Diagnostic Assessment Report

Non-Performing Loan Market Assessment in Pakistan

Developing a Secondary NPL Market

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1. PREFACE

The objective of this Non-Performing Loan (NPL) Market Assessment Diagnostic Report is to examine and assess the NPL market in Pakistan, and identify bottlenecks and practical areas that could be addressed in the short and medium term to make the NPL market in Pakistan more investor friendly. The report analyzes the laws and practices governing NPL resolution in Pakistan, reviews the prudential, accounting, and taxation frameworks and practices applicable to managing, valuing and reporting of NPLs, and evaluates global NPL resolution strategies and models that banks in Pakistan can use.

This report has drawn widely from research and literature, and from primary information collection and face to face interviews with stakeholders including the State Bank of Pakistan (SBP), Securities and Exchange Commission of Pakistan (SECP), valuator companies, legal experts in recovery & insolvency laws, banks, and other financial institutions (FIs).

The report analyzes and sizes the NPL market in Pakistan and identifies key financial trends, NPL concentrations, major participants, sectors, and segments. It presents the current state of Pakistan's NPL market, identifying the legal, prudential, taxation, and other regulatory and practical impediments for financial institutions and potential NPL investors to create and operate a viable secondary market for NPLs. The report also assesses the feasibility of potential secondary market transaction models for NPLs within the context of the current laws and regulations in Pakistan.

2. LIST OF ABBREVIATIONS

ABL	Allied Bank Limited
ABS	Asset Backed Securities
AMC	Asset Management Company
AUM	Assets Under Management
BSD	Banking Supervision Department
BOD	Board of Directors
BPRD	Banking Policy and Regulation Department
CAD	Credit Administration Department
CEO	Chief Executive Officer
CIRC	Corporate and Industrial Restructuring Corporation
CPC	Civil Procedure Code
CRC	Corporate Restructuring Companies
CRSIU	Committee for Revival of Sick Industrial Units
DARP	Distressed Assets Recover Program
DFI	Development Financial Institution
DPD	Days Past Due
DPS	Debt Property Swap
EBA	European Banking Authority
ECB	European Central Bank
eCIB	Electronic Credit Information Bureau
FATF	Financial Action Task Force
FBEs	Foreign Bank Exposures
FDD	Foreign Demand Draft
FIA	Federal Investigation Agency Act, 1974

FIFO	First in first out
FSV	Forced Sale Value
FMC	Fund Management Companies
IFC	International Finance Corporation
IFRS	International Financial Reporting Standard
IFAS	International Financial Accounting Standards
IVSC	International Valuation Standards Council
ITO	Income Tax Ordinance
HBL	Habib Bank Limited
IA	Internal Auditor
JSTs	Joint Supervisory Teams
KKR	Kohlberg Kravis Roberts & Co.
LGD	Loss Given Default
MCB	Muslim Commercial Bank
MENA	Middle East & North Africa
MUFAP	Mutual Funds Association of Pakistan
NAB	National Accountability Bureau
NAV	Net Asset Value
NBP	National Bank of Pakistan
NBFC	Non-Bank Finance Companies
NIT	National Investment Trust
NPL	Non-Performing Loan
NPFs	Non-Performing Finances
OAEM	Other Assets Especially Mentioned
OECD	Organisation for Economic Co-operation and Development
ORBO	Offences in respect of Banks (special courts) Ordinance, 1984

OSED	Offsite Supervision and Enforcement Department
PBA	Pakistan Banks' Association
PCATP	Pakistan Council of Architects and Town Planners
PCRCL	Pakistan Corporate Restructuring Company Limited
PD	Probability of Default
PEC	Pakistan Engineering Council
PPC	Pakistan Penal Code, 1860
RBI	Reserve Bank of India
RICS	Royal Institution of Chartered Surveyors
RM	Relation Management
PRs	Prudential Regulations
SAM/SAMG	Special Asset Management Department/Group
SBP	State Bank of Pakistan
SECP	Security & Exchange Commission of Pakistan
SME	Small & Medium Enterprise
SPV	Special Purpose Vehicle
TERF	Temporary Economic Reforms Facility
TEGOVA	The European Group of Valuers' Associations
UBL	United Bank Limited
UNCITRAL	United Nations Commission on International Trade Law

3. EXECUTIVE SUMMARY

1. **The NPL market in Pakistan compared with regional peers such as India or China is nascent, and the secondary market is nearly non-existent**. In 2020, Pakistan ranked 58th on the resolving insolvency indicator of the World Bank's Ease of Doing Business Index, with a recovery rate of 41 cents/dollar, slightly above the average recovery rate of 38 cents/dollar for the South Asian region. For OECD High Income countries this metric is 70 cents/dollar. The stock of NPLs in Pakistan stood (at 31 Dec 2020) at PKR 828 billion (approximately $5 billion) with 97 percent provision coverage, and the infection ratio was approximately 9 percent (including an average of 17 percent for SME loans). Further, about 10 percent of the total outstanding gross advances as of 31 March 2021 had been restructured or allowed a principal deferment under the State Bank of Pakistan's (SBP) Debt Relief Scheme. Annual trends show a steady rise in commercial banking NPLs since 2017. In 2020, NPLs from the power, cement and agriculture segments were the top three contributors to NPL stock. Loans to the corporate sector comprise roughly 70 percent of NPL stock in Pakistan.

2. **In 2020, the after-tax profits of the banking industry (listed commercial banks) increased to 34 percent compared with 21 percent in 2019.** This was partly on account of general economic relief measures taken by the government and the SBP in response to COVID-19. For the banking sector, these included, a 625 basis points cut in the policy rate, a temporary economic refinance facility (TERF), providing long-term concessionary refinancing at 5 percent for manufacturers and exporters, a Debt Relief Scheme offering principal deferment and restructuring of PKR 911 billion worth of loans (about 10 percent of outstanding gross advances as of 31 March 2021). The net interest income of banks increased by 25 percent, while non-mark-up income jumped by 16 percent mainly due to strong capital gains in Treasuries, marking an annual increase of roughly 11 times. Compared with strong growth in bottom lines in 2020, the growth of loans and advances was lack-luster at only 2 percent.

3. **In Q1 of 2021, NPLs increased by PKR 22 billion to PKR 850 billion.** Based on the financial results for the nine -month period ending 30 September 2021, there has been a better-than-expected recovery of loans, evidenced by some of the banks contributing large gross advances booking 75 percent higher provision reversals in this period when compared with the same period last year.

4. **The NPL reporting framework (comprising SBP circulars and Prudential Regulations (PRs)) lacks provisions necessary to enhance the quality, transparency, and standardization of the NPL data reported by banks**. Enhanced NPL reporting improves banks supervision, increases investor confidence and reduces pricing gaps caused by information asymmetries or uncertainties. Comparisons with the European Banking Authority's (EBA) guidelines on NPLs and reporting templates reveal areas of focus for Pakistan.

   i. **SBP's NPL reporting framework does not require reporting of any operational, qualitative or non-financial information**, such as a bank's NPL governance model, the operating model of its special asset management function, or its NPL strategy. This information is necessary, especially in the case of high NPL banks, for better bank supervision and for external parties to gauge the robustness of a bank's NPL remediation infrastructure.

   ii. **The SBP's NPL regulatory reporting requirements are standardized for all commercial banks in Pakistan and there is no concept of proportionality which is commonly seen in the Europe** (EBA and ECB guidelines enforce enhanced regulatory requirements for banks with infection ratios greater than 5 percent). Proportionality in supervisory standards of NPL reporting is used to set enhanced NPL reporting and disclosure requirements for high-risk banks (for example with NPL stocks above a certain threshold) while keeping the burden of compliance to a minimum.

iii. **In the SBP's NPL reporting framework there are no voluntary NPL reporting requirements like the EBA's NPL transaction or screening templates**. These templates provide a framework for granular and portfolio level reporting of NPLs which can be used for due diligence by potential NPLs investors. The standardization helps transparency and comparability of reported information and enables more transactions in the secondary NPL market. Greater detail in the disclosed information lessens information asymmetries and helps banks selling NPLs to achieve higher prices.

iv. **The SBP's NPL reporting framework requires little information on forborne exposures** (loans whether performing or non-performing which have been restructured, rescheduled or have been provided any other form of concession). An all-encompassing definition, classification, treatment, and reporting measures for forborne exposures does not exist. There are no requirements to report or disclose detailed information on credit quality of forbearance, the quality and effectiveness of forbearance, ageing profile of forbearance, and classification of performing and non-performing forborne exposures. In Europe, these requirements are part of the supervisory standards.

v. **The SBP's NPLs reporting templates do not require information on fair value or market value of NPLs or collaterals.** Reporting and disclosing this information is important to facilitate a secondary market for NPLs.

vi. **Further shortcomings in relation to Basel guidelines on the treatment of problem assets exist**:

  a. No clear guidance on exposure-basis (debtor approach) classification in the case of multiple loans to a borrower or a borrower in a group.
  b. Terms such as 'Concession', 'Unlikeliness to pay', and 'Financial difficulty' are undefined.
  c. Reporting and treatment measures for loans or exposures with multiple restructurings (forbearance measures) are not defined.

5. **There is a need for consistency in the SBP's write off guidelines with those in International Financial Reporting Standard 9 (IFRS 9).** As per SBP requirements and internal risk management policies, banks only consider write offs when all other forms of recovery and resolution have been exhausted. An unsolicited write off does not affect a bank's legal right to recover. The SBP requires banks to comply with time based and other administrative criteria before a write off can be approved. By comparison, the write off requirements under IFRS 9 (applicable from 1 January 2022) are simpler and trigger when an entity has no reasonable expectations of recovering either all or a portion of a financial asset. A comparison of the two guidelines suggests that under the SBP requirements, banks may write off loans that are still subject to enforcement activity. Banks can recover amounts they are legally owed in full, but which have been partially or wholly written off due to no reasonable expectation of recovery. However, under IFRS 9, without clear supervisory guidance, it is difficult for banks to demonstrate a lack of reasonable expectation to recover assets in cases of ongoing enforcement activity, which may create impediments for banks in booking write offs.

6. **In contrast to private commercial banks, writing off loans is extremely difficult for public sector banks.** For public sector banks there is negative public opinion about writing off loans. This has branded written off loans as loans not granted in good faith and which are therefore a waste of public money or a result of corruption.

7. **When compared with similar practices and frameworks in Europe, Pakistan's collateral valuation framework is deficient. These factors affect the quality and accuracy of collateral valuations used or performed by banks and could be presumed to create gaps between market values (realized) and bank values of collateral.** They may also result in sub-optimal recoveries against NPLs and affect investor confidence in the transparency and integrity of the NPL transactions. For banks in Pakistan, guidance related to collateral valuation and the conditions and use of external valuators is provided in the

Prudential Regulations (PRs) issued by the SBP. Further, the criteria for the qualification, performance management, enlistment or de-enlistment, categorization and reporting of external valuators for banks is provided by the Pakistan Banks' Association (PBA). The mandate to govern valuators lies with the Securities and Exchange Commission of Pakistan (SECP) under the Companies Act, 2017, however, for all practical purposes the PBA has continued to discharge these responsibilities to the extent they relate to banks and other SBP regulated entities since the Act was legislated.

i. **The current PBA guidance or PRs on valuation only applies to situations where banks are required to use external valuators**.[1] In situations where banks can perform valuations internally or as per their discretion, there are no minimum standards for the independence, qualification, and experience of banks' internal appraisers (staff) or the methodologies to be used by banks in carrying out such valuations.

ii. **Neither the PRs and the PBA guidance provide much guidance on the selection and use of generally accepted valuation methods or international valuation standards,** such as those published by International Valuation Standards Council (IVSC), and their fitness for asset types or collateral valuation. By comparison, the collateral valuation practices observed in Europe indicate that banks use a variety of market, income, and cost-based approaches. The ECB guidance on NPLs is clear on the supervisory expectations for the use and suitability of valuation methods and other aspects of collateral valuation for banks.

iii. **The PBA guidance for valuators does not mandatorily require valuators to be members or be registered with any international valuation standard setting body**, such as IVSC or the Royal Institution of Chartered Surveyors (RICS), or to acquire such status within any number of years of registration.

8. **There are shortcomings in the existing taxation framework which can create tax disincentives in NPL transactions for investors and banks by increasing the price gap between NPL buyers and sellers.** The increase in the price gap may be caused by the taxation framework which delays and limits provisioning expense benefits or write offs available to NPL buyers and sellers.

   i. The income and profits of a banking company in Pakistan are taxed under the provisions of the 7th Schedule of the Income Tax Ordinance, 2001 (ITO). The primary provision (subject to some exceptions) requires banking profits to be taxed as per the annual financial statements that banks publish and file with the SBP. The rules of allowance or deductibility of provisions are:

      a. Provisions for advances and off-balance sheet credits for consumer and SME portfolios (gross of any reversals) classified as 'Loss' are allowed at a maximum of 5 percent of the total advances for a bank as per PRs subject to an external auditor's certificate.
      b. Provisions for advances for all categories of advances and off-balance sheet credits classified as 'Loss' except for consumer and SME financing, gross of any reversals, are allowed at a maximum of 1 percent of the total advances for a bank subject to an external auditor's certificate.
      c. Provisions exceeding 1 percent or 5 percent for specific portfolios may be carried forward by banks.

   ii. Current tax law does not allow for a deduction of provision until the loan has reached a stage where it is classified as 'loss' which would be at least one year from when it was first classified as an NPL. For example, if additions to the 'loss' categorized NPLs of a bank for a year stand at 3 percent of its gross advances, only one-third of it (by application of the 1 percent limit) may be claimed in that year as a tax allowed expense despite that in accounting books and as per the prudential regulatory framework, the entire 3 percent is fully provided for (with some exceptions). It is common for banks in Pakistan to have these carried-forward pools of disallowed provisions. Despite this common practice, the tax or the accounting framework does not prevent a sale of NPLs below book value. In

[1] State Bank of Pakistan, (2015) Prudential Regulations for Corporate/Commercial Banking (Risk Management, Corporate Governance and Operations) https://www.sbp.org.pk/publications/prudential/PRs-Jan-2015.pdf

this case, if the tax authorities interpret the sale of NPLs as a full and final settlement against a particular loan, that may qualify as a loss realization event and result in an accelerated allowance of actual gains or losses which would otherwise have remained part of the carried forward pool.

iii. The SBP has issued specific PRs for Corporate and Commercial Banking, Agriculture Finance, Housing Financing, Infrastructure Finance, Consumer Finance, Microfinance and SME Finance, however, the ITO only provides specific deductibility criteria for SME Finance and Consumer Finance, leaving all other classes of advances to be treated in the blanket of 1 percent deductibility limit or to be adjusted to fit the definition of consumer or SME.

iv. Reversal of provisions, to the extent they relate to loans which are 'loss' categorized, are treated as income in the fiscal year in which the reversal occurs on the basis that these were tax deductible. Practically, it is common for tax authorities in Pakistan to pick up provision reversal transactions for previously disallowed provisions, designate them as income and re-determine a bank's tax liability, causing double taxation. These are often successfully challenged by banks in Income Tax Tribunals but not without considerable time and effort.

v. Under section 29 of the ITO, advances written off by a financial institution are allowed as a deduction with the condition that 'there are reasonable grounds for believing that the debt is irrecoverable'. Tax authorities demand extensive evidence and documents to allow write offs (even direct write offs), disregarding the multiple regulatory, policy and third-party checks that banks must conduct before booking a loan write off. Tax law should be updated to rely on the regulatory and third-party checks and introduce loan write off provisions which are less cumbersome for banks.

vi. The ITO (including the 7th Schedule) does not specifically cover the tax implications of an NPL portfolio sale, transfer, securitization, fair valuation, and deductibility or otherwise of gains or losses arising due to such transaction. When NPL portfolios are sold or transferred to Special Purpose Vehicles (SPVs), these transactions might not meet the criteria of a true sale or an outright sale and can be disregarded by tax authorities as tax liabilities. The ITO empowers a commissioner to recharacterize a transaction or an element of a transaction that is considered part of a tax avoidance scheme.

9. **In Pakistan, NPL resolution including the use of various NPL resolution strategies (except for sale or securitization) is usually via internal bank-led model.** All commercial banks have in-house special asset management or remedial asset management units which are mandated to resolve NPLs. Large scale professional debt servicing companies for corporate loan portfolios do not exist in Pakistan. In the secondary market, Pakistan Corporate Restructuring Company Limited (PCRCL) was established in 2019. PCRCL is licensed by the SECP and is empowered to acquire, restructure, reschedule and dispose of NPLs and enter into agency and trust arrangements. Its shareholders include 10 commercial banks. The two main challenges it faces include the requirement for additional capital, and the enactment of legal amendments in its empowering statute, which are pending before Parliament and are expected to be promulgated soon. The SECP has indicated it is being approached by different groups of investors with interests in setting up additional CRCs.

10. **The primary strategies deployed in Pakistan for the resolution of NPLs are recovery through court proceedings and debt restructuring.** Key legal developments for the secondary NPL market have been enacting the CRC Act and Corporate Rehabilitation Act, 2018, to facilitate corporate restructuring and rehabilitation, and establishing PCRCL, the first corporate restructuring company in Pakistan.

11. **There have been few securitization transactions in Pakistan even though the legal framework for securitization (including the Companies (Asset Backed Securitization) Rules, 1999 and the circulars issued by the SBP) has been in place for almost two decades.** Developing a secondary market through securitization has not received traction recently. The legal framework for securitization enables a secondary market, however it is impeded by, underlying issues relating to the quality of NPLs, NPL recovery, tax allowance of provisions or losses in an NPL sale transaction. Legal requirements which may also have commercial implications for securitization transactions include the stamp duty or registration requirements, capitalization requirements for the SPV under the capital markets framework, and aligning 'true sale' requirements under the SBP circulars with accounting true sale standards.

12. **The chronic issues in Pakistan's recovery system including court and litigation processes are the primary impediments to NPL resolution.** Recovery laws in Pakistan are evolving and despite a series of laws enacted to address delays and offer fast track recovery avenues to banks and DFIs, disposal of recovery cases remains a time-consuming process. Capacity building and procedural reforms remain a key concern for timely NPL resolution.

13. **Enforcing security interests out of court is challenging in Pakistan. For twenty years, Section 15 of the Financial Institutions (Recovery of Finances) Ordinance, 2001 (which was intended to allow banks and DFIs to foreclose on mortgages without Court intervention) has faced constitutional challenges.** The provision became effective after legislative amendments in 2016 were upheld by the court. The Financial Institutions (Secured Transaction) Act, 2016 permits out of court enforcement for security interests over movable property only for possessory security interests, such as pledge, title retention arrangements and lien over deposit accounts. Unlike mortgages over immovable properties, the modalities and procedures for enforcing possessory movable security interests out of court is not prescribed.

14. **The Corporate Rehabilitation Act, 2018 remains untested. The law is perceived as creditor friendly which may have disincentivized debtors from invoking rehabilitation protection.** The legislation lacks an automatic stay on all proceedings against a debtor, its shareholders, or guarantors at the time a debtor invokes protection under the Act.

15. **Legal and regulatory frameworks related to security arrangements can be an important factor in making the NPL market an attractive sector for investment.** In Pakistan, reforms to develop a regime to govern collateral arrangements and to align with international best practices have been introduced. The framework for security interests over movable property and registry for non-corporate entities was recently introduced through the Financial Institutions (Secured Transactions) Act, 2016 and amendments further align the Act with the United Nations Commission on International Trade Law (UNCITRAL) principles on secured transactions. Other areas of the legislation still require consideration.

    i. **The registry for immovable assets under land laws has been in place in Pakistan for a considerable time, and it continues to be a system of manual registration and verification.** The land titling system is largely based on the traditional deeds registration system, where a sale deed serves as the document of title, and it must be registered manually with registrar of the locality where the immovable property is situated. Issues with the land titling system and ensuing disputes may hamper and delay the enforcement of security interests over immovable property (either through or outside of court proceedings). A centralization and digitization process for land records has begun in some provinces. For security interests over immovable property of corporate entities, a centralized and digitized registry of security interests is maintained by the SECP.

    ii. **As part of ensuring compliance with Financial Action Task Force (FATF) requirements, trust laws have recently been overhauled which mean syndicated security arrangements under trust structures (which are common in Pakistan) must be registered annually with the relevant government agency.** This could make syndicated security structures administratively cumbersome and inefficient and, may have implications for the servicing of NPLs acquired by buyers and for pricing NPLs in the primary and secondary markets.

16. **Banks in Pakistan are generally open to considering secondary market NPL resolution options.** Based on discussions with the Heads of Special Asset Management commercial banks of varying sizes and NPL portfolios, it is understood that banks are generally satisfied with the capacity and expertise of their in-house remediation units. They consider legal impediments as the main challenge for recovery and are open to exploring secondary market transaction options such as with PCRCL, particularly for loans involving multiple creditors. It may be difficult for Islamic Banks to transact with any potential NPL buyer (including PCRCL at this stage) that does not offer a shariah compliant (Islamic) transaction structure.

17. **Assuming significant improvements are made in the legal, taxation, prudential and related, there are two possible NPL transaction models.** These include company restructuring-based models such as ARCs (India), government supported securitizations like the GACS (Italy) or bad banks such as Danaharta (Malaysia) and Sareb (Spain). IFC's investment preferences, including having a risk-reward based proposition, requiring a servicing or distressed asset partner, avoiding asset comingling risk, having a clear exit strategy, separating ownership & servicing of portfolios, and having some reserved powers such as the right to veto portfolio purchases, were also considered.[2]

    i. The first possible investment option is for PCRCL to operate as an asset management company[3] by setting up funds (trusts). These funds can acquire NPL portfolios from banks. IFC and other private investors can fund these acquisitions by purchasing units issued by PCRCL funds. In this model NPLs can be serviced by PCRCL against a servicing fee. For implementation, this model requires pending amendments to the CRC law to be enacted which will allow PCRCL to set up funds.

    ii. The alternate option is for IFC to invest in the equity of PCRCL in its current form. PCRCL can purchase NPLs and keep them on its own balance sheet. These NPLs can be serviced by PCRCL itself or by a third-party servicer. Since third-party servicing companies for corporate loans do not exist, a new servicing company would be set up by PCRCL and could operate as servicing platform or a captive servicing company. In this case, IFC will be paid through dividends instead of collecting shares from direct portfolio recoveries. This model does not require a legal amendment to implement.

18. An action matrix summarizing the key challenges, recommendations, and their relevant stakeholders listed by priority and difficulty is presented below. It catalogs key actionable items and recommendations from the report.

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[2] It is important to note that these options are presented as possible NPL resolution models and any investment decisions by IFC will be based on its sole discretion and subject to IFC's internal policies, management and board approvals.

[3] The asset management company (AMC) is used in the general sense to describe a category of NPL investor companies. It does not refer to an AMC as may be defined in the NBFC regulatory framework of the SECP.

Action Matrix –Constraints and recommendations to improve NPL management and create a secondary NPL market in Pakistan

S. No.	Constraints / Impediment	Recommended Action	Difficulty	Priority / Time[4]	Outcome	Responsibility
PRUDENTIAL/ REGULATORY REPORTING						
1	Shortcomings in the NPL reporting framework that prevent reporting of qualitative, other granular and portfolio level information by banks for benefit of the regulator and potential NPL investors.	Enhance the NPL reporting framework for banks in Pakistan in line with EBA's FINREP framework particularly with respect to reporting qualitative information and new reporting templates similar or comparable to EBA's (voluntary) transaction templates.	Low	Medium (18-36 months)	Better regulatory supervision; pre-empting rising infection ratios, facilitating NPL transactions	SBP
2	Reputational risk and exposures for public sector banks preventing them writing off loans even when they meet regulatory and internal policy criteria.	Introduce legislation that ensures steps should be taken through advocacy and guidelines that prevent write off abuse by public sector banks.	High	High (within 24 months)	Public sector banks can free up liquidity and regulatory capital for new loans, realize tax benefits, and improve their financial positions.	Relevant banks, Ministry of Finance, key political leadership

[4] Time is only provided for those recommendations where a reasonable estimate could be arrived.

