-

(i) Only leased assets having registered mortgage, equitable mortgage (where NOC for creating further charge has not been issued by NBFC) and pledged/leased assets shall be considered. Assets having pari passu charge shall be considered on proportionate basis;

(ii) hypothecated assets and assets with second charge and floating charge shall not be considered;

(iii) valuations shall be carried out by an independent professional valuer who should be listed on the panel of valuers maintained by the Leasing Association of Pakistan (LAP) for this purpose. LAP shall lay down the minimum eligibility criteria with the prior approval of the Securities & Exchange Commission of Pakistan for placement of valuers on the panel to be maintained by it. The valuer while assigning any values to the mortgaged, pledged or leased assets, shall take into account all relevant factors affecting the saleability of such assets including any difficulty in obtaining their possession, their location and condition and the prevailing economic conditions in the relevant sector, business or industry. The realizable values of mortgaged, pledged or leased assets so determined by the valuers must have to be a reasonably good estimate of the amount that could currently be obtained by selling such assets in a forced/distressed sale condition. The valuers should also mention in their report the assumptions made, the calculations/formulae/basis used and the method adopted in determination of the realizable values;

(iv) valuation shall be done at least once in three years. If valuation is older than three years, a re-valuation should be done, otherwise the valuation shall be taken as nil;

(v) the categories of mortgaged, pledged or leased assets to be considered for valuation along with discounting factors to be applied would be as under (no other assets shall be taken into consideration) :-

(a) **Liquid assets** : Valuation of Liquid Assets, excluding pledged stocks, which are dealt with at (d) below, shall be determined by the NBFC itself and verified by the external auditors. However, in the case of pledged shares of listed companies values should be taken at market value as per active list of Stock Exchange on the balance sheet date and as per guidelines given in the TR-23 issued by the Institute of Chartered Accountants of Pakistan. Moreover, valuation of shares pledged against lease rentals shall be considered only if these have been routed through Central Depository Company of Pakistan (CDC), otherwise these will not be admissible for deduction as liquid assets while determining required provisions;

(b) **Land and Building**: Valuation of land and buildings would be accepted as determined by the valuers in accordance with the criteria given at point 5(iii) above and no further discounting factor would be applied on forced sale value determined by them; and

(c) **Plant and machinery :** Entries of classified lessees shall be divided into following categories at the balance sheet date and discounting factors shall be applied to forced sale value as specified below :

Category	Discounting factors to be applied to forced sale value
A. In operation	No discussing factors to be applied
B. In operation at the time of valuation but now closed/in liquidation	• 15% of forced sale value on the date of closure. • 1st year after closure - 25% of forced sale value. • 2nd year - 50% of forced sale value.
C. Closed / in liquidation at the time of valuation and no change in situation.	• After valuation - 1st year 25% of forced sale value. • 2nd year - 50% of forced sale value.

(d) **<u>Pledged stocks</u>** : In case of pledged stocks of perishable and non-perishable goods, forced sale value should be provided by valuers, which should not be more than six months old, at each balance sheet date. The goods should be perfectly pledged, the operation of the godowns should be in the control of the NBFC and regular valid insurance and other documents should be available. In case of perishable goods, the valuer should also give the approximate date when these are expected to be of no value.

(vi) the values of mortgaged/pledged/leased assets determined by the valuers shall be subject to verification by the external auditors, who may reject cases of valuation, which in their opinion, do not appear to have been professionally carried out and values determined are unreasonable, or in the case of which valid documentation of mortgage, pledge or lease, supported by legal opinion wherever required, is not available on record.

6. <u>Investments and other assets</u>.- Subjective evaluation of lease portfolio and other assets shall be carried out by the NBFC. Classification of such assets and provision required thereagainst shall be determined keeping in view the risk involved and the requirements of the International Accounting Standards.

7. <u>Timing of creating provisions</u>**.-** NBFCs shall review, at least on a quarterly basis, the collectibility of their lease rentals portfolio and shall properly document the evaluation so made. Shortfall in provisioning, if any, determined as a result of the quarterly assessment shall be provided for immediately in their books of accounts by the NBFCs.

8. <u>Verification by the Auditors.-</u> The external auditors as a part of their annual audits of NBFCs shall verify that all requirements of this rule in classification of assets and determination of provisions required thereagainst have been complied with. The Securities and Exchange Commission of Pakistan shall also check the adequacy of provisioning during on-site inspection.