S. No.	Constraints / Impediment	Recommended Action	Difficulty	Priority / Time[4]	Outcome	Responsibility
3	No requirements and guidance on acceptable valuation methods for collaterals, potentially affecting the quality of valuations and resulting in a possible price gap.	Define accepted valuation methods by type of asset in the PBA guidelines for valuators	Low	High (within 18 months)	Accurate valuations help reduce price gaps (premiums) and help secondary market transactions.	SBP, SECP and PBA
4	No requirement for external valuators to be members of international valuation bodies, potentially affecting the quality of valuations and a price gap.	Include minimum standards as well as incentives for valuators to acquire memberships of known international bodies in the PBA guidelines for valuators	Medium	Medium (24-36 months)	Accurate valuations improve balance sheet transparency through correct classification and provisioning of loans, reducing price gaps encouraging secondary market transactions.	SBP, SECP, PBA and Valuation firms
5	No guidance for banks on independence, qualification, and experience of banks' internal appraisers or the methodologies to be used when performing valuations internally.	Add guidance on independence, qualification, experience, and methodologies of internal valuating bank staff to SBP's prudential regulations. Initially, this may be introduced for voluntary adoption.	Low	Low	Accurate valuations improve balance sheet transparency through correct classification and provisioning of loans, reducing price gaps, and encouraging secondary market transactions.	SBP, Banks
6	No specialized private servicing companies for corporate loans.	Introduce regulatory and tax incentives to develop the private servicing market and introduce minimum operating standards for private servicers to encourage banks to avail their services.	High	Medium (24-36 months)	Improves the ecosystem and infrastructure of the secondary market, improves recoveries on portfolios, incentivizes new investors, improves risk management for NPL	SECP

S. No.	Constraints / Impediment	Recommended Action	Difficulty	Priority / Time[4]	Outcome	Responsibility
					investors.	
7	Administrative and time-based criteria in SBP's write off guidelines, which can create mild challenges when identifying write offs. No guidance for recognizing write offs in line with IFRS 9.	Simplify write off criteria to remove time limitations and certain procedural requirements, approvals, or certifications. Under IFRS 9, a loan may be written off only when there is no reasonable expectation of recovery. Issue explanatory guidance to clarify that ongoing enforcement activity by a bank would not be deemed as 'reasonable expectation to recover', so that both prudential and accounting requirements are aligned.	Low	High (24-36 months)	Benefits to banks in freeing up liquidity and regulatory capital for new loans, realizing tax benefits, improving their financial position.	SBP
8	No proportionality principle in SBP's prudential framework to enforce enhanced regulatory requirements on high NPL banks.	To actively monitor and pre-empt rising infection ratios for each bank, introduce enhanced regulatory requirements for banks with infection ratios above a certain threshold.	Medium	Medium (24-36 months)	Better regulatory supervision and pre-empting rising infection ratios.	SBP

S. No.	Constraints / Impediment	Recommended Action	Difficulty	Priority / Time[4]	Outcome	Responsibility
9	No definition and framework in prudential regulations to cover forborne exposures, unlikeliness to pay, concessions and financial difficulty as described in the Basel guidelines on the treatment of problem assets.	Update prudential regulations with clear definitions of these terms and as appropriate, the regulatory and external reporting templates for banks including their financial statement disclosures.	Medium	Medium (24-36 months)	Better regulatory supervision; and pre-empting rising infection ratios	SBP
10	Absence of 'debtor-based' approach in the prudential framework as described in Basel guidelines on problem assets. This potentially results in a lack of classification for performing exposures of non-performing borrowers.	Update the classification and provisioning requirements for all categories of loans covered in various PRs to follow a debtor-based approach so that exposures are classified at borrower level and not facility level.	High	Medium (24-36 months)	Improved disclosures and third-party confidence (investors), improved credit risk management.	SBP
11	The banks participating in a securitization transaction should not hold any share capital in the SPV (except in certain cases involving residential and commercial mortgage-based securities). Third parties are reluctant to act as shareholders of the SPV, primarily because of the exposure to negative e-CIB reporting at a group level on account of any default by the SPV.	Revise e-CIB reporting	Low	High	Strengthens NPL resolution mechanisms and furthers development of primary and secondary NPL market.	SBP
TAXATION						

S. No.	Constraints / Impediment	Recommended Action	Difficulty	Priority / Time[4]	Outcome	Responsibility
12	Restrictive deduction limits for loan loss provisions taken in respect of regulatory requirements in the taxation framework which delay and/or limit the taxation benefits that should be available to banks when recognizing NPL provisions.	1. Realizing the original objective of the introduction of the 7th Schedule in the ITO 2001, recognizing and allowing loan provisions in the 7th Schedule should be harmonized with Prudential Regulations and the accounting framework. 2. The revision of limits and allowable provision categories in the tax framework should allow timely deduction of provisions taken as per regulatory requirements given the likely un-collectible cash flows in each of the categories.	High	High (within 24 months)	Encourages timely recognition of provisions, seen as strong enabler for banks as well as NPL buyers (investors), reduces potential price gaps.	Ministry of Finance, FBR
13	The requirement of having 'reasonable grounds for believing that the debt is irrecoverable' to be able to deduct written off loans under the taxation framework creates an administrative hindrance for smooth allowance of expenses (write offs) already booked, approved and audited by banks.	To simplify the taxation of write offs for banks, it should be brought in the ambit of 7th Schedule of the ITO by reducing the scope of section 29. As part of a broader harmonization effort, the 7th schedule be aligned with the prudential and accounting frameworks applicable to banks. This will allow both provisions and write offs to be recognized in the same manner and satisfying the same standards as required by the prudential and accounting frameworks, respectively.	Medium	High (within 24 months)	Encourages timely recognition of write offs, seen as a strong enabler for banks as well as NPL buyers (investors), reduces potential price gaps.	Ministry of Finance, FBR

S. No.	Constraints / Impediment	Recommended Action	Difficulty	Priority / Time[4]	Outcome	Responsibility
14	No specialized tax framework for NPL sale, transfer or securitization transactions including the absence of generally accepted fair valuation methods for NPL transactions and the discretionary powers of tax authorities to re-characterize associated corporate structures on the premise of tax avoidance.	Introduce specialized provisions to the ITO that address the tax impacts of portfolio sale, transfer, agency or securitization transactions especially with respect to recognition of specialized legal structures and the use of generally accepted fair valuation models. These specialized provisions should allow timely deductions of any losses from the sale of NPLs with simple rules closely aligned with the accounting framework. A more principle-based and less restrictive tax framework will be more conducive to developing a secondary NPL market.	High	High (within 24 months)	Adds certainty and simplicity to structuring NPL transactions and in turn enables a secondary market to be created and attracts new NPL investors.	Ministry of Finance, FBR
LEGAL/JUDICIAL						
15	Absence of provisions in the CRC Act necessary to enable PCRCL to set up funds such as an asset management company.	Enact the pending legislative amendments that will allow PCRCL to set up funds and operate as an asset management company.	High	High (within 24 months)	Allows the creation of a secondary market based on best practice models, improves risk management for investors, improves scalability and the investment potential of investment vehicles.	SECP, Federal Government

S. No.	Constraints / Impediment	Recommended Action	Difficulty	Priority / Time[4]	Outcome	Responsibility
16	No Islamic financial instrument to allow for NPL transactions with Islamic banks.	NPL resolution models should consider developing and offering shariah compliant variants of instruments for NPL transactions to engage Islamic banks and financial institutions.	High	Medium (24-36 months)	Opens a new segment of investors, improves secondary market depth.	SBP, PCRCL (and any other future institute)
17	Certain provisions of the Companies Act are not aligned with the Secured Transactions Act.	Enact fresh legislation (pending before the Parliament) to effect the changes proposed under the Secured Transactions Amendment.	Low	High	Ensures consistency and brings certainty in rights of buyers/investors of NPL.	Ministry of Finance/ Legislature
18	Contrary to the UNCITRAL Model Law on Secured Transactions, the Secured Transactions Act does not override contractual anti-assignment clauses.	Enact fresh legislation to effect the changes proposed under the Secured Transactions Amendment.	Low	High	Alignment of legal regime with international best practices and protection of rights of NPL buyers and investors.	Ministry of Finance/ Legislature
19	The land title system in Pakistan is largely based on manually registered sale deeds which is a time consuming and unreliable process and does not facilitate public access to reliable land records.	Complete the process of centralization and digitization of land title system across Pakistan.	High	High	Risk mitigation and Protection of rights of NPL investors and buyers. Facilitates due diligence during a pricing.	Ministry of Finance/concerned boards of revenue
20	With the recent revamping of trust laws in Pakistan, creating and registering syndicated security arrangements has become complex and may ultimately have implications for servicing of NPLs acquired by buyers, and pricing of NPLs in the	To facilitate creation and registration of trusts for holding of security interests for financings and to align them with financing raised through the issuance of debt securities, the security trusts created as part of syndicate financings should be brought within the scope of "specialized trusts" for which the registration	Medium	High	Facilitates effecting NPL transfers and servicing	Federal Government/SBP

S. No.	Constraints / Impediment	Recommended Action	Difficulty	Priority / Time[4]	Outcome	Responsibility
	primary and secondary markets.	requirements under trust laws have been relaxed.				
21	Capacity and administrative constraints have caused a backlog of pending cases and delays in conclusion of recovery proceedings.	Increase the number of Banking Courts to address the large number of cases. Dedicate some High Court benches to banking matters. Design a course to train judicial officers and Banking Courts for capacity building purposes. Prepare a list of qualified eminent professionals to act as amicus curiae.	High	High	Helps develop an effective recovery system and facilitates efficient NPL resolution.	Executive/Ministry of Law, Justice & Parliamentary Affairs/PBA
22	No uniform guidelines for court procedures leads to delays in recovery proceedings.	Develop guidelines and manuals to make proceedings efficient and which delineate the life of a banking suit and procedures to follow when dealing with an application for leave to defend and other interlocutory applications.	Low	High	Helps develop an effective recovery system and expedites NPL resolution.	Judiciary
23	Applying CPC provisions to recovery proceedings causes delays.	Remove all references to CPC and recovery proceedings should only be governed by the Recovery Ordinance.	High	High	Helps develop an effective recovery system and facilitates efficient NPL resolution.	Ministry of Finance/ Legislature
24	There is ambiguity on whether foreign FIs without a place of business in Pakistan are permitted to invoke jurisdiction of the Banking Courts.	Provide clarity through Section 2(a) of the Recovery Ordinance where a foreign financial institution (regardless of whether it has a place of business in Pakistan) falls within the scope of the Recovery	High	High	Helps remove uncertainty and facilitates NPL resolution involving foreign investors.	Ministry of Finance/ Legislature

S. No.	Constraints / Impediment	Recommended Action	Difficulty	Priority / Time[4]	Outcome	Responsibility
		Ordinance.[5]				
25	In terms of Section 19(1) of the Recovery Ordinance, in practice, in Sindh, automatic conversion to execution proceedings is not accepted, and a bank or DFI is required to apply for execution proceedings and is subject to the time limitations.	If the borrower fails to deposit the decretal amount within seven days, the attachment and sale of the assets [the list of which would be submitted with the application for leave to defend] should automatically follow. The same may be addressed through the judicial handbook.	Low	High	Helps develop an effective recovery system and facilitates efficient NPL resolution.	Ministry of Finance/ Legislature/Judiciary
26	There are considerable delays in recovery proceedings on account of borrowers challenging the decree on the basis of improper or lack of service, delays in decisions on leave to defend, recording of evidence, procedural formalities at execution stage, as well as improper notice by borrowers for the filing of appeals.	Create specific guidelines relating to the sufficiency of service of notice, timeframes for decision on and proceedings in connection with leave to defend, disposal of suit, limitations on ex-parte ad-interim orders in appeal without adequate notice.	Low	High	Helps develop an effective recovery system and facilitates efficient NPL resolution.	Federal Government/Judiciary
27	Despite the restrictive grounds spelt out for granting injunctions against out of court sale of mortgaged property under Section 15(13) of the Recovery Ordinance, injunctive orders are frequent.	Include guidelines in connection with injunctive relief under Section 15(13) in the judicial handbook and make them part of the judicial training program.	Low	High	Helps develop an effective recovery system and facilitates efficient NPL resolution.	Judiciary

[5] In view of recent case law (Syed Itrat Hussain Rizvi v. Tameer Micro Finance Bank Limited through Attorney and another (2018 CLD 116 [Sindh] and judgment of the Lahore High Court in Writ Petition No.5591 /2018 (Muhammad Tuseef and 4 others vs. The State Bank of Pakistan and 30 others), microfinance banks do not fall within the definition of 'financial institution' for the purposes of the Recovery Ordinance. Albeit outside the scope of this Report, an amendment to this effect may also be considered.

S. No.	Constraints / Impediment	Recommended Action	Difficulty	Priority / Time[4]	Outcome	Responsibility
28	A specific process for out of Court enforcement of security interests over movable property has not been prescribed and for all practical purposes, enforcement is only availed under an order of the Banking Court.	It may be clarified that Section 16(3) of the Recovery Ordinance permits recovery/sale of movable property at any stage and without the need for any order of the Banking Court and procedure and modalities may be prescribed for out of Court recovery/sale of movable property subject to/in conjunction with the Secured Transactions Act.	Medium	High	Facilitates out of Court NPL resolution and contributes towards developing an NPL market.	Federal Government
29	A consolidated framework for company insolvency and non-corporate entities does not exist. Even for companies, the insolvency regime is spread across multiple laws.	Capture all laws, procedures, and modalities in connection with corporate insolvency and rights of secured/unsecured creditors under a consolidated regime, establishing a corporate insolvency recovery mechanism involving decisions to either restructure or else liquidate the company. Further, all companies, partnership firms, proprietorship firms may be brought within the fold of this single insolvency framework.	High	High	Improves certainty and effectiveness in the NPL resolution mechanisms and furthers development of primary and secondary NPL markets.	Legislature/Federal Government/SECP
30	The official liquidator is required to be appointed from the list of provisional managers and liquidators maintained by the SECP. However, based on stakeholder feedback, liquidation proceedings are prone to delays, and there appears to be a need for capacity building and training for liquidators.	Create training programs and handbooks concerning liquidation procedures and modalities to build capacity.	Medium	High	Improves certainty and effectiveness in the NPL resolution mechanisms and furthers development of primary and secondary NPL markets.	Judiciary/SECP

S. No.	Constraints / Impediment	Recommended Action	Difficulty	Priority / Time[4]	Outcome	Responsibility
31	Despite a heavy focus on creditor rights and the Corporate Rehabilitation Act being in the field for over three years – the framework has failed to gain traction.	Decide whether the Corporate Rehabilitation Act should be reformed to encourage defaulters to exercise protections available under the Act. A key amendment to consider is to provide for an automatic stay on all proceedings against a debtor, its shareholders, or guarantors at the time the defaulter invokes protection under the Act.	High	High	Improves certainty and effectiveness in the NPL resolution mechanisms and furthers development of primary and secondary NPL markets.	Legislature/SECP
32	There has been some legal controversy as to whether stamp duty is payable on the transfer of assets pursuant to schemes sanctioned by High Court/SECP following some judicial precedents.	The matter may be addressed through appropriate provincial notifications, like the ICT notification exempting payment of stamp duties.	Medium	High	Makes the NPL resolution strategy cost effective and furthers development of primary and secondary NPL markets.	Provincial Governments
33	The 'true sale' standard under the SBP Circular, applicable where banks and DFIs are originators, is more stringent when compared with international accounting standards, as no recourse against the originator is permitted.	Some limited recourse should be permitted such as where the originator breaches a warranty that was relied upon by the SPV to purchase the NPLs. For example, if the originator warrants as to the accuracy of past defaults and this turns out to be materially incorrect, some recourse against the originator should be permitted. The extent of such recourse should fall within the domain of the relevant accounting standards to determine whether a particular sale could be accorded an off-balance sheet treatment in the hands of the	Low	High	Strengthens NPL resolution mechanisms and furthers development of primary and secondary NPL markets.	SBP/Federal Government

S. No.	Constraints / Impediment	Recommended Action	Difficulty	Priority / Time[4]	Outcome	Responsibility
		originator.				
34	Under the SBP circular relating to securitization, the ABS needs to have a minimum credit rating of 'A' and be listed. Further, regulatory compliances are prescribed in PSX regulations which may be an impediment in development of NPL market.	Relax these requirements in relation to a securitization involving NPLs. Clarify the ambiguity under the SECP Securitization Rules, through amendments to confirm that listing is not a mandatory requirement.	Low	High	Strengthens NPL resolution mechanisms and furthers development of primary and secondary NPL markets.	SECP/SBP/PSX
35	High stamp duty and registration costs may be an impediment in the securitization of NPLs.	All provinces should issue notifications like the ICT notification to exempt or relax the payment of stamp and registration costs in connection with securitizing NPLs.	Medium	High	Strengthens NPL resolution mechanisms and furthers development of primary and secondary NPL markets.	Provincial Governments
36	Various subordinated legislation and regulatory measures are pending issuance t which are necessary for making the CRC Act an effective NPL restructuring regime.	Following passage of the CRC Act amendment, the Federal Government will need to issue a notification to set up a Corporate Restructuring Board. To facilitate and regulate the asset management structure proposed under the amendments, the SECP will need to develop a framework within the rules and regulations of the Corporate Restructuring Companies Act, 2016. A further amendment will be required to determine whether a financial institution should be permitted to control a CRC.	Medium	High	Strengthens NPL resolution mechanisms and develops further investment opportunities for NPL investors/buyers.	Legislature/SECP/Federal Government

4. PAKISTAN NPL MARKET OVERVIEW

4.1. The Structure of the NPL Market in Pakistan & NPL Market Players

There are two types of financial institutions in Pakistan. The financial institutions which are regulated by the State Bank of Pakistan (SBP), including commercial banks, microfinance banks, specialized banks, and DFIs. The other type is financial institutions which are regulated by the Securities and Exchange Commission of Pakistan (SECP) and are commonly called non-bank finance companies, including, leasing companies, mutual funds, and investment finance companies (deposit taking and non-deposit taking).

Of all these FIs, SBP regulated commercial banks and other FIs are the main players in the NPL market. A detailed analysis of the NPL portfolio trends, the proportions held across various banks and ranking of major NPL market players in Pakistan is in Section 4.2 of this report.

NPL resolution takes place through in-house functions in banks. A secondary market is virtually non-existent (except for PCRCL). All commercial banks have asset management or remedial asset management units which are mandated to resolve NPLs transferred to them using restructuring, litigation, debt-asset swaps, out of court settlements or other similar tools. When resolving these NPLs, it was understood that some banks contracted individuals or third parties for asset identification or coordination with local land revenue offices, but they do not use any debt servicing companies like those operating in European NPL markets.

PCRCL has been licensed by the SECP under the CRC Act. Its shareholding is held by ten financial institutions — Allied Bank Limited, Bank Alfalah Limited, Bank Al Habib Limited, Faysal Bank Limited, Habib Bank Limited, Habib Metropolitan Bank Limited, MCB Bank Limited, Meezan Bank Limited, National Bank of Pakistan, and United Bank Limited.

The CRC Act empowers any licensed CRC for the acquisition, restructuring, rescheduling and disposition of NPLs and various related matters, and equips them for dealing with corporate NPLs.

For general services related to tax, legal or transaction advisory and with respect to NPL transactions or other structured finance deals, the market is concentrated with only a few accounting and legal firms participating. Table 1 contains a list of players and stakeholders in the corporate NPL market.

TABLE 1: STAKEHOLDERS FOR CORPORATE NPLS

S. No.	Stakeholder Category for Corporate NPLs	Description
1	Private Commercial Banks	These are various categories of commercial banks which are potential NPL sellers. Commercial Banks, among others, are regulated by the SBP. A list of banks in each of these categories is in Annex B.
2	Public Commercial Banks	
3	Islamic Banks (private commercial)	
4	Specialized Banks	
5	Foreign Banks	
6	Development Finance Institutions (DFIs)	These are non-deposit taking financial institutions regulated by the SBP and have corporate loans in their banking book. As of 31 December 2020, total NPLs of DFIs stood at PKR 15.9 billion. (State Bank of Pakistan, 2020).

S. No.	Stakeholder Category for Corporate NPLs	Description
7	Non-bank finance companies (NBFCs)	Among other NBFCs, there are non-deposit taking leasing companies and investment finance companies which deal in asset leasing, credit guarantees and wholesale financing. The most notable include Pakistan Microfinance Investment Company (PMIC), IfraZamin (infrastructure guarantee company), Pakistan Credit Guarantee Company and Orix Leasing. NBFCs' volume of lending to the economy is limited, and their holdings of non-performing assets are also minimal.
8	Regulators	SECP regulates companies and the capital market in Pakistan. Banks and DFIs are additionally governed by the SBP. The Federal Board of Revenue is the tax authority for federal income and sales taxes while provincial sales taxes are governed by provincial revenue boards.
9	Credit Bureaus/Registry/Credit Rating Agencies	The primary credit bureau in Pakistan is the SBP owned e-CIB. Two other licensed private credit bureaus also operate in Pakistan – Datacheck and Tasdeeq – and there are two credit rating agencies are functioning in Pakistan – Pakistan Credit Rating Agency and JCR-VIS Credit Rating Company.
10	Debt Collection Companies (Servicers)	These are companies offering collection, recovery, asset tracking and repossession services mainly for consumer loans. A non-exhaustive list of these companies based on web-searches is in Annex O.
11	Collateral Management Companies	In the agriculture sector and specific to electronic warehouse receipts, Nayamat Collateral Management Company offers financing, repository, accreditation, and other similar services for collateral management.
12	Transaction Advisory Firms	These firms offer financial valuation, due diligence, capital raising, transaction structuring services, and other services generally associated with transaction advisory.

S. No.	Stakeholder Category for Corporate NPLs	Description
13	Judiciary	The High Courts and Banking Courts at the district level are key stakeholders in resolving NPLs, as all cases related to default, liquidation, insolvency, winding up, and restructuring are managed by these courts. The Pakistan Bar Council also plays a role in resolving NPLs, and delays are generally caused by frequent strikes in litigation proceedings.
14	Investment Banking Advisory	All commercial banks and the top 10 commercials banks and DFIs offer investment banking advisory services especially with respect to capital market transactions. Other stock brokerage houses such as Taurus Securities, Arif Habib Securities, BMA Capital, IGI Finex, JS Global, KASB Securities and Elixer Securities also offer these services.
15	Capital Market	Pakistan Stock Exchange is the exchange for tradable debt and equity securities. It also provides listing regulations (in addition to SBP or SECP regulations).
16	General Investors (Potential)	Insurance companies and asset management companies are among the potential financial services companies in Pakistan that could invest in marketable securities. As of June 2021, the insurance industry has total assets of PKR 2 trillion (12 percent non-life & 88 percent life). The top five insurance companies in Pakistan hold a combined market share of 85 percent of total industry assets. As of June 2021, the mutual funds industry has total assets under management of PKR 1 trillion. The top five asset management companies in Pakistan hold a combined market share of 25 percent of the total assets under management. The asset classes are divided into equity, debt, money market and other assets in the percentages of 24 percent, 24 percent, 42 percent and 10 percent respectively. Banks (although less preferred due to their loan origination role) are also potential minority investors.

S. No.	Stakeholder Category for Corporate NPLs	Description
17	NPL Investors	Pakistan Corporate Restructuring Company (PCRCL) is the only known buyer and servicer for corporate NPLs in Pakistan.
18	Pakistan Banks' Association and Valuators	Pakistan Banks' Association plays a role in coordinating banking industry efforts for NPL resolution. A list of approved valuator companies by type of asset specialization is available from the Pakistan Banks' Association (www.pakistanbanks.org.pk).

4.2. NPL Trends, Sectoral Composition and Other Financial Data

Based on available data, NPL sectoral distributions, volumes, and trends, across various financial institutions and sectors of conventional and Islamic banking have been analyzed. This analysis is critical to ascertain the opportunity size and investor potential of the NPL market in Pakistan, to determine suitable interventions, including new NPL transaction models and the creation of a secondary NPL market.

Overview of Pakistan's Banking Industry

Pakistan's banking industry comprises of a total of 32 banks, including five public-sector commercial banks, four foreign banks, 15 conventional banks, five Islamic banks in the local private sector, and three specialized banks. The Islamic banking industry in Pakistan also includes Islamic banking windows operated by 17 conventional banks (including public sector and specialized banks). A list of these banks is in Annex B.

Local private commercial banks account for approximately 77 percent of total banking assets, of which 67 percent belong to private sector conventional banks and 10 percent to Islamic Banks. Private commercial banks are the largest providers of credit, with an estimated total loan value of more than PKR 6.53 trillion in December 2020 (with conventional banks' lending PKR 5.5 trillion and Islamic banking institutions lending PKR 1.02 trillion). Based on total banking assets, the five public sector banks have a market share of 19 percent (lending approximately PKR 1.6 trillion in advances), while foreign banks (licensed branches of foreign banks) and specialized banks have a total share of 3 percent and 1 percent respectively. These specialized banks only have a credit portfolio of PKR 185 billion out of the total of PKR 8.2 trillion.

Table 2 details the share of credit market between different types of banks and Table 3 shows the credit portfolio of Islamic Banking Branches of Public Sector and Private Sector Conventional banks.

TABLE 2: CREDIT MARKET SHARE OF DIFFERENT TYPES OF BANKS

Type	Total Assets (PKR million)	Credit Portfolio (PKR million)	Deposits	Equity	Total Banks	Market share (% of assets)	Market share (% of credit portfolio)	Market share (% of deposits)
Public Sector Banks	4,761,786	1,575,708	3,664,602	362,070	5	19%	19%	20%

Private Sector Conventional Banks	16,884,264	5,506,264	12,485,446	1,228,392	15	67%	66%	67%
Islamic Banks	2,499,410	1,023,616	2,032,632	129,488	5	10%	12%	11%
Foreign Banks	733,826	72,368	274,380	76,541	4	3%	1%	1%
Specialized Banks	244,569	113,617	61,466	65,942	3	1%	1%	0.3%
Industry Totals	25,123,854	8,291,572	18,518,525	1,862,433	32	100%	100%	100%

Source: Quarterly Compendium: Statistics of the Banking System, Financial Stability Department SBP, 2020

The difference in the total assets of the industry and the sum of equity and deposits represents other liabilities such as borrowings from SBP and other banks, bill payables and general accruals.

TABLE 3: CREDIT MARKET SHARE OF ISLAMIC BANKING BRANCHES

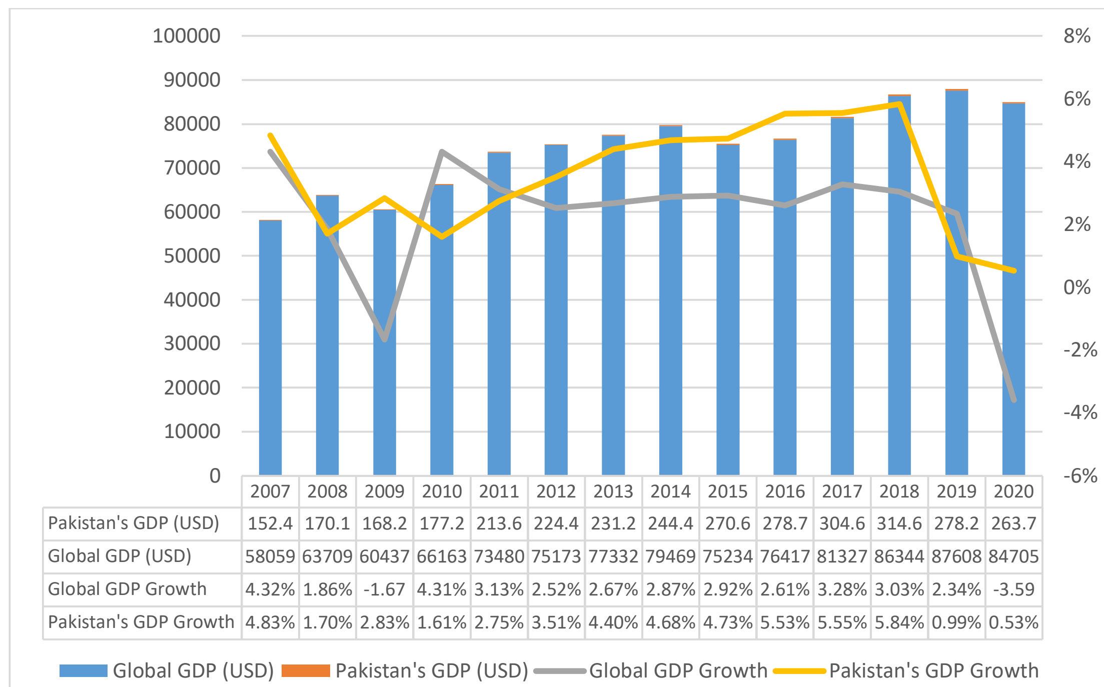
Type	Total Assets (PKR million)	Credit Portfolio (PKR million)	Deposits	Equity	Total Banks	Market share (% of assets)	Market share (% of credit portfolio)	Market share (% of deposits)
Islamic Banking Branches of Conventional Banks	1,770,037	857,424	1,356,329	117,571	17	7%	10%	7%

Source: Quarterly Compendium: Statistics of the Banking System, Financial Stability Department SBP, 2020

Pakistan's Economy and the Banking Industry

While the impacts of the Global Financial Crisis of 2008-2009, were felt around the world in varying degrees, its effects on Pakistan's economy were less adverse. Figure 1 shows that as average global GDP growth declined from 4.32 percent in 2007 to 1.86 percent in 2008 and then fell further to 1.67 percent in 2009, however, Pakistan's GDP grew by 1.70 percent in 2008 and 2.83 percent in 2009. One of the reasons for this growth is that Pakistan's economy is largely driven by domestic demand and its participation in global value chains is relatively limited when compared with countries like India, Bangladesh, China, Malaysia, or Thailand. Table 4 illustrates an observable decline in the export of goods and services to GDP ratio of these countries from 2008 to 2010 while Pakistan's ratio increased over the same time period.

FIGURE 1: GLOBAL GDP GROWTH VS GDP GROWTH OF PAKISTAN



Source: The World Bank, 2020

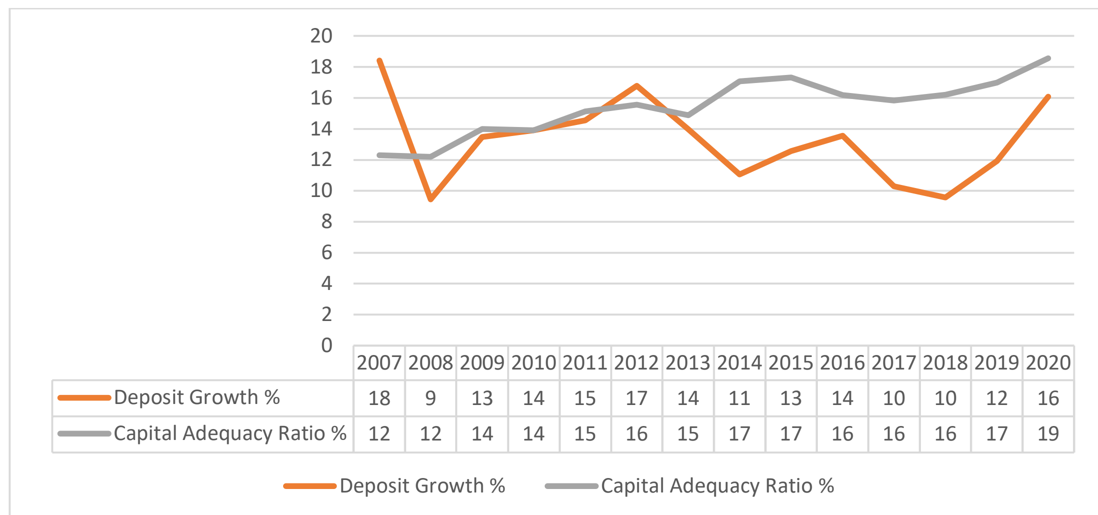
TABLE 4: EXPORT OF GOODS AND SERVICES AS A PERCENTAGE OF GDP

	Pakistan	India	Malaysia	Bangladesh	Thailand	China
2008	12%	24%	100%	18%	71%	33%
2009	12%	20%	91%	17%	64%	25%
2010	14%	22%	87%	16%	66%	27%

Source: The World Bank, 2020

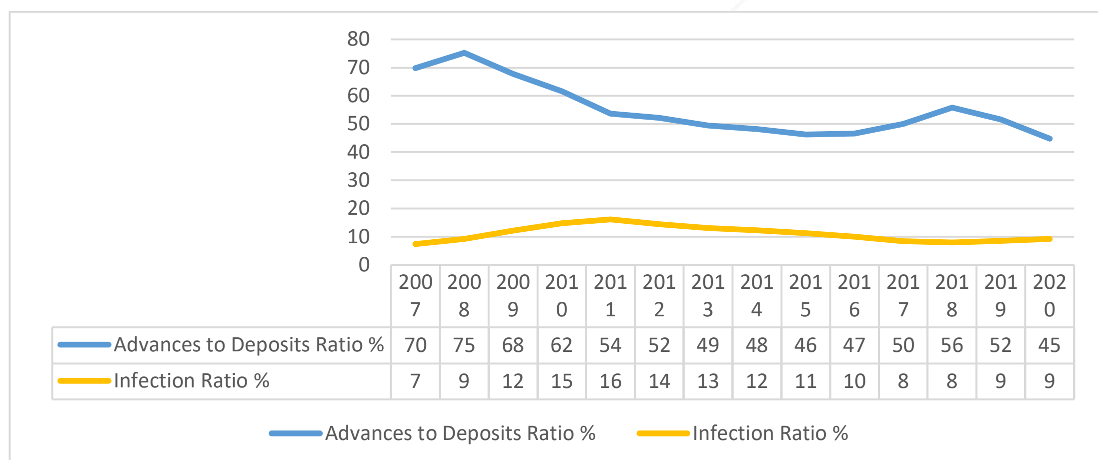
The banking industry in Pakistan has been stable and has grown steadily since 2008. As shown in Figure 2, deposits have increased at an average annual rate of approximately 13 percent and capital adequacy ratios have consistently improved from 12 percent to an average of 19 percent. Both these measures show that banks have had sufficient liquidity and stability to grow. The infection ratios shown in Figure 3 have also been declining since 2011, showing a relative improvement in asset quality.

FIGURE 2: DEPOSIT GROWTH & CAR



Source: Quarterly Compendium: Statistics of the Banking System, Financial Stability Department SBP, 2020

FIGURE 3: ADR & INFECTION RATIO



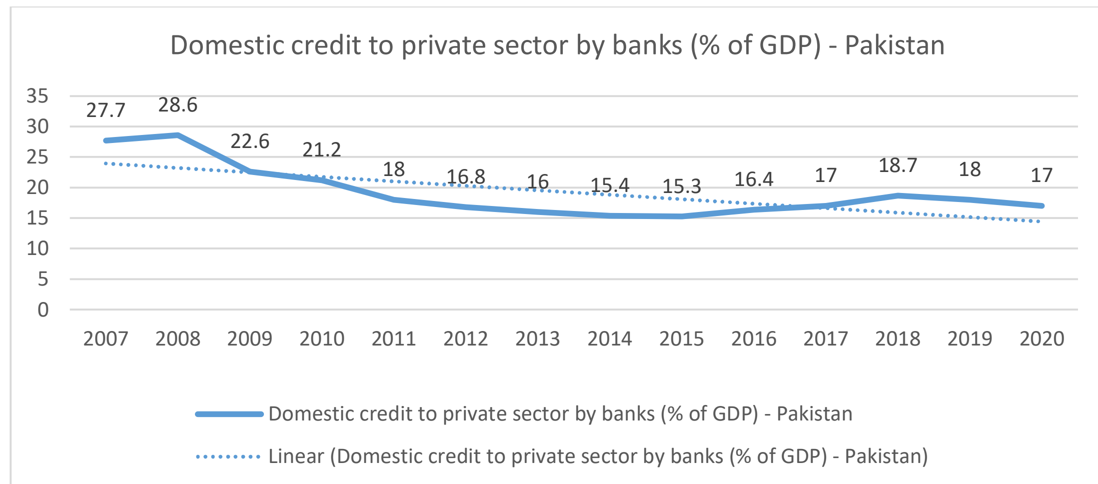
Source: Quarterly Compendium: Statistics of the Banking System, Financial Stability Department SBP, 2020

Despite the growth, the good performance and stability of the banking sector have not proportionately contributed to the economy. As shown in Figures 4 and 5, not only has Pakistan's Private Sector (domestic) Credit to GDP ratio been consistently declining (from 28.6 percent in 2008 to 17 percent in 2020) its relative standing among other regional economies is also among the lowest. In addition, Figure 3 shows the banking industry's Advances to Deposits Ratio has also decreased from 75 percent in2008 to 45 percent in 2020. Assessing these combined trends shows the banking industry has continued channeling its liquidity away from private sector borrowers. Heavy borrowing by the government is one of the primary reasons of private sector borrowers have been crowded out.

Further, in private sector lending, the pie is overwhelmingly dominated by corporate and commercial loans. Loans to micro, small and medium enterprises account for very little of total banking advances in Pakistan. As a result, micro, small and medium enterprises, resort to internal finance for working capital and capex needs (as these enterprises are often collateral-deficient and lack documented financial records). The banking sector's aversion to lend to relatively riskier segments of the economy is caused by weak title, contract, and recovery laws, uncertainties around loan write offs, unchecked government borrowing thresholds and stringent capital requirements (which

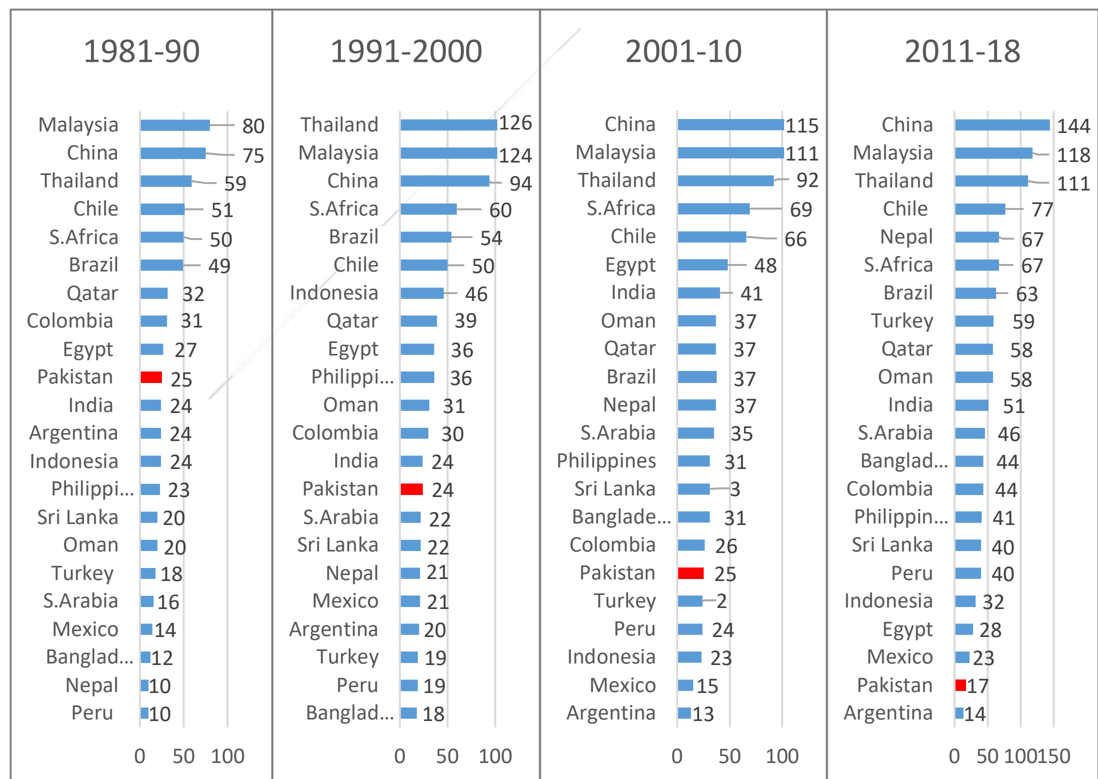
make it particularly difficult to lend to informal or semi-formal segments of the economy).

FIGURE 4: DOMESTIC CREDIT TO PRIVATE SECTOR BY BANKS (% OF GDP)



Source: Quarterly Compendium: Statistics of the Banking System, Financial Stability Department SBP, 2020

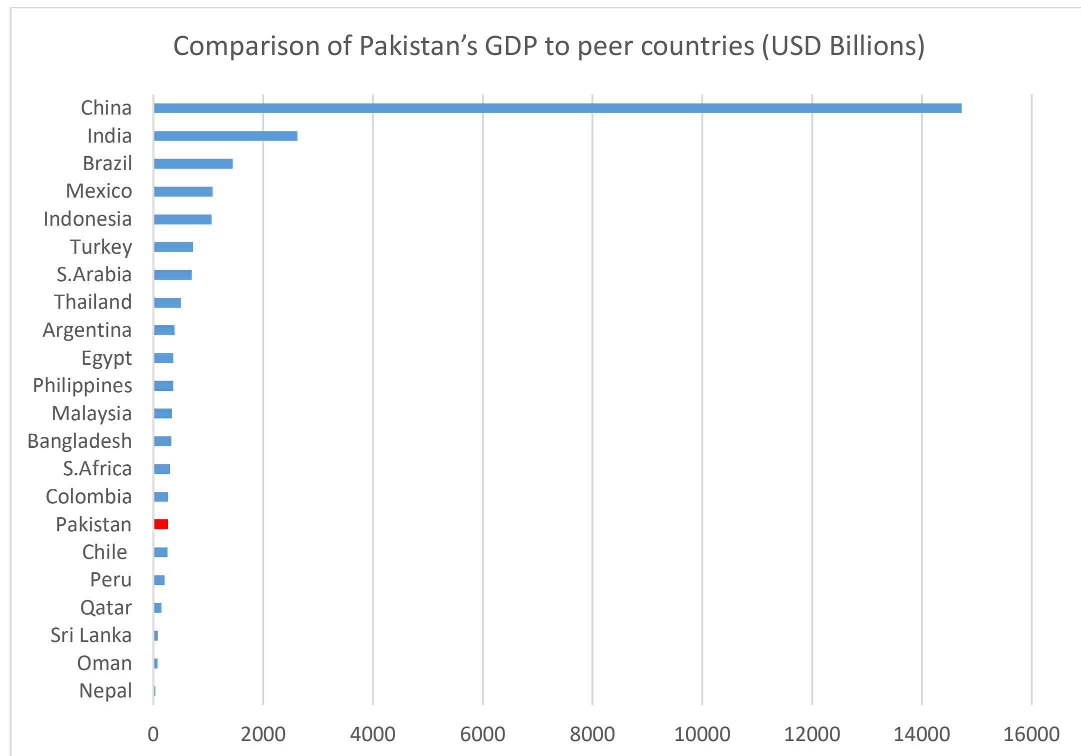
FIGURE 5: PAKISTAN'S RELATIVE STANDING IN CREDIT-TO-GDP RATIO



Source: Quarterly Compendium: Statistics of the Banking System, Financial Stability Department SBP, 2020

Despite having one of the lowest GDPs in 2020 compared with peer countries (as shown in Figure 6), Pakistan continues to benefit from growing Chinese investments, and Iran's return to international markets is projected to enhance mutual commerce. The China-Pakistan Economic Corridor (CPEC), a 3,000-kilometer network of roads, railroads, and oil and gas pipelines connecting Pakistan and China, is projected to boost Pakistan's economy until 2030. The 2019 bailout package from the International Monetary Fund targeting stability and structural reform appears to be on track to address macroeconomic concerns.

FIGURE 6: COMPARISON OF PAKISTAN'S GDP TO PEER COUNTRIES



Source: The World Bank, 2020

Five-year Performance of the Banking Industry

The banking industry has performed strongly over the past five years (from December 2016 to December 2020).

- Total banking assets increased from PKR 15.8 trillion to PKR 25.1 trillion (cumulative growth of 59 percent)
- Deposits rose from PKR 11.7 trillion to PKR 18.5 trillion, growing by 57 percent
- Net advances increased from PKR 5.5 trillion to PKR 8.3 trillion, a growth of 51 percent
- Investments jumped from PKR 7.5 trillion to PKR 11.9 trillion, growing by 59 percent
- Equity rose from PKR 1.4 trillion to PKR 1.8 trillion, growth of 38 percent
- Profit after Tax increased from PKR 0.19 trillion to PKR 0.24 trillion, growth of 29 percent
- Non-Performing Loans rose from PKR 0.6 trillion to PKR 0.83 trillion, an increase of 37 percent

Despite the COVID-19 pandemic, Pakistan's banking sector achieved growth of 7.8 percent in 2020. Figure 7 provides a snapshot of the size of assets base and the net advances provided by the banking sector. After-tax profits of the banking industry (listed commercial banks) increased by 34 percent (in 2019 they increased by 21 percent).

The increased profitability was primarily the result of various relief measures taken by the government and the SBP. These included a 625 basis point cut in the policy rate, a temporary economic refinance facility (TERF) providing long-term concessionary refinance at 5 percent for manufacturers and exporters, a Debt Relief Scheme offering principal deferment and restructuring of PKR 911 billion worth of loans, approving PKR 18 billion of financing facility enabling hospitals and medical centers to enhance their capacities, Rozgar Scheme to prevent layoffs by financing wages and salaries of employees, increase in borrowing and lending limits for consumer and SME financing, and some relaxations in regulatory capital limits. A detailed account of COVID relief measures for corporate, commercial and consumer financing facilities is in Annex Q. On the back of these measures, net interest income rose by 25 percent while non-mark-up income jumped by 16 percent due to strong capital gains in Treasuries (an annual increase of roughly 11 times).

Under the Debt Relief Scheme,[6] borrowers had an option to either defer their principal amount for up to twelve months while continuing to service mark-up amounts or restructure their loans for more than twelve months including adjustments (if any) to the mark-up amount. The principal deferment option was available for six months up until 30 September 2020 and resulted in deferment of PKR 657 billion. The restructuring option lasted for one year up until 31 March 2021 and resulted in restructuring worth PKR 254 billion of loans. According to the SBP, the scheme preserved the solvency of more than 1.8 million borrowers and combatted temporary economic disruptions by providing a combined relief worth PKR 911 billion. Corporate borrowers benefit the most from this scheme closely followed by the borrowers of MFBs, contributing to 79 percent and 13 percent of the total relief amount respectively. These forbearance measures constitute about 10 percent of the value of total outstanding gross advances of PKR 9.1 trillion as of 31 March 2021.

In terms of health of the loans which were subject to the relief measures granted by the SBP (or where the borrowers availed the benefits under the above schemes), quarterly results published by banks shows that the loans that were subject to relief measures have showed a better-than-expected recovery. Some of the larger contributing banks in terms of gross advances have consistently booked higher reversals in their provisions in the 9-month period ending 30 September 2021 when compared with the same period in 2020. Table 5 provides a snapshot of this with related information on the state of recoveries published in banks' financial statements.

TABLE 5: REVERSAL IN PROVISIONS AND ASSET QUALITY OF LOANS

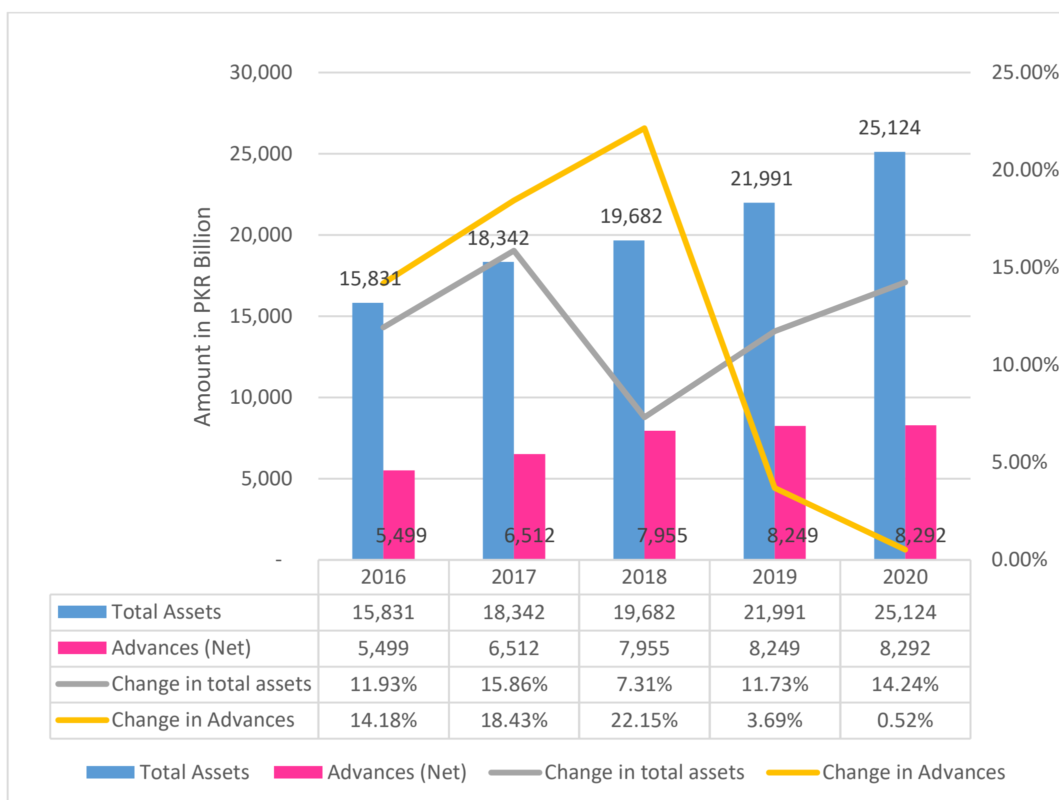
Banks	Reversals in provisions against advances for 9 months (1 Jan 2021 – 30 Sep 2021) in PKR millions	Reversals in provisions against advances for 9 months (1 Jan 2020 – 30 Sep 2020) in PKR millions	Comments on asset quality published in the financial statements
HBL	4,617	2,547	The total provisions (on advances, investments, other assets, off balance sheet items) reduced by nearly 50 percent over nine months in 2020, which included PKR 5.2 billion of COVID-19 related general provision. The infection ratio fell from 6.3 percent in Dec 2020 to 5.8 percent in Sept 2021 and the specific coverage improved from 88.9 percent to 91.6 percent over the same period. Total coverage is maintained at over 100 percent.

[6] Only loans which were performing as on 31 Dec 2019 were eligible under the scheme

Banks	Reversals in provisions against advances for 9 months (1 Jan 2021 – 30 Sep 2021) in PKR millions	Reversals in provisions against advances for 9 months (1 Jan 2020 – 30 Sep 2020) in PKR millions	Comments on asset quality published in the financial statements
NBP	2,449	4,035	Reflecting the economic environment triggered by the COVID-19 pandemic and previous portfolio weaknesses, the asset quality of the bank came under considerable pressure. As of 30 Sept 2021 NPLs were PKR 201.66 billion, being 17.7 percent higher than 2020.
UBL	3,210	947	The bank's business in Pakistan recorded a net provision reversal (net reversal arises when provision reversal exceeds the provision charge) of PKR 1.4 billion for nine months of 2021 versus a net provision charge (net charge arise when provision charge exceeds the provision reversal) of PKR 1.7 billion in nine months of 2020. Asset quality was 5.7 percent in Sept 2021, improving from 6.3 percent in Dec 2020, while specific coverage improved from 85.7 percent in Dec 2020 to 87.1 percent in Sept 2021.
MCB	5,246	1,426	Proactive monitoring and recovery efforts led to a net provision reversal of PKR 294 million in provision maintained against NPLs. While the general loss reserve created by the uncertainty surrounding COVID-19 was reversed, by PKR 3 billion, the systematic risks surrounding the economic recovery receded and domestic activity resurged.
ABL	869	405	The bank continued its momentum towards a low infection ratio and high overall coverage ratio which stood at 2.6 percent and 93.9 percent respectively. Private sector credit offtake stimulated as economic recovery gained momentum.
Total	16,391	9,360	The analysis of reversals in provision against advances for 2020 and 2021 and related qualitative information on asset quality shows an overall improvement in the asset quality of loans and an increase of 75 percent in provision reversals in the nine months period ending 30 Sept 2021 compared with the same period last year. Provision reversals are generally booked based on loan recoveries

Banks	Reversals in provisions against advances for 9 months (1 Jan 2021 – 30 Sep 2021) in PKR millions	Reversals in provisions against advances for 9 months (1 Jan 2020 – 30 Sep 2020) in PKR millions	Comments on asset quality published in the financial statements
			(with some exceptions), so the overall increase in provision reversals may be attributed to above expectation recoveries for banks.

FIGURE 7: TOTAL ASSETS AND NET ADVANCES OF THE BANKING SECTOR



	2016	2017	2018	2019	2020
Total Assets	15,831	18,342	19,682	21,991	25,124
Advances (Net)	5,499	6,512	7,955	8,249	8,292
Change in total assets	11.93%	15.86%	7.31%	11.73%	14.24%
Change in Advances	14.18%	18.43%	22.15%	3.69%	0.52%

Source: Quarterly Compendium: Statistics of the Banking System, Financial Stability Department SBP, 2020

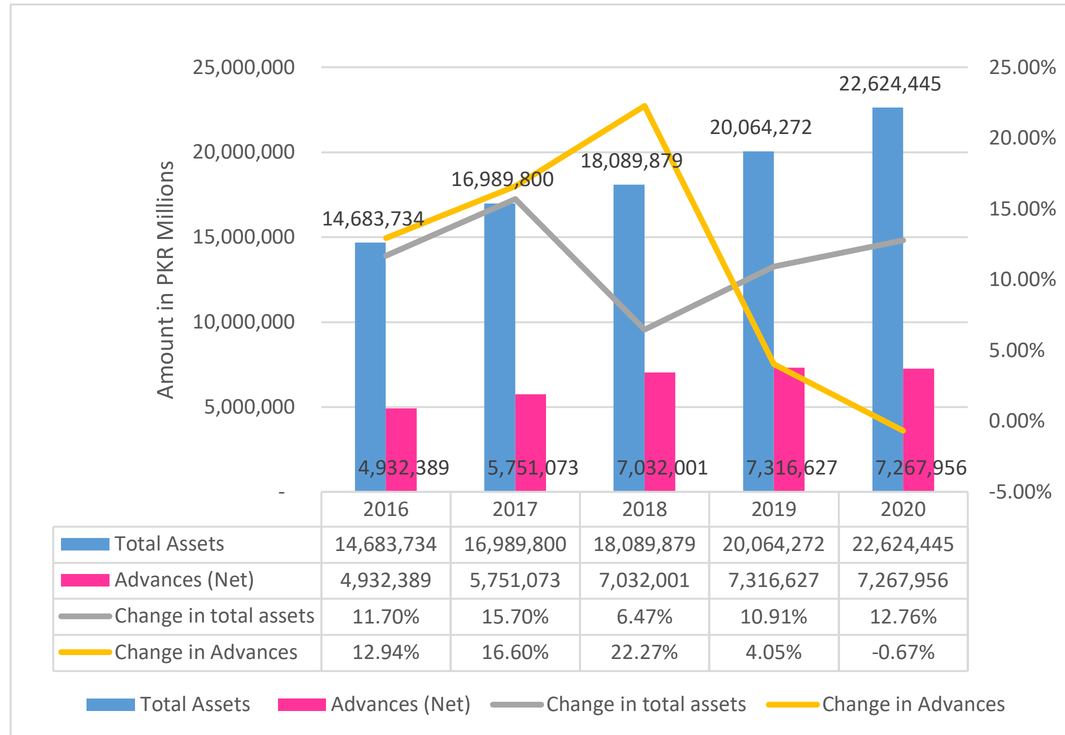
As shown in Figure 7, the total assets of the banking industry have been rising since 2017, growing from 7.3 percent in 2018 to almost 12 percent in 2019, and grew by more than 14 percent in 2020. Credit portfolios have increased but have not grown as much as assets. In 2018 advances grew by 22.15 percent, this reduced to 3.7 percent in 2019 and then a mere 0.5 percent in 2020.

Trend Analysis of Conventional Banks of Pakistan

Over the past five years, the total asset base of conventional banks (including all the commercial and specialized banks other than the Islamic Banks) has steady increased steadily, which can be attributed to the growth of Islamic

Banking Branches of conventional banks as shown in Figure 8.

FIGURE 8: TOTAL ASSETS AND NET ADVANCES OF THE CONVENTIONAL BANKS



	2016	2017	2018	2019	2020
Total Assets	14,683,734	16,989,800	18,089,879	20,064,272	22,624,445
Advances (Net)	4,932,389	5,751,073	7,032,001	7,316,627	7,267,956
Change in total assets	11.70%	15.70%	6.47%	10.91%	12.76%
Change in Advances	12.94%	16.60%	22.27%	4.05%	-0.67%

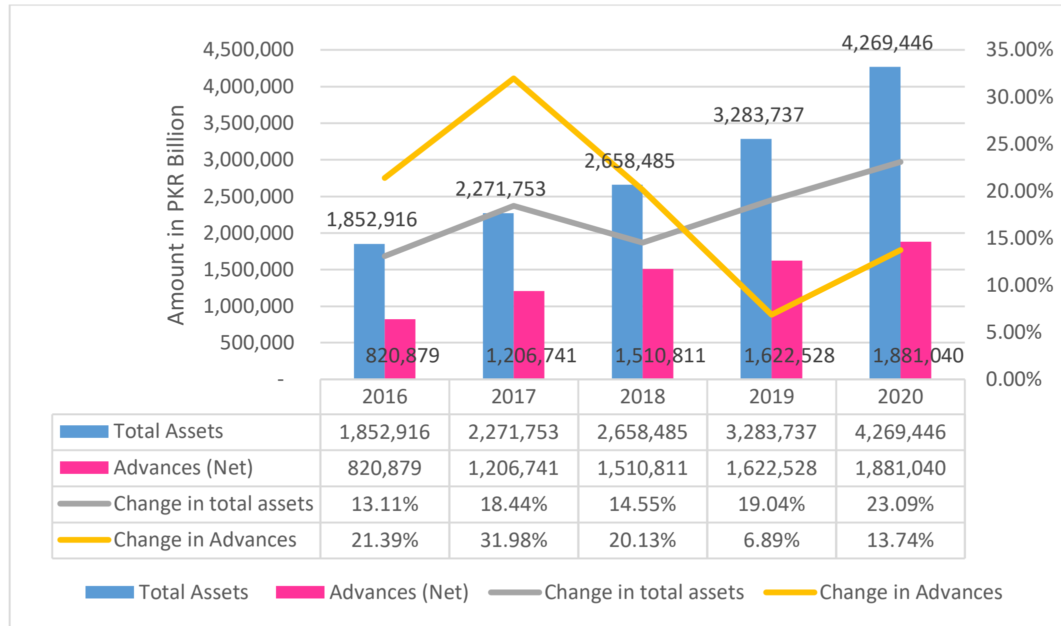
Source: Quarterly Compendium: Statistics of the Banking System, Financial Stability Department SBP, 2020

Advances, slightly decreased during 2020, mainly due to the slowdowns caused by countrywide lockdowns and social distancing restrictions. The reduction in private sector advances was broad; though financing to the textiles, cement, and sugar sectors increased during the first half of 2020.

Trend Analysis of Islamic Banking Industry of Pakistan

Figure 9 shows the total assets and finances of both Islamic Banks and Islamic Banking Institutions in Pakistan for the last five years.

FIGURE 9: TOTAL ASSETS AND NET ADVANCES OF ISLAMIC BANKING INSTITUTIONS



	2016	2017	2018	2019	2020
Total Assets	1,852,916	2,271,753	2,658,485	3,283,737	4,269,446
Advances (Net)	820,879	1,206,741	1,510,811	1,622,528	1,881,040
Change in total assets	13.11%	18.44%	14.55%	19.04%	23.09%
Change in Advances	21.39%	31.98%	20.13%	6.89%	13.74%

Source: Quarterly Compendium: Statistics of the Banking System, Financial Stability Department SBP, 2020

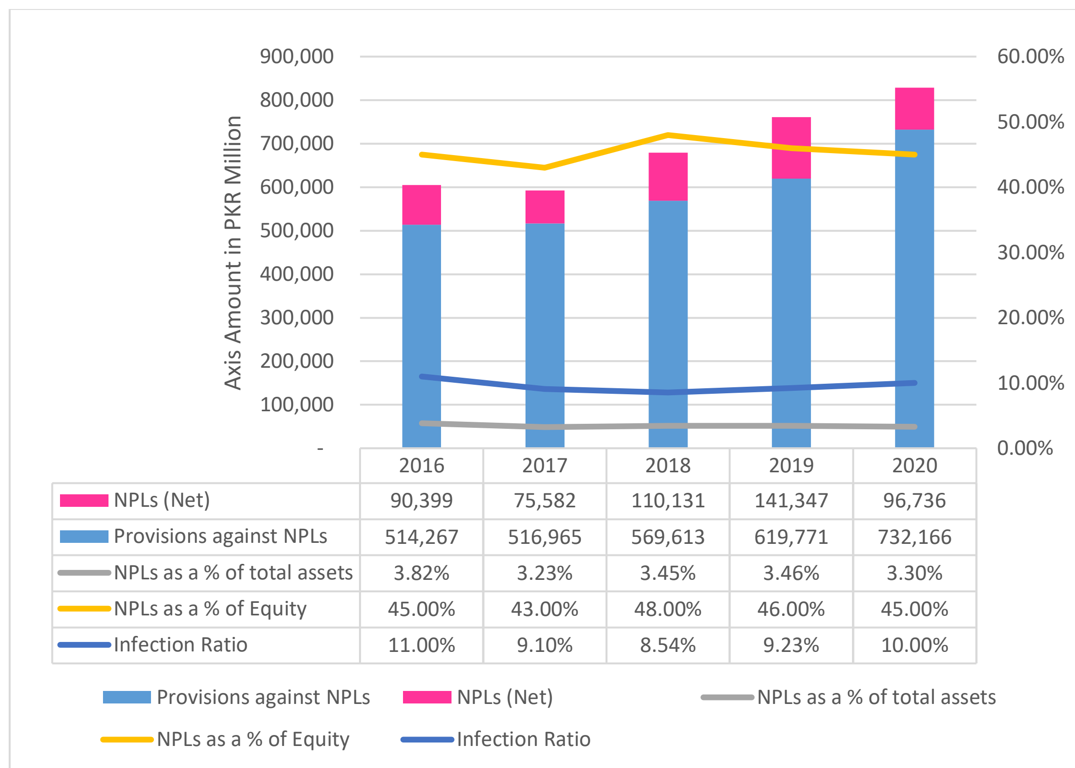
The growth in total assets shown in Figure 9 is primarily because of investments made by Islamic banking institutions that registered a considerable increase of 17.9 percent (PKR 191 billion) in 2020 and were recorded at PKR 1.2 trillion compared with a rise of 0.3 percent in corresponding period of 2019. This increase is mainly attributed to investments made by Islamic banking institutions in government sukuk between 2016 and 2020. The government issued domestic sovereign sukuk of PKR 201.2 billion during that period.

Trend Analysis of Non-Performing Loans in Pakistan's Banking Industry

Annual trend analysis of the industry shows that between 2016 and 2020, NPLs of the commercial banks in Pakistan have shown a steady increase from 2017 to 2020. However, in 2020, when compared with gross NPLs, net NPLs reduced considerably, by 32 percent, from PKR 141,347 million in 2019 to PKR 96,736 million in 2020, without a decrease the gross NPL. This can be explained by the increase in loan provisioning (18 percent) from the previous year.

Moreover, after a decline in 2017, NPLs as a percentage of assets increased in 2018 and 2019 but fell from 3.46 percent to 3.3 percent in 2020. This is because although the banking industry grew its asset base in 2020, it has been under increasing pressure caused by reduced offtake of advances, cautious customer outlook, and increases in credit losses and delinquencies. Figure 10 presents the breakdown of gross NPLs into provisions, net NPLs, and gross NPLs as a percentage of total assets.

FIGURE 10: NET NPLS AND INFECTION RATIO OF BANKING SECTOR



	2016	2017	2018	2019	2020
NPLs (Net)	90,399	75,582	110,131	141,347	96,736
Provisions against NPLs	514,267	516,965	569,613	619,771	732,166
NPLs as a % of total assets	3.82%	3.23%	3.45%	3.46%	3.30%
NPLs as a % of Equity	45.00%	43.00%	48.00%	46.00%	45.00%
Infection Ratio	11.00%	9.10%	8.54%	9.23%	10.00%

Source: Quarterly Compendium: Statistics of the Banking System, Financial Stability Department SBP, 2020

Public sector banks and specialized banks (also public sector) have the highest ratio of NPLs to assets (5.62 percent and 27.48 percent respectively) and the highest NPLs to credit portfolio infection ratio (16.99 percent and 22 percent respectively).

Among private sector banks, Table 6 shows Islamic banks have performed better than conventional banks, with the lowest ratio of NPLs to both the asset base and credit portfolios. Foreign banks have the lowest ratios, however the total advances to foreign banks in 2020, reduced significantly, from PKR 91 billion to PKR 72 billion (a decrease

of 21 percent), which could be a reason for their low NPL ratios.

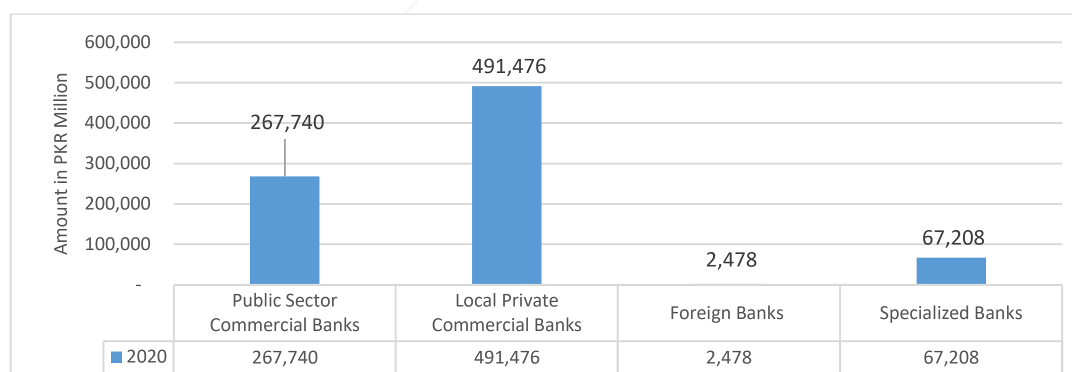
TABLE 6: NPLS AGAINST ASSET BASE AND CREDIT PORTFOLIO OF BANKS

Type	NPLs (PKR Million)	NPLs/Assets %	NPLs/Credit Portfolio %
Public Sector Banks	267,740	5.62%	16.99%
Private Sector Conventional Banks	485,515	2.88%	8.8%
Islamic Banks (Excluding IBBs)	5,961	0.58%	3.20%
Foreign Banks	2,478	0.34%	3.42%
Specialized Banks	67,208	27.48%	59.15%

Source: Quarterly Compendium: Statistics of the Banking System, Financial Stability Department SBP, 2020

- The group-wise division of NPLs as shown in Figure 11 indicates that local private commercial banks (including conventional as well as Islamic banks) hold the highest NPLs in their credit portfolio, amounting to over 59 percent of NPLs in the industry.
- Since 2017, NPLs of public sector commercial banks have increased by 25 percent, and NPLs of private commercial banks have grown by 20 percent, from PKR 291 billion to PKR 407 billion in 2020.
- Foreign banks, which hold a 0.3 percent share of total NPLs in the market, have dropped from PKR 2.84 billion in 2017 to PKR 2.48 billion in 2020.
- The NPL to equity ratio of the banking industry declined from 45 percent in 2016 to 43 percent in 2017, rose to 48 percent in 2018, and then dropped over the next two years to 46 percent in 2019 and 45percent in 2020.

FIGURE 11: BANKS' GROUP-WISE NPLS



Source: Quarterly Compendium: Statistics of the Banking System, Financial Stability Department SBP, 2020

Table 7 provides details of the split between secured and unsecured loan portfolios within the banking industry.

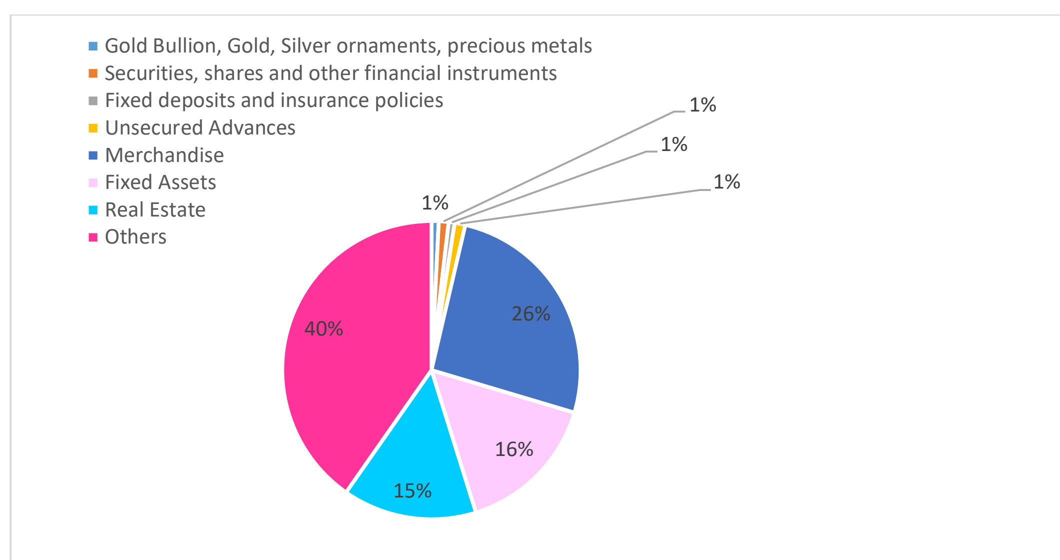
TABLE 7: COLLATERALIZED ADVANCES FOR SCHEDULED BANKS

Type	Collateralized Advances (PKR Million)	Unsecured Advances (PKR Million)	Percentage of Collateralized Advances
Public Sector Banks	1,686,621	9,037	99.47%
Private Sector Conventional Banks	6,196,716	132,567	97.91%
Foreign Banks	70,794	4	99.99%
Specialized Banks	146,478	1,298	99.12%

Source: Classification of Scheduled Banks' Advances, State Bank of Pakistan, 2020

Collateral accepted as securities by banks includes gold bullion, gold, silver ornaments, precious metals, securities, shares and other financial instruments, merchandise (food items, raw materials finished or manufactured goods), fixed assets, real estate and fixed deposits and insurance policies. The "others" category includes advances secured by guarantees and other secured advances. The composition of collateral accepted by banks in 2020 is illustrated in Figure 12.

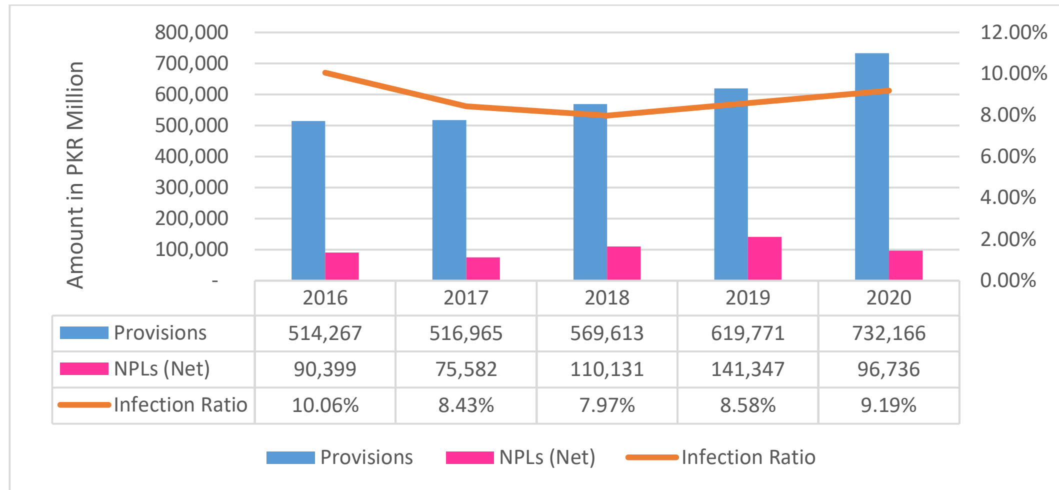
FIGURE 12: COMPOSITION OF ADVANCES BY TYPE OF COLLATERAL



Non-Performing Loans of Conventional Banks and Islamic Banks

The net NPLs of conventional banks in Pakistan reduced from PKR 90.4 billion in 2016 to PKR 75.6 billion in 2017 but increased to PKR 110 billion in 2018 and PKR 141.3 billion in 2019. In 2020, net NPLs decreased to PKR 96.7 billion, after loan deferral facilities were implemented by the central bank, which has resulted in delayed NPL recognition. This also explains the sharp increase in provisions in 2020, as shown in Figure 13.

FIGURE 13: PROVISIONS, NET NPLS, AND INFECTION RATIO

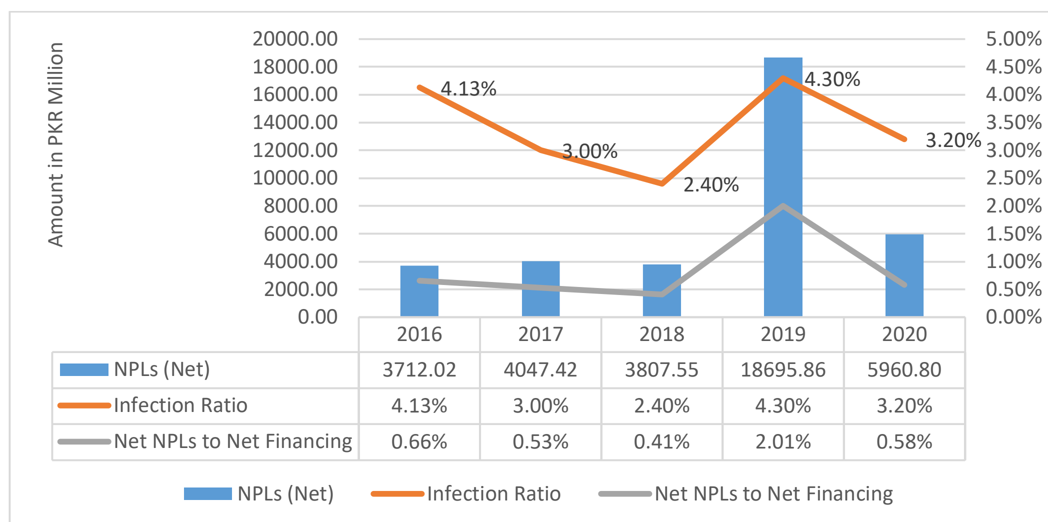


	2016	2017	2018	2019	2020
Provisions	514,267	516,965	569,613	619,771	732,166
NPLs (Net)	90,399	75,582	110,131	141,347	96,736
Infection Ratio	10.06%	8.43%	7.97%	8.58%	9.19%

Source: Quarterly Compendium: Statistics of the Banking System, Financial Stability Department SBP, 2020

For Islamic Banks in Pakistan, the infection ratio decreased from 4.13 percent in 2016 to 3 percent in 2017 as illustrated in Figure 14. It then increased in 2018 and 2019 before dropping again by the end of 2020 to 3.2 percent. Similarly, the ratio of net NPLs to net financing also decreased from 2 percent in 2019, when it was the highest in a decade, to 0.58 percent in 2020.

FIGURE 14: NET NPLS AND INFECTION RATIO OF ISLAMIC BANKS



	2016	2017	2018	2019	2020
NPLs (Net)	3712.02	4047.42	3807.55	18695.86	5960.80
Infection Ratio	4.13%	3.00%	2.40%	4.30%	3.20%
Net NPLs to Net Financing	0.66%	0.53%	0.41%	2.01%	0.58%

Source: Quarterly Compendium: Statistics of the Banking System, Financial Stability Department SBP, 2020

Top 10 banks in terms of NPLs and Infection Ratio

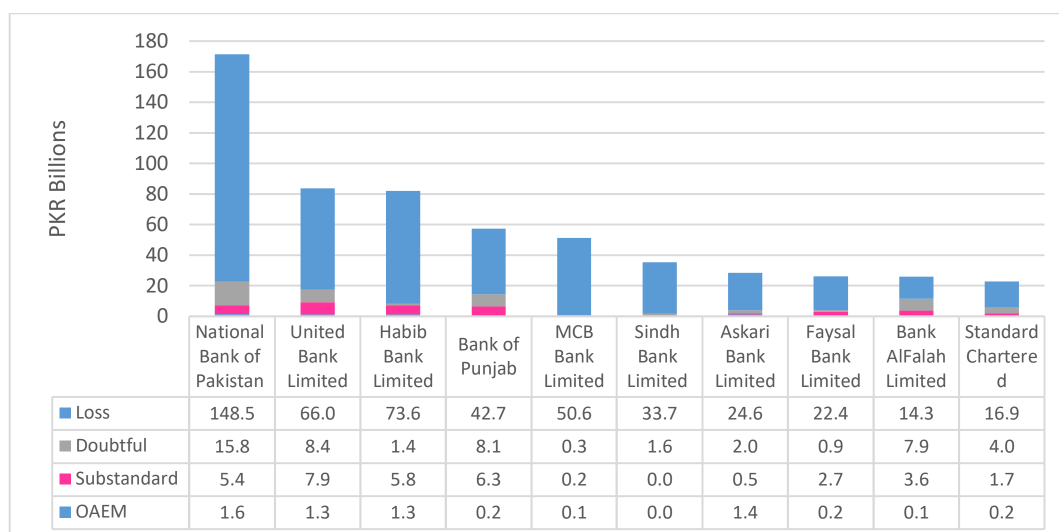
The top ten banks ranked according to highest NPLs in December 2020, are highlighted in Table 8. The NPL to credit portfolio ratio shows that Sindh Bank Limited, which ranks as sixth in terms of NPL portfolio, has the highest infection ratio (46 percent) in the banking industry. It also has the highest NPL to equity ratio of 185 percent. National Bank of Pakistan (NBP) and Bank of Punjab have the second highest infection ratios, each with 15 percent. It is important to note that the rise of NPLs for NBP to 15 percent, was larger than the usual growth rate of about 6 percent per annum (CAGR). NBP's annual report shows this larger than usual increase was mainly on account of general downturn in the economy in 2020 and effects on profitability caused by COVID-19 lockdowns.

TABLE 8: TOP 10 BANKS IN TERMS OF NPLS, 2020

Sr. No.	Bank Name	Non-Performing Loans (PKR million)	Gross Advances Portfolio (PKR million)	Equity (PKR million)	NPLs to Gross Advances Ratio (Infection)	NPLs to Equity	Market Share of NPLs
1	National Bank of Pakistan	171,294	1,159,873	274,402	15%	62%	21%
2	United Bank Limited	83,623	691,202	184,073	12%	45%	10%
3	Habib Bank Limited	82,104	1,305,409	265,495	6%	31%	10%
4	Bank of Punjab	57,251	391,890	52,383	15%	109%	7%
5	MCB Bank Limited	51,189	598,365	192,991	9%	27%	6%
6	Sindh Bank Limited	35,334	76,356	19,077	46%	185%	4%
7	Askari Bank Limited	28,411	421,819	54,681	7%	52%	3%
8	Faysal Bank Limited	26,160	339,745	60,218	8%	43%	3%
9	Bank AlFalah Limited	25,860	600,899	91,017	4%	28%	3%
10	Standard Chartered Bank Pakistan Limited	22,695	199,753	81,677	11%	28%	3%
11	Others	244,981	3,238,427	586,419	7.6%	42%	30%
Industry Totals		828,902	9,023,738	1,862,433	9.2	45%	100%

Source: Quarterly Compendium: Statistics of the Banking System, Financial Stability Department SBP, 2020

FIGURE 15: NON-PERFORMING LOANS BY CLASSIFICATIONS

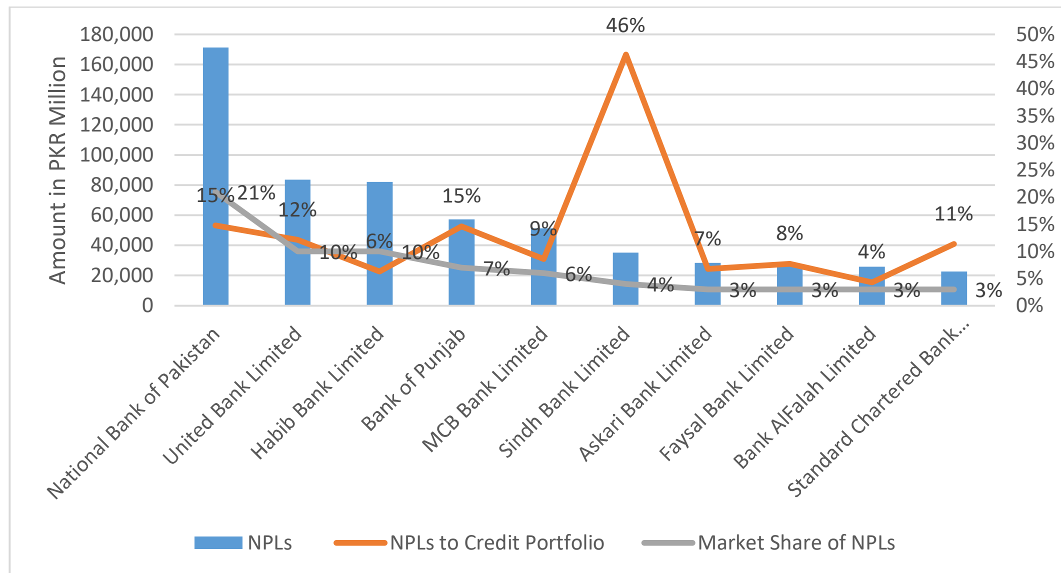


	National Bank of Pakistan	United Bank Limited	Habib Bank Limited	Bank of Punjab	MCB Bank Limited	Sindh Bank Limited	Askari Bank Limited	Faysal Bank Limited	Bank AlFalah Limited	Standard Chartered
Loss	148.5	66.0	73.6	42.7	50.6	33.7	24.6	22.4	14.3	16.9
Doubtful	15.8	8.4	1.4	8.1	0.3	1.6	2.0	0.9	7.9	4.0
Substandard	5.4	7.9	5.8	6.3	0.2	0.0	0.5	2.7	3.6	1.7
OAEM	1.6	1.3	1.3	0.2	0.1	0.0	1.4	0.2	0.1	0.2

Source: Annual Reports 2020 for Top 10 Banks

In absolute terms, the NBP is the second largest bank in terms of total assets, but it has the largest portfolio of NPLs, accounting for 21 percent of all NPLs in the country, as shown in Figure 16. This is primarily because it is a public sector commercial bank, which tend to have a higher risk of loan defaults than private commercial banks or foreign banks. Similarly, the Bank of Punjab, also a public sector commercial bank, ranks fourth bank for the highest percentage of NPLs. It owns about 7 percent of the total share of NPLs in the market although it holds only to 4 percent of the industry's total assets.

FIGURE 16: TOP 10 BANKS IN TERMS OF NPLs



Source: Financial Report 2020, Pakistan Stock Exchange, 2020

There are several reasons for higher infection ratios for Pakistan's public sector banks. First, their increased participation in government-led schemes or initiations as part of their developmental role in the economy. Over the past two decades, it has been common for the national and provincial governments to assign public sector banks a responsibility to fund or execute projects either fully or partially or as a first mover. Funding and services include sector-specific concessional loans, interest free loans, and collection services. These developmental initiatives or government schemes are not evaluated by public sector banks for their commercial viability. Together with the desire to meet targets (such as loan disbursements) over short periods, they result in sub-optimal underwriting practices and poor enforcement of credit quality standards. These lax practices, politically motivated loans and malpractices caused by weak governance and control mechanisms contribute to a higher stock of NPLs in public sector banks.

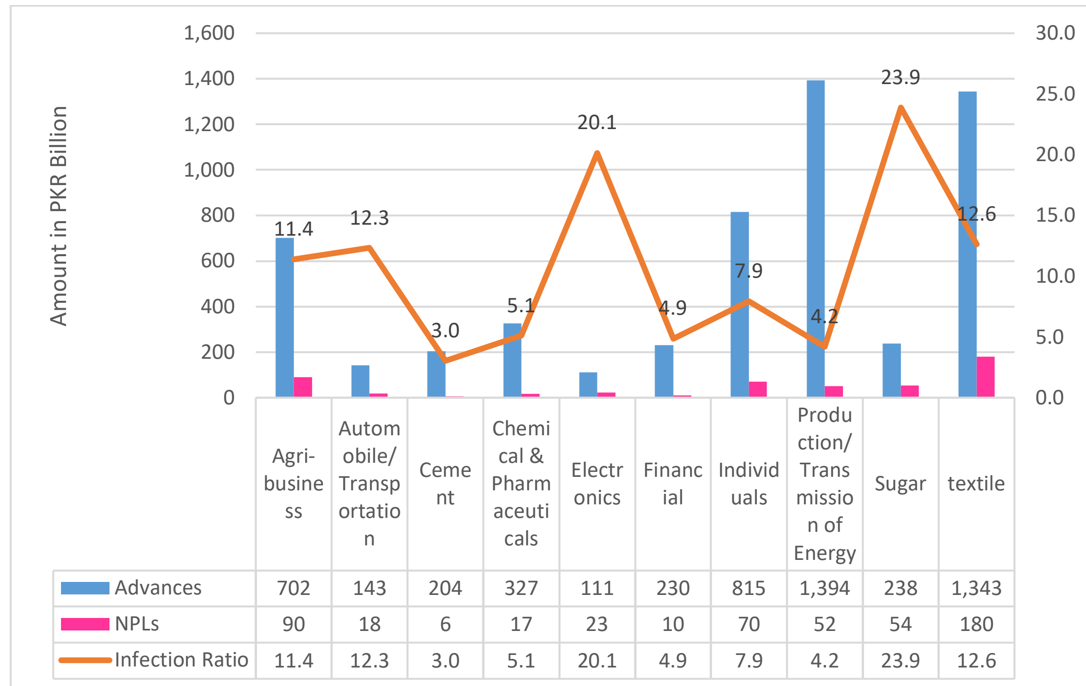
Writing-off loans to clean up balance sheets is heavily stigmatized and carries poor public opinion in Pakistan, mainly a result of previous court decisions or political campaigns. This has branded written-off loans as loans not granted or availed in good faith and a waste of public money or source of corruption. Public sector banks are the worst affected by this anti-write off culture, since they are in practice directly governed and controlled by the government despite the presence of an independent Boards of Directors. The increased scrutiny and activism by law enforcement and national accountability agencies and greater questioning of bank officials about the particulars of write-offs in the past few years has also contributed to this problem. This practice and an aversion to writing off uncollectible loans results in accumulation of NPL stocks and rising infection ratios.

Sector-wise distribution of Advances and NPLs

Analyzing the sector-wise distribution of advances helps to identify the main recipients of banking sector credit. Figure 17 shows the sector-wise distribution of advances and NPLs for the top 10 industry sectors, accounting for 61 percent of NPLs. The production and transmission of energy accounted for 15 percent of advances, with a credit volume of PKR 1.39 trillion and a further 15 percent was loaned to the textile sector, with a credit volume of 1.34

trillion. These two sectors are followed by individuals, including retail and personal loans, which borrowed around 9 percent and agribusiness borrowed 8 percent of all advances.

FIGURE 17: DISTRIBUTION OF ADVANCES AND NPLS OF TOP 10 SECTORS



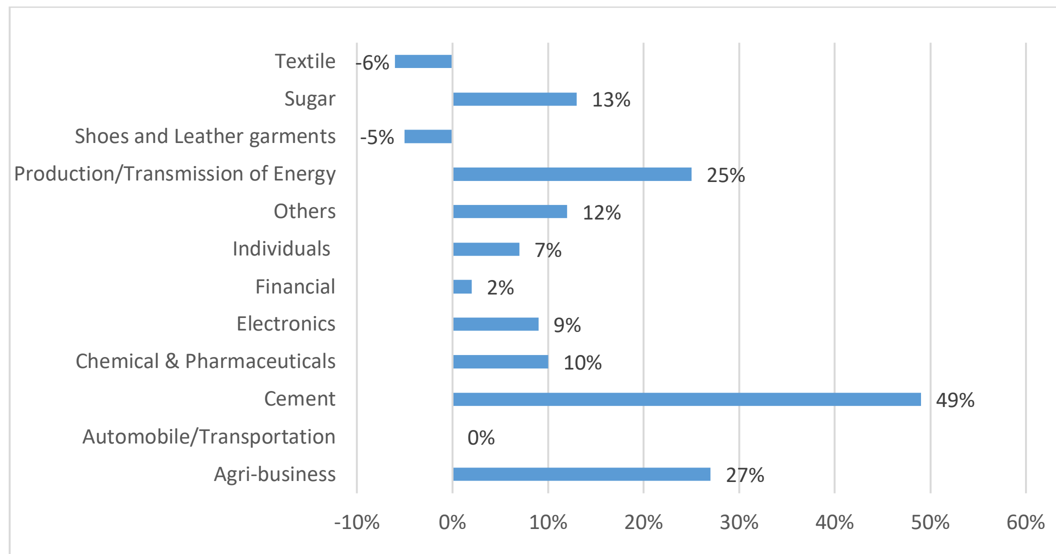
	Agri-business	Automobile/ Transportation	Cement	Chemical & Pharmaceuticals	Electronics	Financial	Individuals	Production/ Transmission of Energy	Sugar	textile
Advances	702	143	204	327	111	230	815	1,394	238	1,343
NPLs	90	18	6	17	23	10	70	52	54	180
Infection Ratio	11.4	12.3	3.0	5.1	20.1	4.9	7.9	4.2	23.9	12.6

Source: Quarterly Compendium: Statistics of the Banking System, Financial Stability Department SBP, 2020

Although the energy sector had the most advances, the sugar, electronics, textile, agribusiness, and automobile sectors had the highest rates of NPLs in 2020. During second half of 2020, COVID-19 and locust plagues reduced Pakistan's agricultural sector's growth prospects and put millions of farmers under distress. Over the past three years, the electronics sector's infection ratio has risen from 15.7 percent to 20.7 percent, while the textile sector ratio has improved to 14.7 percent from 22 percent.

The change in NPLs within the different sectors (Figure 18) shows that NPLs of textile and shoes and leather garments sectors have declined by 6 percent and 5 percent respectively. The cement, agri-business, power/transmission of energy and sugar sectors, had the most banking sector NPLs in 2020. Most of the increases in NPLs came from the cement sector (49 percent) followed by agribusiness (27 percent) and the production and transmission of energy (25 percent). The rise in NPLs could have been higher if the SBP had not allowed banks to consider deferring, restructuring and rescheduling of loans on borrowers' request. NPLs for the banking sector increased to an average of 9.2 percent of loans during 2020, from an average of 8.6 percent in 2019, although banks were expected to manage infections with the government's support.

FIGURE 18: SECTOR-WISE CHANGES IN NPLS

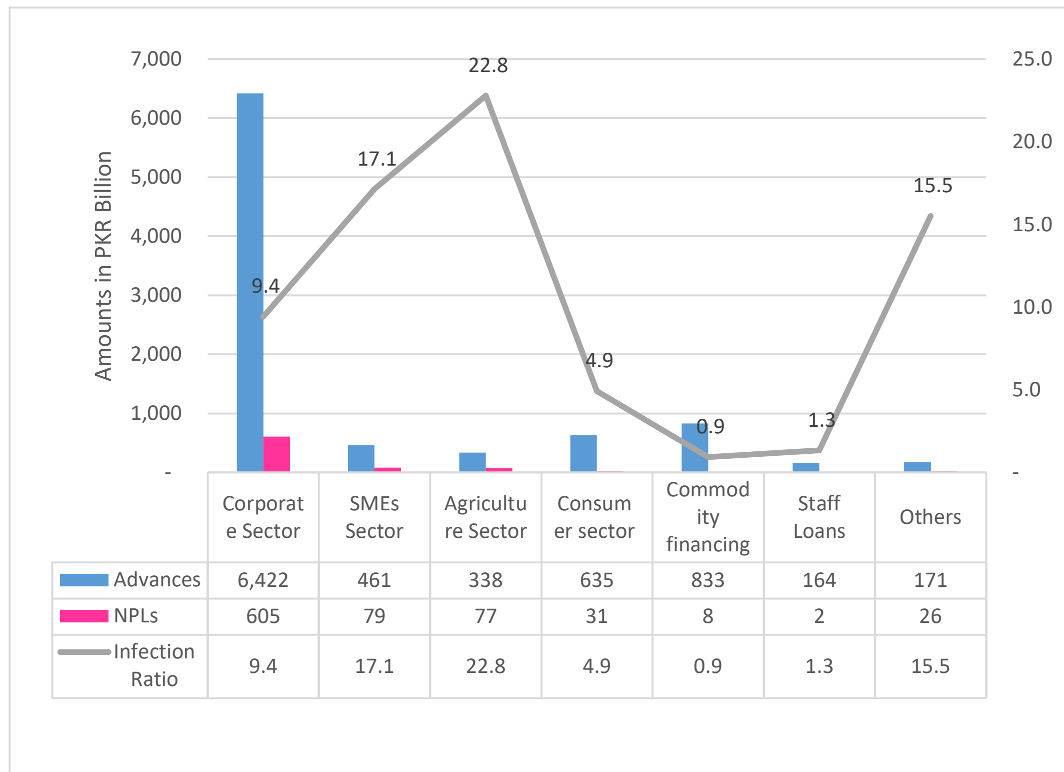


Source: Quarterly Compendium: Statistics of the Banking System, Financial Stability Department SBP, 2020

Analysis of Segment-wise division of Advances and NPLs for 2020

Analysis shows that 71 percent of bank advances go to the corporate sector, which has an infection ratio of 9.4 percent. The commodity financing sector, which has the second highest share of advances has the lowest infection rate – just 0.9 percent. Agribusiness has the highest infection ratio, 22.8 percent, followed by the SME sector which has an infection ratio of 17.1 percent. Details of all segments are in Figure 19.

FIGURE 19: SEGMENT-WISE DIVISION OF ADVANCES AND NPLS



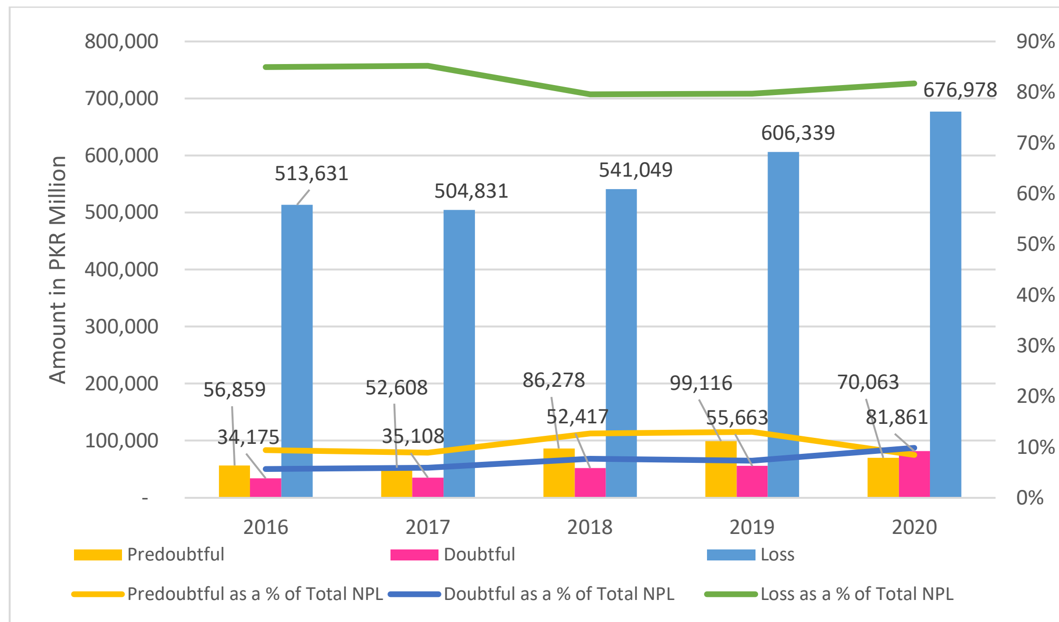
	Corporate Sector	SMEs Sector	Agriculture Sector	Consumer sector	Commodity financing	Staff Loans	Others
Advances	6,422	461	338	635	833	164	171
NPLs	605	79	77	31	8	2	26
Infection Ratio	9.4	17.1	22.8	4.9	0.9	1.3	15.5

Source: Quarterly Compendium: Statistics of the Banking System, Financial Stability Department SBP, 2020

Trend Analysis of Categories of NPLs

For this analysis, NPLs have been characterized as pre-doubtful (including OAEM and substandard NPLs), doubtful, and loss. Figure 20 shows that more than 80 percent of the NPLs in the last five years were losses. In 2020, loss NPLs increased from PKR 606 billion to PKR 677 billion; doubtful NPLs increased from PKR 56 billion in 2019 to PKR 82 billion in 2020; and pre-doubtful NPLs fell from PKR 99 billion to PKR 70 billion.

FIGURE 20: CATEGORY-WISE BREAKUP OF NPLS



Source: Quarterly Compendium: Statistics of the Banking System, Financial Stability Department SBP, 2020

Key take-aways from this Analysis

- The banking sector grew by 7.8 percent in 2020 and after-tax profits (including listed commercial banks) increased by 34 percent (compared with 21 percent in 2019).
  The increased profitability was primarily the result of various relief measures taken by the government and the SBP. These included, a 625 basis points cut in the policy rate, principal deferment scheme (which resulted in PKR 657 billion worth of loans being deferred), temporary economic reforms facility (TERF), relaxations in the regulatory criteria for restructuring of loans, increased borrowing and lending limits for consumer and SME financing, and some relaxations in regulatory capital limits. On the back of these measures, net interest income rose by 25 percent while non-mark-up income jumped by 16 percent, mainly due to strong capital gains in treasuries which increased by roughly 11 times year on year.
- Long-term trends in asset and deposit growth and the rising capital adequacy ratios, reflect the steady growth of Pakistan's banking industry. However, this growth has had a decreasing contribution to the wider economy as evidenced by a consistently declining private sector credit to GDP ratio and a falling advances to deposit ratio. One of the reasons for this is the crowding out of private sector borrowers due to excessive government borrowing.
- In 2020, net NPLs reduced considerably, by 32 percent, but gross NPLs have grown, due to the increases in loan provisioning (18 percent). The infection ratio for the industry was 9 percent.
- More than 80 percent of NPLs in the last five years fell into the loss category. The pre-doubtful NPLs in 2020 reduced by 29 percent, while the numbers of NPLs categorized as doubtful and loss rose.
- Private sector banks own the largest share of NPLs, but the infection ratio of public sector banks and specialized banks (owned by the state) are the highest.
- The top 10 banks in terms of NPLs include National Bank of Pakistan, with an infection ratio of 15 percent and a market share of 21 percent, United Bank Limited with an infection ratio of 12 percent, and a market

share of 10 percent, and Habib Bank Limited, with an infection ratio of 6 percent and a market share of 10 percent.

- The energy sector (production and transmission) receives the most advances in the industry. However, the highest NPLs are from the sugar, electronics, textile, agribusiness, and automobile sectors. The change in NPLs in 2020 within the different sectors shows that for the textile and shoes and leather garments sectors, they have declined by 6 percent and 5 percent respectively and, highest growth in NPLs was in the cement, agribusiness and production and transmission of energy sectors.

5. PRUDENTIAL REQUIREMENTS FOR MANAGING & REPORTING NPLS

A review of prudential requirements (PRs) for managing and reporting NPLs is critical in the context of this study as they provide minimum regulatory standards and expectations for recognizing, accounting, reporting, managing, restructuring, and writing off NPLs. These requirements have direct and indirect impacts on the profitability, risk premiums, interest margins and balance-sheet liquidity of banks. They also affect (favorably or unfavorably) the potential for developing an NPL market depending on whether the requirements are enabling or restrictive. Lastly, these requirements help to maintain a sound financial sector through their reporting and disclosure requirements.

The PRs provide guidance for classifying and provisioning of loans. Banks in Pakistan categorize loans in the following broad categories:

i. Satisfactory/performing accounts where there is no evidence of weakness, and all obligations are met on time.

ii. Watch list accounts where the account starts showing early signs of a borrower's inability to meet commitments and require close monitoring. There is generally no provisioning in this category as the account only shows early signs of credit deterioration, but occasionally subjective provisions are made against these exposures.

iii. Depending on the days past due (DPD), NPLs are classified according to the SBP's requirements. Classifications include (the percentages can vary for some asset classes):

   a) Other Assets Especially Mentioned (OAEM) having the requirement of 10 percent provision of the outstanding loan amount, these are advances in arrears for 89 days or less.
   b) Substandard having the requirement of 25 percent provision of the outstanding loan amount, these are advances in arrears for 90 days or more but fewer than 180 days.
   c) Doubtful having the requirement of 50 percent provision of the outstanding loan amount, these are advances in arrears for 180 days or more but fewer than 365 days.
   d) Loss having the requirement of 100 percent provision of the outstanding loan amount, these are advances in arrears for 365 days or more.

The SBP has issued specific PRs for specific asset classes such as agriculture financing, housing finance, and consumer financing. Annex T provides a comprehensive list of all the PRs and the NPL classification categories based on days past due.

The following sections discuss the relevant aspects of credit risk management frameworks and practices of banks in Pakistan, the NPL reporting framework, write off framework, and collateral framework, and compare them with practices and guidance issued by European regulators and by global standard setters.

5.1. Analysis of Macro prudential regulations

Macro prudential regulations primarily aim to ensure the stability of a financial system. SBP in Pakistan has occasionally issued specific prudential regulations for different segments of borrowers, including a specific set of PRs for corporate and commercial borrowers. Under these, SBP provides guidelines to banks on the risk management and operations of credit cases. PRs for corporate and commercial borrowers set specific exposure limits, allowed investments, detail collateral guidelines and minimum margin requirements, and provide regulatory guidelines, including provisioning requirements, non-funded exposures, and window dressing.[7]

In addition to these prudential regulations, SBP has issued several other detailed guidelines and instructions to banks on their credit risk management strategies, policies, tools, and processes. These include guidelines on overall

[7] State Bank of Pakistan, (2015) Prudential Regulations for Corporate/Commercial Banking (Risk Management, Corporate Governance and Operations) https://www.sbp.org.pk/publications/prudential/PRs-Jan-2015.pdf

credit risk management and on credit scoring models used to analyze borrowers' credit risk.

SBP is also formulating and implementing a wider and comprehensive Macro Prudential Policy Framework (MPPF) to ensure system-wide financial sector stability. To enhance its assessment of pro-cyclical systemic risk capabilities, SBP has established a macro stress-testing regime to capture macro-financial interlinkages. Several variables were identified as early warning indicators (EWIs) of systemic risk. SBP is coordinating with the Securities & Exchange Commission of Pakistan (SECP) and Finance Division to create a National Financial Stability Council (NFSC) and a well-structured institutional setup for MPPF.

A survey carried out by the International Monetary Fund (IMF) across 49 countries, identified the nine instruments that have been most frequently applied to achieve macro prudential objectives.[8] Table 9 shows the instruments for Pakistan.

TABLE 9: MACRO-PRUDENTIAL INSTRUMENTS

Macro-Prudential Instrument	Regulated by SBP	Requirement
Caps on Loan to Value (LTV)	Yes	30% for Equity Instruments 20% for eligible TFCs Instruments
Caps on Debt to Income (DTI)	No	-
Ceilings on credit or credit growth	No	-
Caps on Foreign Currency Lending / Limits on net open currency / currency mismatch	Yes	Foreign Exchange Exposure Limits (FEEL) up to 25% of the paid up capital of the bank are defined
Limits on maturity mismatch	No	-
Reserve Requirements	Yes	SLR: Conventional Banks: 19%; IBs/IBBs: 14% CRR: 5%.
Countercyclical Capital Requirements	No	-
Time-varying dynamic provisioning	No	-
Restrictions on profit-distribution	Yes	Banks are allowed to suspend dividends for capital buffer.

Compared with other developing countries in the region, SBP's prudential regulations are slightly more stringent in terms of risk limits and regulations. Table 10 shows that risk exposure limits for corporate borrowers are lower than the average of neighboring developing economies.

[8] International Monetary Fund, (2011) Macroprudential Policy: What Instruments and How to Use Them? https://www.imf.org/external/pubs/ft/wp/2011/wp11238.pdf

TABLE 10: EXPOSURE LIMITS FOR COUNTRIES

	Pakistan	Bangladesh	Turkey	India
Exposure Limit for Group	Total Exposure: 25% of the capital Funded Exposure: 25% of the capital	Total Exposure: 35% of the capital Funded Exposure: 15% of the capital	Total Exposure: 25% of the Capital	Total: 30%

Under SBP's PRs, large exposures are defined as exposures exceeding 10 percent of a bank's equity, which is in line with other countries, including Bangladesh. Moreover, the overall Foreign Exchange Exposure Limit (FEEL) is set at 25 percent of a bank's capital, or Rs 5,000 million, whichever is higher.[9]

Similarly, reserve requirements are also different for banks in Pakistan compared with other countries.

TABLE 11: RESERVE REQUIREMENTS FOR COUNTRIES

	Pakistan	Bangladesh	Malaysia	India
Reserve requirements	FX: 1. 5% Cash Reserve Account (US$) 2. 10% Special Cash Reserve Account (US$) PKR: SLR: Conventional Banks: 19%; IBs/IBBs: 14% CRR: 5%.	Conventional Banks SLR: 13% CRR: 4% Islamic Banks: SLR: 5.5% CRR: 4%	2% of eligible liabilities	4% of NDTL SLR: 18%

5.2. NPL Reporting Framework for Banks in Pakistan

The NPL reporting of banks in Pakistan is three broad categories.

1. Internal Reporting (Management Reporting): Reports that are internally generated by banks for ongoing monitoring and decision making on performing, watch-listed, and NPLs. Typically, a bank's Credit Administration Department (CAD) and a Finance Department regularly report key information to Business Heads, Chief Risk Officer (Risk Management Department), Head of Special Asset Management (Special Asset Management Department), Credit Risk Committee of the Management and Board Risk & Compliance Committee.

Reports and relevant analysis are prepared by risk management departments (or by credit administration) and are submitted to Board Risk Management Committees quarterly, or sometimes more frequently. Similar reports and analysis based are used by management risk committees and relevant business units. The business risk review function of a bank's internal audit department also uses NPL reports to review the quality and risk review a bank's

[9] State Bank of Pakistan (July 2020), Foreign Exchange Exposure Limit (FEEL), DMMD Circular No.16 of 2020 https://www.sbp.org.pk/dmmd/2020/C16.htm

loan book. Typical reports include:

- Days past due reports
- Single party exposure
- Group exposure
- Product exposure
- Sector wise exposure
- Risk rating wise exposure
- Classified exposure
- Region/ Business Division wise exposure
- Facility wise exposure, including unfunded exposures
- Detail of securities held by the bank
- External rating of credit exposure
- Property held under Debt Property Swap Arrangement
- Statements of discrepant documents, further bifurcated into various products and business divisions

Banks also reporting on the watch-listing of accounts and watch-listed accounts. Watch-listing is where accounts with signs of deterioration and flagged for enhanced monitoring and management. Credit policies require business functions, especially branches or relationship managers, to identify and report on deteriorating credits for watch-listing. These are also identified by risk management departments, internal, or external auditors based on publicly available information such as account behavior with other lending banks, borrower litigations, borrower financials statements, or payment behavior.

2. External Reporting: Banks are required to report standard disclosures in their periodic or annual statutory financial statements. Bank financial statements are produced in Pakistan according to the format of financial statements specified by the SBP, the Companies Act, 2017, and the Banking Companies Ordinance, 1962.

In the financial statements, banks are required to report on performing and non-performing advances at a minimum (for comparative periods):

i. Gross advances performing and non-performing by:
   a. Loans / advances (conventional business)
   b. Islamic financing and related assets
   c. Bills discounted or purchased

ii. Specific provision against:
   a. Loans / advances (conventional business)
   b. Islamic financing and related assets
   c. Bills discounted or purchased

iii. General provision against performing advances

iv. Maturity wise disclosure of finance leases

v. Gross advances in local currency and foreign currency

vi. Domestic NPLs and provisions against NPLs as defined in Annex T

vii. A movement of General and Specific Provisions comprising:
   a. Opening balance
   b. Provision charged during the year
   c. Reversals

d. Amounts written off

e. Amounts written off against agriculture financing

f. Closing balance

viii. If the bank has taken the benefit of Forced Sale Value (FSV) in computing the provisions against NPLs subject to the criteria and limits provided by the prudential regulations, banks are required to disclose this and the benefit of FSV availed.

ix. For write offs, the following information needs to be specifically disclosed:

a. Loans written off against provisions

b. Loans directly charged to profit and loss account (direct write offs)

c. Domestic and overseas write offs above PKR 500,000 and below PKR 500,000

x. As per the Banking Companies Ordinance, 1962, banks are required to disclose written off loans or any other financial relief of PKR 500,000 or more in an annexure to its annual financial statements, except where such disclosure is restricted by overseas regulatory authorities. The disclosure should include:

a. Name and address of the borrower

b. Name of individuals, partners, or directors with their CNIC no.

c. Total outstanding principle, markup and other charges

d. Written off – principle and markup

e. Other financial relief (amount)

xi. A movement of advances and provisions for exposure to related parties

xii. Gross advances, NPLs and associated provisions by industry sectors such as textiles, agriculture, cement and sugar.

xiii. Gross advances, NPLs and associated provisions by exposure to public sector and private sector

xiv. Banks are also required to disclose guarantees, commitments, and other off-balance sheet exposures in financial statements.

xv. In addition to these requirements, banks must also make disclosures of debt property swap arrangements. This includes of all terms and conditions of DPS and associated costs to be borne by each party, actual gains or losses realized on the sale of each one of these properties, and provision reversal and NPL reduction, resulting from settlement through DPS.[10]

3. Regulatory Reporting: Banks regularly report to the SBP for it to use during onsite inspections, in the data bank of the Credit Information Bureau and when publishing various industry-wide reports or other aggregates.

TABLE 12: SBP REPORTING REQUIREMENTS

S. No.	Name and Circular Reference	Frequency	Reporting Requirements
1	Monthly statement of loans classified by category of borrowers - A-07	Monthly	• Borrower Name/ Institution • Exposure category • Outstanding • Disbursement • No. of Accounts • Non-performing assets and provision against such non-performing assets

[10] State Bank of Pakistan (2016), Regulations for Debt Property Swap https://www.sbp.org.pk/bprd/2016/C1-DPS-Regulations.pdf

S. No.	Name and Circular Reference	Frequency	Reporting Requirements
			• Loan Application Received, Accepted, in-progress, Rejected (numbers and PKR)
2	Statements of position - BSD Circular No. 4 of 2005	Weekly, Monthly and Quarterly	• Gross Advances • Provisions – General and Specific • Gross Advances by public and private sectors • Schedule of exposures to public sector by category including federal, provincial, local governments, state enterprises and autonomous bodies
3	Conditions on Non-performing Loans - BSD Circular 9 of 2003	Quarterly	• A quarterly movement of NPLs showing adjustments for cash recovery, rescheduling, or restructuring. This information is presented for domestic and overseas NPLs further divided by public and private sector NPLs. • Category wise (OAEM, Sub-standard, Doubtful, Loss) provision required and provision held against the above. • Sectoral classification of NPLs presented in (a) above
4	Reporting to Electronic Credit Information Bureau (eCIB)	Monthly	• Financial and non-financial information • Customer information • Director information • Details of guarantors • Information of associated companies/ parent/ group • Approved financing limits • Total outstanding principal • Total outstanding markup • Total outstanding principal in days past due buckets • Total outstanding markup in days past due buckets • Amount restructured or rescheduled • Amount under litigation • Amount written off or waiver provided • Amount of any cash recovery against loans past due 90 days • Provision • Aging (past due buckets) • Customer rating information • Collateral information • In case only partial liability is settled through DPS, the banks will report the outstanding amount in its respective overdue/classification category of eCIB and NPLs reporting.
5	Reversals of provision against cash recovery	Quarterly	• Borrower name • Amount classified • Category of classification • Provision held at the start of the quarter • Provision reversed
6	Details of loans and advances rescheduled/ restructured	Monthly	• Outstanding markup, principal, and other charges at the time of rescheduling / restructuring

S. No.	Name and Circular Reference	Frequency	Reporting Requirements
			• Category of classification at the time of rescheduling / restructuring • Date of rescheduling or restructuring • Final repayment date as per rescheduling or restructuring • Grace period in months (if any) • Amount written-off or waived: a. Principal b. Markup c. Other Charges d. Total amount/ written off waived

5.3. Prudential Treatment of Restructured Loans

The PRs for corporate and commercial banking (PRs for other loan asset types follow similar requirements), require that loan restructuring takes place when borrowers facing financial difficulty are granted concessions by banks which intend to improve performance of the loan. Restructuring relaxes the terms and conditions of the financing facility, including repayment tenor, mark-up and profit rate and charges and fees. Rescheduling is a similar concept, where a financing facility is modified by extending the loan period, without changing any other terms and conditions.

- The prudential regulations state that banks may reschedule or restructure their loans as per their policy (common features of banks' policies on restructuring are covered in the next section) but changes should not be aimed at avoiding classifying the loan as non-performing.
- At the time of rescheduling or restructuring, banks and DFIs must consider and examine the requests for working capital strictly on merit, taking into consideration the viability of the project or business, and appropriately securing their interest.
- All fresh loans granted by the banks to a borrower after rescheduling or restructuring a borrower's existing facilities are to be monitored separately and are subject to classification under the prudential regulations on the strength of their own specific terms and conditions.
- Banks are further required to ensure that the classification status and provisioning, is unchanged in relevant reports to the SBP merely because a loan has been rescheduled or restructured. However, while reporting to the SBP's Credit Information Bureau (CIB), such loans or advances may be shown as 'rescheduled or restructured' instead of 'overdue'.
    - The SBP has instructed all FIs that in the case of recovery against overdue/write off/late payment, FIs will clearly mention a debtor's borrowing history including overdue/write off/late payments in debtor clearance letters and their history will be reflected in the debtor's credit report for one year.
    - In amendments to the Prudential Regulations for SME Financing, the SBP allows banks and DFIs to use credit information reports of private credit bureaus that are licensed by the SBP. These are aimed at facilitating SME financing by providing an enabling regulatory environment.[11] While considering any credit proposal (including renewing, enhancing, rescheduling or restructuring), banks shall obtain an e-CIB report on their prospective borrower(s) from Electronic Credit Information Bureau.
- When an NPL has been restructured or rescheduled by a bank, its classification category can only be changed to performing or upgraded when the terms and conditions of the rescheduling or restructuring are fully met for a period of at least one year (excluding any grace period) and at least 10 percent of the total restructured loan

[11] State Bank of Pakistan (2021), Prudential Regulations - Small & Medium Enterprise Financing https://www.sbp.org.pk/publications/prudential/SME-PRs-Updtd-Apr-2021.pdf

amount (principal and mark-up), is recovered in cash. If the borrower repays or adjusts in cash at least 35 percent of the total restructured loan amount, the one-year period for declassification will not apply.

- Regardless of the classification status of the restructured/rescheduled loan, the unrealized mark-up on loans declassified after rescheduling or restructuring can only be considered income when at least 50 percent of the amount is realized in cash.
- If a borrower defaults either on principal or mark-up after the rescheduled or restructured loan has been declassified, the loan will again be reclassified to the same category it was in at the time of rescheduling or restructuring, and the unrealized markup taken to income account will also be reversed. Banks may further downgrade the classification, considering the subjective criteria, at their discretion.

5.4. NPL Reporting Framework for Banks in Europe

Supervisory (Regulatory) Reporting

In Europe, the EBA has developed a mandatory FINREP framework for providing guidance to the banks for supervisory reporting of financial information, including NPLs. Within this there is a set of reporting templates and two of which refer to NPLs and forborne loans. All investment firms and banks in the euro zone must report according to this framework as it is a basis for EBA and ECB analysis and supervision.

In 2018, the European Banking Authority (EBA) published final guidelines on the disclosure of non-performing and forborne exposures.[12] They provided additional disclosure requirements for NPLs and forborne exposures that are consistent with the Guidance for Banks on NPLs issued by the ECB.[13] These requirements were intended to provide market participants and stakeholders a better picture of the quality of banks' assets, the main features of their non-performing and forborne exposures, and in the case of more troubled banks, the distribution of the problematic assets and the value of the collateral backing those assets.

The disclosure requirements in these guidelines are based on the proportionality principle and the guidelines included a set of common templates applicable to all banks, and a set of additional templates applicable only to credit institutions with a gross NPL ratio of 5 percent or higher.

The EBA guidelines require disclosures from all banks on account of NPLs and forborne exposures, details of which are covered in Annex R.

EBA NPL Templates

To reduce information asymmetries between potential buyers and sellers of NPLs and as a foundation for secondary NPL market initiatives, the EBA also issued voluntary NPL templates in 2017.[14] They allow banks to supply comparable and standardized data on NPLs to investors and other stakeholders. The practical experience from their use and feedback from banks resulted in a redesign to improve their effectiveness and usability. Despite these changes, the NPL data templates are not widely used due to their voluntary nature and complexity.[15] Annex I has more details on EBA NPL Templates.

5.5. A Comparison of SBP's NPL Reporting Requirements with European NPL Reporting Requirements

A comparison of the NPL regulatory reporting requirements of the SBP with those set by the EBA both under

[12] European Banking Authority (October 2018), Guidelines on management of non-performing and forborne exposures https://www.eba.europa.eu/sites/default/documents/files/documents/10180/2425705/371ff4ba-d7db-4fa9-a3c7-231cb9c2a26a/Final%20Guidelines%20on%20management%20of%20non-performing%20and%20forborne%20exposures.pdf

[13] European Central Bank (2017), Guidance to banks on non-performing loans https://www.bankingsupervision.europa.eu/ecb/pub/pdf/guidance_on_npl.en.pdf

[14] "NPLs," European Banking Authority, accessed February 18, 2021, https://www.eba.europa.eu/risk-analysis-and-data/npls

15 Napoli, Caterina; Ruvolo, Alessio Gerhart, (May 6, 2021), "The EBA discussion paper for the review of the standardized NPL data templates," Diritobancario https://www.dirittobancario.it/art/eba-discussion-paper-review-standardized-npl-data-templates/

supervisory reporting and voluntary NPL reporting highlights several differences.

TABLE 13: SBP & EUROPEAN NPL REPORTING REQUIREMENTS

SBP NPL Reporting Requirements	European NPL Reporting Requirements
SBP's NPL regulatory reporting requirements are standardized for all the commercial banks in Pakistan and there is no concept of proportionality where additional disclosures are required, or additional information is required for banks meeting certain risk criteria.	The EBA has standardized criteria for all banks in the FINREP framework for standardized reporting (which contains two specific worksheets devoted to NPLs). It also requires additional reports from the banks with a gross NPL ratio higher than 5 percent.[16]
SBP's NPL reporting requirements mainly comprise binding reports, which are required to be regularly submitted in a fixed format. There are no voluntary disclosures or guidelines.	EBA's NPL templates, were designed in a way that they could act as a market standard and be used by banks on a voluntary basis for NPL transactions.
SBP's NPL reporting requirements are based on reporting of aggregates or totals with respect to transactional aspects of NPLs except for e-CIB reporting. Borrower information is not required to be reported (the templates or forms are designed for reporting of aggregate information on NPLs and provisions and other similar information).	In Europe, banks provide granular and comprehensive NPL reporting, for example, in EBA's NPL Transactions Template.[17]
The SBP NPL reporting framework (comprising various circulars) requires little to no information on forborne exposures (loans whether performing or non-performing which have been restructured, rescheduled or provided any other form of concession). Although banks are required to submit monthly reports on restructured or rescheduled loans to the SBP, providing aggregates and movement of outstanding balances, pre and post restructuring final repayment dates and any grace period allowed. They are report such details for the purpose of e-CIB reporting but detailed information on forborne exposures is not reported.	The EBA's NPL reporting requirements and the supervisory expectations set by ECB include detailed information on credit quality of forbearance, the quality and effectiveness of forbearance, the ageing profile of forbearance on a regulatory portfolio basis, classification of performing and non-performing forborne exposures, nature and effectiveness of past forbearance measures.[18]
The SBP NPL reporting framework (comprising various circulars) requires little to no information on valuation of collaterals either in total or on a disaggregated basis. Information on the type, market value of collateral, or impairments in the value of collaterals against loans is not required. Further, information on any asset swaps, possession of collateral, litigations, or the other work-out measures for NPLs is also not a reporting	EBA's NPL reporting requirements and the supervisory expectations set by the ECB, require information on the type, market value of collateral, and any impairment in the value of collaterals against loans. In addition, information on any asset swaps, possession of collateral, litigations, or the other work-out measures for NPLs is also a reporting

[16] European Banking Authority (October 2018), Guidelines on management of non-performing and forborne exposures https://www.eba.europa.eu/sites/default/documents/files/documents/10180/2425705/371ff4ba-d7db-4fa9-a3c7-231cb9c2a26a/Final%20Guidelines%20on%20management%20of%20non-performing%20and%20forborne%20exposures.pdf
[17] "NPLs," European Banking Authority, accessed February 18, 2021, https://www.eba.europa.eu/risk-analysis-and-data/npls
[18] European Central Bank (2017), Guidance to banks on non-performing loans https://www.bankingsupervision.europa.eu/ecb/pub/pdf/guidance_on_npl.en.pdf

SBP NPL Reporting Requirements	European NPL Reporting Requirements
requirement.	requirement.
In all the templates for NPL or related reporting for SBP, information on fair value, market value or recoverable value of NPLs is not required. Banks are only required to provide the carrying amount of the outstanding NPL principal and markup. The reporting of fair values of NPLs and collateral will be important for the creation of a secondary market for NPLs in Pakistan.	EBA's NPL reporting requirements and the supervisory expectations set by ECB require detailed information on fair value, market value or the recoverable value of NPLs.
SBP's NPL reporting requirements do not require any operational, qualitative or non-financial information such as a bank's NPL governance model, its special asset management function operating model, its NPL strategy or any other similar information. These aspects of a bank's NPL governance and management might come to be reviewed as part of other requirements issued by the SBP such as those related to risk management, internal controls or in SBP's supervisory inspections, but not as part of NPL reporting.	EBA's NPL reporting requirements and the supervisory expectations set by ECB require banks to provide comprehensive non-financial information. This includes the NPL governance model, the operating model of its special asset management function, its NPL strategy and other information for banks with the NPL ratio greater than 5 percent.
All the requirements in SBP's NPL reporting framework (which comprises various circulars) are for the purpose of supervision, e-CIB reporting, or to publish industry-wide statistics.[19] (State Bank of Pakistan, 2003). There is no voluntary or best practice NPL reporting framework to support the exchange of standardized information between NPL buyers and sellers in a potential NPL transaction scenario.	In addition to mandatory reporting requirements, the EBA has made available to banks, voluntary NPL transaction templates whose aim is to improve granular and portfolio level reporting of NPLs to create a more efficient, transparent and enabling market for NPL transactions.

5.6. A Comparison of SBP's NPL Framework with BCBS Guidelines on Problem Assets

The Basel Committee Guidelines for the Prudential Treatment of Problem Assets were issued to address the inconsistencies among the terminologies and definitions used in the credit categorization process.[20] These terms and definitions varied widely across jurisdictions and banks because there was no international framework to guide banks and supervisors when categorizing problem loans. The influence of local accounting, regulatory, legal and tax standards lead to situations where a category with the same name in different jurisdictions or banks did not actually refer to loans with the same creditworthiness.

A comparison of various requirements of these BCBS guidelines with the counterpart requirements in the PRs is in Table 14. Understanding of these differences in the context of this study is critical as they identify situations where SBP PRs deviate from the global best practices for reporting and managing NPLs.

[19] State Bank of Pakistan (July 2020), Foreign Exchange Exposure Limit (FEEL), DMMD Circular No.9 of 2003 https://www.sbp.org.pk/bsd/2003/C9.htm
[20] Bank for International Settlements (2016), Guidelines Prudential treatment of problem assets – definitions of non-performing exposures and forbearance https://www.bis.org/bcbs/publ/d403.pdf

(Shades in the table represent: Green = Consistent, Amber = Partial difference, Pink = Considerable difference)

TABLE 14: COMPARISON OF BCBS GUIDELINES AND SBP PRS

S. No.	Key Clauses from BCBS Guidelines[21]	Coverage in SBP Prudential Regulations[22]
	Non-Performing Exposures	
1.	The following exposures are considered non-performing: 1. All exposures that are "defaulted" under the Basel II framework (where the bank considers that the obligor is unlikely to pay its credit obligations, or the obligor is past due more than 90 days on any material credit obligation). 2. All exposures that are "credit impaired" according to the applicable accounting framework (Stage 3 – credit impaired under IFRS 9). 3. All other exposures that are not defaulted or credit impaired but are material exposures that are more than 90 DPD, or where there is evidence that full repayment is unlikely without the bank realizing collateral.	NPLs are generally defined as loans and advances whose markup/interest or principal is overdue by 90 days or more from the due date (with some exceptions listed in Annex T). In addition to the time-based criteria prescribed by the SBP, subjective evaluation of a performing and non-performing credit portfolio is required for risk assessment and, where necessary, all accounts (including those performing) will be classified using time-based criteria. Such evaluation shall be carried out according to the credit worthiness of the borrower, its cash flow, operation in the account, adequacy of the security, inclusive of its realizable value and documentation covering the advances.
2.	Non-performing exposures should always be categorized for the whole exposure, including when non-performance relates to only a part of the exposure, for instance, unpaid interest.	The PRs do not explicitly mention categorizing an NPL as a whole exposure. However, it is implied that any unpaid amount on the loan (interest or principal) would result in the entire loan to be marked as non-performing.
3.	Identifying an exposure as non-performing is not intended to affect its categorization as impaired for accounting purposes or as defaulted. Under IFRS 9, the identification of an exposure as non-performing does not necessarily influence the impairment stage in which the exposure is allocated for accounting purposes.	The PRs are silent over the accounting treatment. One of the main reasons for this lack of guidance could be that banks face difficulties implementing IFRS 9. This resulted in SBP deferring its implementation until December 31, 2021. IFRS 9 is applicable for accounting periods beginning on or after 1 Jan 2022 in Pakistan.
4.	Collateralization or received guarantees should not influence whether an exposure is categorized as non-performing. However, the	The PRs mention that banks and DFIs can avail the benefit of Forced Sale Value (FSV) of collateral held against loans or advances, determined in

[21] Clauses have been sourced from Bank for International Settlements (2016), Guidelines Prudential treatment of problem assets – definitions of non-performing exposures and forbearance https://www.bis.org/bcbs/publ/d403.pdf

[22] Coverage sourced from State Bank of Pakistan, (2015) Prudential Regulations for Corporate/Commercial Banking (Risk Management, Corporate Governance and Operations) https://www.sbp.org.pk/publications/prudential/PRs-Jan-2015.pdf; (2016) Prudential Regulations for Consumer Financing, https://www.sbp.org.pk/publications/prudential/PRs-Consumer.pdf; (2014) Prudential Regulations for Microfinance Banks https://www.sbp.org.pk/acd/2014/C3-Annex.pdf; (2016) Housing Finance Prudential Regulations SBP, (2014), Prudential Regulations for Agriculture Financing https://www.sbp.org.pk/smefd/2016/Housing-Finance-Prudential-Regulations.pdf;

S. No.	Key Clauses from BCBS Guidelines[21]	Coverage in SBP Prudential Regulations[22]
	bank may consider the collateral when assessing a borrower's economic incentive (both positive and negative) to repay under the unlikeliness to repay criteria. Any recourse by the bank shall not be considered in this judgment. The collateralization or guarantee status does not influence the past-due status, including counting past-due days and determining the exposure as non-performing once the threshold for materiality and overdue days are met.	accordance with the guidelines, before making any provision. This statement indicates that collaterals play a key role in the number of provisions made by financial institutions. The level of collateral held should have no effect on whether banks classify a loan as performing or non-performing, as this is based on timely payments from the borrower.
5.	A counterparty is a natural or legal person to which a bank has exposure. When an exposure to a counterparty is categorized as non-performing, all exposures to that counterparty should be categorized as non-performing (this is the debtor approach). However, for retail exposures as defined in the Basel II standard, exposures can be categorized as non-performing on a transaction-by-transaction basis. In these cases, banks should consider the categorization status of other exposures to the same counterparty, except when this information is not available.	Each PR has defined a borrower counterparty in its own context. Collectively, according to the PR it can be defined as a person on whom a bank or DFI has taken any exposure. The PRs for corporate have not instructed financial institutions to mark all the exposures of a borrower as non-performing based on a single non-performing exposure considered to be material by the financial institutions. Similarly, the PRs for consumer and SME finance (covering the retail exposures) assess each exposure on the individual merits and this treatment is in line with Basel requirements.
6.	When applied, the debtor approach applies at the level of a single counterparty. When a counterparty belongs to a group, designating an exposure to one entity of a group as non-performing does not mean designating all exposures to the other entities from the same group are also designated non performing. However, designating the exposure to one of the group entities as non-performing should be a consideration when assessing the creditworthiness and performing status of exposures to other entities in the group.	Group means persons, whether natural or juridical, if one of them or their dependent family members or its subsidiary, have control or hold substantial ownership interest over the other. The PRs have only defined the maximum exposure limits for a single borrower and borrower group (total exposure as a percentage of FI's equity). Specific guidance on the impact of NPLs of one or more entities in the group on the overall classification and treatment of exposures to the group or vice-versa is not provided.
7.	Past due – an exposure where any amount due under the contract (interest, principal, fee, or other amount) has not been paid in full on the date it was due. An exposure should be considered past due from the first day of missed payment, even when the amount is not considered material.	For restructured loans or classified loans , the PRs provide that classification categories will not be upgraded or changed to performing unless more than the prescribed threshold of the outstanding loan has been paid in cash. However, for performing loans (especially those which are overdue but not 90-days overdue), the PRs do not provide a clear statement or guidance.

S. No.	Key Clauses from BCBS Guidelines[21]	Coverage in SBP Prudential Regulations[22]
8.	Material – an exposure that hits the materiality threshold in force in a jurisdiction as defined by supervisors. A bank needs to have a categorization process in place for all exposures. The materiality threshold should be applied by reference to an aggregated exposure or past-due amount determined by supervisors connected with the counterparty's debt and not the bank.	The PRs define it as "Large Exposure", which means an exposure of 10 percent or more of a bank or DFI's equity to a single borrower or group.
9.	"Unlikely full repayment" – an exposure where the full repayment of the principal and/or interest by the counterparty is unlikely without relying on the bank's realizing collateral or risk mitigants, even when it is not past due or has been past due for less than 90 days. For these exposures, Basel II provides examples of possible indicators of unlikeliness to pay such as the bank putting the credit obligation on a non-accrued status; the bank making a charge-off or account-specific provision resulting from a significant perceived decline in credit quality subsequent to the bank taking on the exposure; the bank selling other credit obligations from the same counterparty at a material credit-related economic loss. The likelihood of repayment could also be assessed by analyzing the financial situation of the counterparty, using information such as (i) patterns of payment behaviors in past circumstances; (ii) new facts that change the counterparty's situation; and (iii) financial analysis.	The PRs state that ongoing customer due diligence is performed at reasonable periodic intervals (to assess the likeliness of payments) or on significant occasions such as when the nature of product and services requested by the customer changes, a significant transaction or series of transactions take place, and a significant change occurs in the way customer operates their account. A subjective evaluation of the performing and non-performing credit portfolio is required to assess the risk. Where necessary, any account including the performing account will be classified, and the classification category can be downgraded on time-based criteria. The PR for consumer finance states that banks and DFIs should have an efficient and computerized MIS, which should be able to effectively cater to the needs of the consumer financing portfolio. It should be flexible enough to generate the reports used to effectively monitor the bank or DFI's exposure in the area.
10.	Financial analysis of non-retail counterparties may include, as appropriate, the following ratios: leverage ratio; debt/EBITDA ratio; interest coverage ratio; current liquidity ratio; or ratio of (operating cash flow + interest expenses)/interest expenses; LTV ratio; and any other relevant indicators. For retail counterparties, this analysis may include consideration of debt service coverage ratio, loan-to-value ratio, credit scores and any other relevant indicators.	The PRs provide LTV in the form of minimum margin requirements for financing against certain assets, such as 30 percent in case of financing against shares. In the case of consumer financing, a maximum debt burden ratio of 50 percent is also prescribed. Apart from these some counterparty exposure limits are also provided but specific ratios on financial performance and position are not provided, rather banks are required to define them as part of their credit policy.
11.	When applying the criterion of unlikely full repayment to an exposure, the contractual features of the exposure (for example an	The PRs require FIs to frequently monitor their exposures. This can be done while analyzing delinquency reports, quarterly product wise profit,

S. No.	Key Clauses from BCBS Guidelines[21]	Coverage in SBP Prudential Regulations[22]
	interest-only mortgage loan, a loan in which the repossession of collateral for repayment is contractually provided for, or a retained first-loss tranche in a securitization transaction) should not automatically result in its categorization as non-performing without analyzing the payment behaviors or the financial situation of the counterparty. Regardless of its contractual features, an exposure is categorized as non-performing when it is more than 90 days past due and meets the materiality threshold.	and loss account duly adjusted with the provisions of classified accounts. Borrower repayment patterns are carefully analyzed before marking the account as non-performing under subjective criteria. Like the Basel guideline, the loan is marked as non-performing when it is 90 DPD (with some exceptions noted in Annex T).
	Forbearance	
12	Forbearance occurs when a counterparty (natural or legal person) is experiencing financial difficulty in meeting its financial commitments and the bank grants a concession that it would not otherwise consider whether or not the concession is at the discretion of the bank and/or the counterparty. A concession is at the discretion of the counterparty when the initial contract allows it to change the terms of the contract in its own favor due to financial difficulty. The identification of an exposure as forborne does not affect its categorization as impaired for accounting purposes (IFRS 9) or as defaulted in accordance with the Basel II Framework.	The PRs frequently use the terms restructuring and rescheduling. Restructuring means where due to borrower's financial difficulty, a bank or DFI grants concession to the borrower that it would not otherwise consider. Restructuring would normally involve relaxing the terms and conditions of the financing facility which can include repayment tenor, mark-up/profit rate and charges/fee. Rescheduling is where banks and /DFIs, due grant borrowers facing financial difficulty concessions in the form of allowing or extending the grace period of the existing financing facility, without changing the other terms and conditions of the financing facility. Forbearance as defined by Basel and restructuring and rescheduling as defined by the PRs are conceptually aligned. However, the scope of forbearance as defined by Basel is deemed to be wider as it encompasses all possible types of concessions and is more widely used internationally, compared with the concept of restructuring and rescheduling as defined by the PRs. Further, the restructuring and rescheduling provisions in the PRs do not differentiate between transactions that are the initiative of the borrower or the lender. Specific guidance on the alignment of this treatment with IFRS 9 is not provided in the PRs as IFRS 9 is yet to be implemented in Pakistan.
13.	Forbearance includes concessions that are granted due to the counterparty's financial	Restructuring or rescheduling is granting concessions to a borrower facing financial

S. No.	Key Clauses from BCBS Guidelines[21]	Coverage in SBP Prudential Regulations[22]
	difficulty on any exposure in the form of a loan, a debt security, or an off-balance sheet item (for example loan commitments or financial guarantees), regardless of the accounting measurement method. Forbearance is identified at the individual exposure level to which concessions are granted because of the counterparty's financial difficulty.	difficulties. Like the Basel guideline, all fresh loans granted by the banks and DFIs to a borrower after rescheduling or restructuring their existing facilities may be monitored separately and will be subject to classification under the PRs on the strength of their own terms and conditions.
14.	Financial difficulty – to identify cases of forbearance, banks should first determine if the counterparty is experiencing financial difficulty. Some indications include, if the counterparty is past due on any of its material exposures, if it is not currently past due but is likely to be in the foreseeable future, if its outstanding securities have been delisted, and if available cash flows will be insufficient to service all its loans or debt.	The PRs have not explicitly defined the term financial difficulty. It is implied in the PRs that FIs are required to perform ongoing monitoring of loans. Some of the financial difficulty indicators in the PRs include the nature of product and services requested by the borrower changes, a significant transaction or series of transactions take place in the borrowers' business, and a significant change occurs in the way borrower operates their account.
15.	Concession – concessions are special contractual terms and conditions provided by a lender to a counterparty facing financial difficulty so that the counterparty can sufficiently service its debt. The main characteristic of these concessions is that a lender would not extend loans or grant commitments to the counterparty, or purchase its debt securities, on these terms and conditions under normal market conditions. Supervisors may set specific materiality thresholds for what constitutes a concession. Concessions include extending the loan term, rescheduling the dates of principal or interest payments, and capitalizing arrears. Concessions can be triggered by changes in the conditions of the existing contract, giving considerably more favorable terms for the counterparty, a supplementary agreement, or a new contract to refinance the current transaction. They can also include the exercise of clauses embedded in a contract that enable the counterparty to change the terms and conditions of its contract or to take on additional loans at its own discretion.	The PRs have used but not elaborated on the term concession. Concession is regarded as a means of performing restructuring or rescheduling of loans. Like the BIS guidelines, the restructuring definition within the PRs states that concessions are granted to the borrower that the bank or DFI would not otherwise consider. Concessions involve relaxing the terms and conditions of the financing facility which include repayment tenor, mark-up/profit rate and charges or fees and extending the grace period of the existing financing facility without changing the other terms and conditions. The PRs have also imposed conditions for restructuring and rescheduling for consumer finance and housing finance loans. Annex C has more details.
16.	Refinancing an existing exposure with a new contract because a counterparty is experiencing financial difficulty could qualify as a concession, even if the terms of the new	The PRs for agriculture financing provide guidance in this respect. They state that banks and DFIs are prohibited from adjustment lending (adjusting the existing loan with a fresh loan) to avoid

S. No.	Key Clauses from BCBS Guidelines[21]	Coverage in SBP Prudential Regulations[22]
	contract are no more favorable for the counterparty than those of the existing transaction.	classification or meet allocated targets for financing.
	Interaction of forbearance with non-performing exposures	
17.	Forbearance can be granted on performing and non-performing exposures. When applied to a non-performing exposure, it remains non-performing. When forbearance is applied to a performing exposure, banks must assess whether the exposure meets the non-performing criteria, even if the forbearance results in a new exposure. When the original exposure would have been categorized as non-performing at the time of granting forbearance, the new exposure should be categorized as non-performing.	Banks and DFIs may reschedule or restructure their loans as per their policies but not to avoid classification. The rescheduling or restructuring of non-performing loans shall not change the status of classification of a loan or advance unless the terms and conditions of rescheduling or restructuring are fully met for a period of at least one year (excluding any grace period) from the date of the rescheduling or restructuring, and at least 10 percent of the total restructured loan amount is recovered in cash. However, this one year condition does not apply when the borrower has repaid or adjusted in cash at least 35 percent of the total restructured loan amount (principal and mark-up), either at the time of restructuring agreement or later, during any grace period. Further, the PRs do not provide guidance for cases where a performing loan is provided a concession that prevents it from being classified as non-performing, when it otherwise would have been classified as non-performing. The requirements described here pertain to corporate and commercial loans. All other PRs follow the same approach but have slight differences in the period and percentages applied.
18.	Banks should ensure they appropriately categorize of exposures on which forbearance have been granted more than once. When a forborne exposure under the probation period is granted new forbearance, this should re-start the probation period, and banks should consider whether the exposure should be categorized as non-performing.	The PRs mention that where a borrower subsequently defaults after a rescheduled or restructured loan has been declassified by the bank or DFI, the loan will be classified in the same category as it was at the time of rescheduling/ or restructuring and the unrealized markup on such loans taken to income account shall also be reversed. However, banks and DFIs can downgrade the classification, taking into account the subjective criteria at their discretion.
19.	The continuous repayment period for non-performing exposures and the probation period for forbearance can run concurrently. All non-performing forborne exposures should remain non-performing until they meet the performing criteria. After this, the remaining probation	Banks and DFIs may reschedule or restructure their loans as per their policies but not to avoid classification. The rescheduling or restructuring of non-performing loans shall not change the status of classification of a loan or advance unless the terms and conditions of rescheduling or restructuring are

S. No.	Key Clauses from BCBS Guidelines[21]	Coverage in SBP Prudential Regulations[22]
	period for forbearance should be identified as a performing forborne exposure.	fully met for a period of at least one year (excluding any grace period) from the date of the rescheduling or restructuring, and at least 10 percent of the total restructured loan amount is recovered in cash. However, this one-year condition does not apply when the borrower has repaid or adjusted in cash at least 35 percent of the total restructured loan amount (principal and mark-up), either at the time of restructuring agreement or later, during any grace period. Further, the PRs do not provide guidance for cases where a performing loan is provided a concession that prevents it from being classified as non-performing, when it otherwise would have been classified as non-performing. The requirements described here pertain to corporate and commercial loans. All other PRs follow the same approach but have slight differences in the period and percentages applied.
20.	When a forborne exposure becomes non-performing during the 12-month probation period, the probation period starts again.	The PRs do not state whether a restructured or rescheduled loan classified as non-performing during the probation period would cause the probation period to restart.
	Criteria for exiting from forborne exposure category	
21.	A forborne exposure will be identified that way until it meets both of the exit criteria: (i) When all payments, as per the revised terms, have been made in a timely manner over a continuous period of not less than one year (probation period for reporting). The starting date of the probation period should be the scheduled start of payments under the revised terms, regardless of the performing or non-performing status of the exposure at the time that forbearance was granted. (ii) The counterparty has resolved its financial difficulty.	According to the PRs, banks and DFIs are directed to ensure that the classification status and provisioning are not changed in relevant reports to the SBP merely because a loan has been rescheduled or restructured. The PRs guide that a non-performing loan which goes through restructuring or rescheduling can be classed as performing again however, there is no official category from which of restructured or rescheduled loans can exit.
	Criteria for exiting NPE	
22.	An exposure ceases to be non-performing and can be recategorized as performing when all the following criteria are simultaneously met: (i) The counterparty does not have any material	Unlike Basel, the PRs have no guidance on the reclassification of NPLs to performing. However, it may be implied that if time-based criteria (90 DPD) and/or subjective criteria (FIs assess a borrower to be in financial difficulty) for

S. No.	Key Clauses from BCBS Guidelines[21]	Coverage in SBP Prudential Regulations[22]
	exposure more than 90 days past due. (ii) Repayments have been made when due over a continuous repayment period as specified by the supervisor of at least three months. (iii) The counterparty's financial situation has improved so that the full repayment of the exposure is likely, according to the original any modified conditions. (iv) The exposure is not defaulted according to the Basel II framework or credit impaired according to the applicable accounting framework.	categorizing the loan as NPL is no longer met, then the loan can be classed as performing. The period over which the borrower is expected to make continuous payments before categorizing the loan as performing is not provided. The Basel guidelines also account for materiality of the NPL. If the material amount of NPL is repaid by the borrower, then the loan can be marked as performing. However, the PRs have not provided any materiality-based criteria.
23.	Some situations will not lead to the recategorization of a non-performing exposure as performing. (i) The partial write off of an existing non-performing exposure, (when a bank writes off part of a non-performing exposure that it deems to be uncollectible). (ii) Repossession of collateral on a non-performing exposure, until the collateral is disposed of and the bank realizes the proceeds (when the exposure is kept on balance sheet, it is deemed non-performing). (iii) Extension or granting of forbearance measures to an exposure that is already identified as non-performing subject to the relevant exit criteria for non-performing exposures. The recategorization of a non-performing exposure as performing should be made on the same level (debtor or transaction approach) as when the exposure was originally categorized as non-performing.	The PRs do not state whether partially writing off NPLs would allow the remaining outstanding loan amount to be categorized as performing. They also do not include guidance on whether the collateral proceeds received from an NPL would result in that NPL being categorized as performing. The PRs have clearly laid out criteria, where the rescheduling or restructuring of non-performing loans will not change the loan's classification status unless the terms and conditions of rescheduling or restructuring are fully met for a period of at least one year (excluding any grace period) from the date of such rescheduling or restructuring and at least 10 percent of the total restructured loan amount is recovered in cash. However, the condition of the one-year retention period, prescribed for restructured or rescheduled loans to remain in the classified category, will not apply if the borrower has repaid or adjusted in cash at least 35 percent of the total restructured loan amount, either at the time of the restructuring agreement or later during any grace period.

Changes to the PRs, including the introducing a 'debtor approach', a classification category for forborne exposures, clear definition of situations which qualify as a concession, and specific additional minimum due diligence ratios, could result in an increase in classified loans for banks. The impact of the three stages of classification under IFRS 9 cannot be determined because IFRS 9 has not yet been implemented in Pakistan and the impact assessments performed by banks or the pro forma financial statements submitted to SBP are not publicly available.

5.7. Write Off Policy and Practice for Banks in Pakistan

Banks in Pakistan have introduced loan write off policies and procedures either on a stand-alone basis or as part of their overall credit risk management framework. These policies provide guidance on pre-conditions for loan write offs, criteria for selecting loans for write off, contents of a write off proposal, and management and board level authority matrices for the approval of write offs.

These write off policies and practices are based on the minimum requirements or standards for write off set by SBP and BPRD.

Some key features of banks' write off policies and practices are:

- As a matter of policy write offs are only considered by a bank when all other forms of recovery and resolution have been exhausted. The write off does not affect bank's legal right to recover.
- There are two main types of write off options available to banks. One is the direct write off method in which a loan or part of it may be written off for commercial reasons without it having completed the time and other minimum criteria. This is an exception and does not occur frequently. The second and the more common write off is when loss categorized NPLs have been classified as such for more than three years, making them eligible for write off subject to fulfilling some additional conditions.
- Banks also propose loans for write offs for example when a loan has been loss categorized and it is known conclusively that the security documentation is defective.
- Banks' minimum conditions of write offs, are the same as or are slightly more stringent than those stated by SPB BPRD circulars.

SBP regulatory requirements of write off

The regulatory requirements for write offs are primarily contained in BPD Circular 29 of 2002 (this was a one-time scheme which allowed banks to formulate their own policies based on the circular) and BPRD Circular 6 of 2007 issued by the SBP. The circulars contain several requirements.

- NPLs which have been classified as 'loss' for three years or more are eligible for write offs. Should a bank receive repayments, after a loan is classified loss that do not change the classification category, the loan still qualifies for write off under the remaining conditions.
- The authority to approve write offs resides with the Board of Directors (this is consistent with the requirement of the Companies Act, 2017). The Board is empowered to delegate this authority to appropriate levels of the management.
- Banks are required to obtain SBP prior approval if a write off pertains to the bank's CEO or its Directors or their dependents or any business concerns where they hold a financial interest of more than 5 percent.
- Before processing a write off, banks must realize all liquid collaterals (including FDRs, Government Securities, and Share Certificates held under lien and pledged goods) available to the bank against the loan in question.
- Banks are not allowed to write off loans where the forced sale value of securities held, is more than the recoverable outstanding amount. This condition does not apply to cases recommended or /settled under any general incentive scheme of SBP or such other Committee(s) as notified by SBP or Committee for Revival of Sick Industrial Units (CRSIU).
- Banks must obtain a signed confirmation from the branch or unit originating the loan that the borrower or its guarantor has no known means of payment.
- Banks must ensure that the borrower(s) has not created other business interests and assets out of the NPLs to be written off.
- Banks must ensure that the borrower(s) is not involved in any criminal misappropriation of stocks, movable and immovable assets, or security.

- The write off proposal must be audited by the bank's internal auditor (IA) (except for where the outstanding amount of principal is below Rs. 0.5 million). The IA is required to clearly indicate any deviations or irregularities from the approved credit policy during the process of sanction, disbursement, documentation, monitoring and supervision of the loan and its underlying securities.
- At the time of processing a write off, banks are required to have valuation of collateral completed by a PBA approved valuator where the outstanding principal exceeds PKR 5 million and by the bank when the outstanding principal is less than PKR 5 million. The valuation report must state the market value and forced sale value of the collateral.
- Banks are required to submit reports of quarterly write offs to their Board of Directors.
- Banks are required to report information for write offs to SBP's Credit Information Bureau.
- Where banks are unable to comply with one or more of these requirements, they may put up the case to their Board of Directors for consideration. The Board may then decide the write off case on merit, recording reasons. Such write offs must be reported to the SBP.

Implementation of IFRS 9 in Pakistan

For banks in Pakistan, IFRS 9 is yet to be implemented. The SBP communicated these key requirements about implementing IFRS 9 for banks in Pakistan in 2019.

- The implementation of IFRS 9 has been deferred to accounting periods beginning 1 Jan 2021.
- Banks have been asked to submit pro forma financial statements prepared in accordance with the requirements of IFRS 9 to the SBP.
- Banks are required to perform a parallel run of IFRS 9 implementation starting from 1 Jan 2020 to test the IFRS 9 outcomes. Banks are also required to submit quarterly reports on the status of IFRS 9 implementation to the SBP.
- Other requirements with respect to progress, oversight, and implementation of IFRS 9 and necessary internal changes were also provided.

Write off requirements under IFRS 9

According to IFRS 9, an entity is required to directly reduce the gross carrying amount of a financial asset when the entity has no reasonable expectations of recovering either all or part of a financial asset. A write off constitutes a de-recognition event under IFRS 9. Write offs can relate to all or part of a financial asset.

In an example provided in IFRS 9, where an entity plans to enforce the collateral on a financial asset and expects to recover no more than 30 percent of the financial asset, it should write off the remaining 70 percent, if the entity has no reasonable prospects of recovering any further cash flows from the financial asset.

IFRS 7 provides further guidance on the indicators that there is no reasonable expectation of recovery. These include stopping enforcement activity and where the bank's recovery method is foreclosing on collateral and the value of the collateral is such that there is no reasonable expectation of recovering in full. Banks may write off financial assets that are still subject to enforcement activity. Banks can still seek to recover amounts they are legally owed in full, but which have been partially or wholly written off due to no reasonable expectation of recovery.

More clarity is required to make it easier for banks to argue under IFRS 9 and IFRS 7 that there is no reasonable expectation of recovering the contractual cash flows if the loan is still subject to enforcement activity.

5.8. A Comparison of Write off Requirements under IFRS 9, SBP Instructions and Bank Polices

A comparison of the IFRS 9 accounting requirements and the write off requirements under the SBP which could create conflict, or which require clarification, is set out in Table 15. Conflicts between various frameworks which prevent, delay or complicate timely and adequate recognition of provisions or write offs can hamper the development of a viable NPL market and may be a disincentive by NPL investors.

TABLE 15: WRITE OFF REQUIREMENTS UNDER IFRS 9 AND SBP

Write off Requirements under IFRS 9	Write off Requirements under SBP
Under IFRS 9, the core principle for writing off (derecognizing) a loan is when the entity has no reasonable expectations of recovering a financial asset in its entirety or a portion thereof. There are no other operational or procedural pre-conditions provided in IFRS 9 which may delay, prevent, or advance a write off.	Under SBP, pre-conditions exist in the write off requirements. For example, the need for a loan to have been classified as 'loss' for a period of three years before being considered for a write off. Some banks have more stringent requirements which can go up to five years. Under IFRS 9, a bank may be able to demonstrate that it has no reasonable expectation of recovering without waiting for a loan to complete the three-year post 'loss' categorization tenor but it will be prevented from booking a write off based on the SBP requirements – unless an exception from the Board of Directors is obtained. Further, additional tax specific criteria for allowance of write-off expenses are in the tax framework.
IFRS 9 does not have any guidance or allowance for operational or administrative criteria preventing a loan from being written off. The criteria in IFRS 9 are purely based on risk, rewards, continuing involvement of the accounting entity, and the variability of cash flows pre and post transaction.	Other SBP operational conditions which prevent a loan from being written off include, for example, when the counterparty is a related party (Directors or the CEO), when borrower has created assets from the defaulted loan which are identifiable, when the forced sale value exceeds the outstanding loan principal amount or when there is a criminal misappropriation of collateral. Detailed supervisory guidance will be necessary if regulatory or operational pre-conditions for write offs which prevent a bank from writing off a loan, that would otherwise meet the criteria provided in IFRS 9.
IFRS 9 provides that a loan may be written off when the entity has no reasonable expectations of recovering a financial asset. IFRS 9 also provides indicators for banks to assess the impairments of financial assets, including significant financial difficulty of the borrower, a breach of contract, such as a default or past due event, or the likelihood that a borrower will enter bankruptcy.	SBP provides no guidance on the indicators. It will be important to provide specific indicators or conditions through which banks can demonstrate to regulators, external auditors, or other external parties that there is no reasonable expectation of recovery. This will be especially required in situations where the bank intends to write off a loan but chooses to continue with enforcement activity such as litigation.
Under IFRS 9, it would be difficult to demonstrate that there is no reasonable expectation of recovery if there are ongoing cash recoveries. This means loans may meet the SBP's current write off criteria but are effectively prevented from being written off by IFRS 9 because a bank is unable to reasonably demonstrate an inability for the loan to be repaid.	The SBP write off requirements provide that a loss categorized loan which has qualified for a write off would continue to do so regardless of any subsequent cash recoveries if the payments do not improve the loan's classification. This requirement would not be consistent with IFRS 9.

5.9. Collateral Framework for Banks in Pakistan

The SBP's PRs provide guidance about collateral valuation and the conditions and use of external valuators for banks in Pakistan.

- Banks must have a Collateral Management Policy which covers generally acceptable forms, quality, valuation at the time of acceptance and the tenor of a loan, haircuts, price volatility, diversification, margin calls limits, substitution of collateral, and managing collateral in the event of a counterparty default.
- The PRs provide criteria for determining the value of pledged stock, plant & machinery under charge and mortgaged properties.

The PRs define two types of valuations — a 'Full Scope Valuation' and a 'Desktop Valuation'. The PRs do not describe a 'full scope valuation' but, a desktop valuation is described as an interim brief review of full-scope valuation so that any significant changes in the factors on which the full-scope valuation was based, are accounted for and highlighted to the lending bank. Banks must complete annual external valuations for property and plant and machinery assets. The full-scope valuation is required every three years and in the interim, desktop valuations can be carried out annually or more frequently.

Little other information about activities or procedures for full scope valuations and desktop valuations is provided. For Desktop Valuations, evaluators are required to pay a short visit to the borrower's site, and it is the bank's responsibility to ensure that the evaluator has all the necessary information for the interim review.

In practice the full-scope valuation includes the following steps depending upon the type of collateralized asset:

i. Valuation of Land and Building

   These include real estate valuations such as built-up properties, open plots, commercial buildings, office premises, industrial units, or warehouses. Most of these valuations are based on a market approach and comparative method:

   a. Visit the property to understand property dynamics, such as the condition of buildings and civil works.

   b. Evidence gathered from property dealers, real estate agents, market enquiries, and properties listed for sale on different online portals for comparable values.

   c. Adjustment based on experience and judgment to account for the specific element of property under evaluation.

ii. Plant and Machinery

   Valuation of plant and machinery is based on a cost approach and comparative method:

   a. Historical cost and technical specifications are derived from purchase documents and fixed asset registers. For imported plant and machinery, documents such as a letter of credit, bank payment form, pro-forma invoice, commercial invoice, goods declaration issued by customs department, or a packing list are required.

   b. Survey of the plant and machinery to assess the condition and discuss with the concerned technical team to understand the plant and machinery's practical condition.

   c. Evaluating replacement cost with factors such as inflation, and foreign currency rates.

   d. Evaluating the current value after application of suitable depreciation rates and obsolescence factor.

5.10. Collateral Valuation - External Valuators

External valuators are mandatory for mortgaged property and plant and machinery asset valuation. For pledged stocks, external valuators are only required when determining the stock's FSV. The FSV is required when a loan has been classified as non-performing and a bank intends to claim a reduction against the computed provision. For Liquid Assets (assets readily convertible into cash), banks determine the value which is then verified by the bank's

external auditors. For pledged shares of listed companies, values are taken at market value from the Stock Exchange(s) on the balance sheet date.

The PRs also require that:

- External valuators appointed by the banks are on the PBA's panel of evaluators.
- While assigning any values to the pledged stock, plant and machinery under charge, and mortgaged property, evaluators are required to consider all relevant factors affecting the salability 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.
- Evaluators must provide a reasonably good estimate of the amount that could be obtained by selling such assets in a forced or distressed sale condition when assigning values to pledged stock, plant and machinery under charge, and mortgaged property.
- Evaluators must make their assumptions clear, explain their calculations, formulae, and basis used to determine values. In practice, FSV is calculated by applying a haircut percentage to the market value assessed by the valuator. The haircut percentage is applied depending on the condition, quality, material, useful life, and wear and tear of land and buildings and plant and machinery. Land and buildings have a haircut between 10 percent and to 20 percent, where the plant and machinery's haircut can range from 15 percent to 30 percent. The PBA provides these ranges to external valuators and while they could be considered arbitrary, they allow valuators to apply their professional judgement and skepticism in reaching an appropriate FSV.

Further criteria for the qualification, performance management, enlistment/ de-enlistment, categorization and reporting of external valuators for banks is provided and governed by the PBA. The PBA's approved list of valuators has three panels, each specializing in different types of assets.

i. Agriculture, Residential & Commercial land, and buildings
ii. Industrial plant and machinery
iii. Commodities

5.11. Potential for Differences in the Market Value and Book Value of Collateral

There are several deficiencies in Pakistan's bank collateral and valuator frameworks when compared with similar guidance from Europe. An understanding of these differences is important as they can affect the quality and accuracy of the valuation reports used by banks and result in differences between bank collateral values and market values.

i. The PBA requires that the key person (majority owner) for valuators has a minimum of five years' experience in carrying out valuations for the banking industry or as an enlisted valuator or as a part of a valuation team. For property valuations, they must also be an architect or town planner registered with the Pakistan Council of Architects and Town Planners, and for plant and machinery be an engineer registered with the Pakistan Engineering Council. No minimum qualifications or experience is necessary for other staff or valuators used by these professional valuation firms. In practice, however, valuators generally have a minimum of bachelor's degree in civil or mechanical engineering. Valuation firms also require the valuators to have a minimum of three years' work experience in their relevant fields. International or local professional qualifications or certifications are not commonly pursued by valuators in Pakistan.

   Neither the Pakistan Engineering Council (PEC), nor the Pakistan Council of Architects and Town Planners (the two bodies that regulate each profession) provide any standards, exams or accreditation criteria specific to valuation of assets or property.

   In Europe, valuations used by banks to must comply with European or international standards. The International Valuation Standards Council (IVSC) is an independent, not-for-profit organization that produces and implements universally accepted standards for the valuation of assets. IVSC has more than 160 member organizations operating in 137 countries including the Practicing Valuers Association of India, the Institution

of Valuers India and other similar bodies from Malaysia, Sri Lanka, Thailand, and Egypt. The ECB Guidance mentions standards issued by TEGOVA and by the Royal Institute of Chartered Surveyors (RICS). These both adhere to the standards outlined by the IVSC but provide more details, including on the licensing and training of appraisers.

ii. The PBA guidance for valuators does not mandate that valuator firms have membership or be registered with any international valuation standard setting body such as IVSC or RICS. In fact, in the enlistment criteria, there is only a 5 percent weightage for having membership of any professional body. Among the list of accepted professional bodies, RICS is the only international one.

iii. In Annex V of its Guidelines for Valuators, the PBA provides minimum valuation standards. These are mainly about standardizing the content of the report.[23]

a) Valuation reports are to be signed by authorized signatories of the Valuator.
b) Means of identification of assets to be clearly stated in the report.
c) Means of assessment of market value, the approach and the methodology used to be clearly stated in the report (but no approach or methodology or guidance in this regard is prescribed).
d) Visible factors impairing salability of the asset to be specified such as ownership, geographical, territorial or political factors.
e) Valuation reports to state if ownership was verified and comment on the market demand of the asset.
f) Valuation reports to state any other assumptions made in arriving at the values.

These criteria offer little guidance on the selection and use of accepted valuation methods or international valuation standards and their fitness for asset types. In practice, the PBA communicates preferred methods of asset and collateral valuation to professional valuation firms.

a) For valuing land and buildings, the PBA prescribes using the market approach method where fair values are established through local inquiries and property dealers comparing local properties in the area. For buildings, the year of construction plays a major role as the depreciation of 3 percent per annum. is charged for residential and 5 percent per annum for commercial properties. This method is like the "market approach - comparative method" defined by TEGOVA, which is consistent with IVSC.
b) For valuing plant and machinery, PBA recommends the replacement cost method where fair values are established through inquiring about the cost of replacing the asset in its present condition and for this information about manufacturers and mechanics for plant and machinery is necessary. This method is like the "cost approach – depreciated replacement cost method" as defined by TEGOVA, which is consistent with IVSC.

iv. All approved firms must submit certain data on valuations every quarter and the PBA uses a sample of these to assess the market values and FSV derived by valuators and question accuracy where required. Banks can also file complaints with the PBA if they believe the valuator is under or overvaluing collateral, in which case PBA can impose a penalty on the valuation firm or remove them from the list of approved valuators.

v. The collateral valuation practices in European countries indicate that banks use market, income, and cost-based approaches. In each of these, the bank deploys different valuation methods such as comparative, capitalization, discounting, or a combination of these to arrive at a collateral value.

The ECB guidance on NPLs is clear on the supervisory expectations with respect to the use and appropriateness of valuation methods for banks. There are some key differences between the ECB's guidance and the PBA's.

a) The ECB provides that the requirements for collateral valuation are supervisory expectations and provide best practices for the policies, procedures, and disclosures which banks should adopt when valuing immovable property held as collateral for NPLs. Meanwhile, the collateral guidance in Pakistan is

[23] Pakistan Banks' Association (2013), Guidelines For Enlistment Of Valuers And Monitoring Of PBA Panels Of Professional Valuers, https://pakistanbanks.org.pk/wp-content/uploads/2020/10/guidelines_for_2013_20121220.pdf

provided by PBA which is an association of banks which does not have a mandate to regulate or set binding standards for banks.

b) The ECB requires all valuations to be performed by independent, qualified, internal, or external valuators as per given specific criteria.

c) Banks regulated by the ECB should develop and implement robust internal quality assurance (QA) policies and procedures for challenging valuations. Key aspects of such QA program are that:
   - It is carried out by an independent unit, such as Risk Management function.
   - Valuations must be back-tested to understand their accuracy.
   - The independence of external valuators must be tested.

d) Unlike the PBA, the ECB requires banks to adopt a valuation methodology fit for asset type.
   - Immovable property collateral is required to be valued, adhering to European and international standards. National standards (local country standards) are also be accepted if they follow similar principles.
   - All immovable property collateral is required to be valued based on market value or mortgage lending value. A definition of market value is provided.
   - Valuations exclusively based on discounted replacement cost method are not allowed.
   - For income generating properties, a discounted cash flow or market comparable approach is allowed.

Other criteria are also provided for the use of market discounts, computation of future cash flows, back-testing valuations, valuation of foreclosed assets and public disclosure requirements related to collaterals.

vi. The PBA guidance on valuation only applies to situations where banks are required to use external valuators. In cases where banks can perform their own valuations, (outstanding loans below a certain threshold, movable assets, pledges of current assets, liquid collaterals and certain desktop valuations) there are no minimum standards for independence, qualification, experience of banks' internal appraisers or the methodology used.

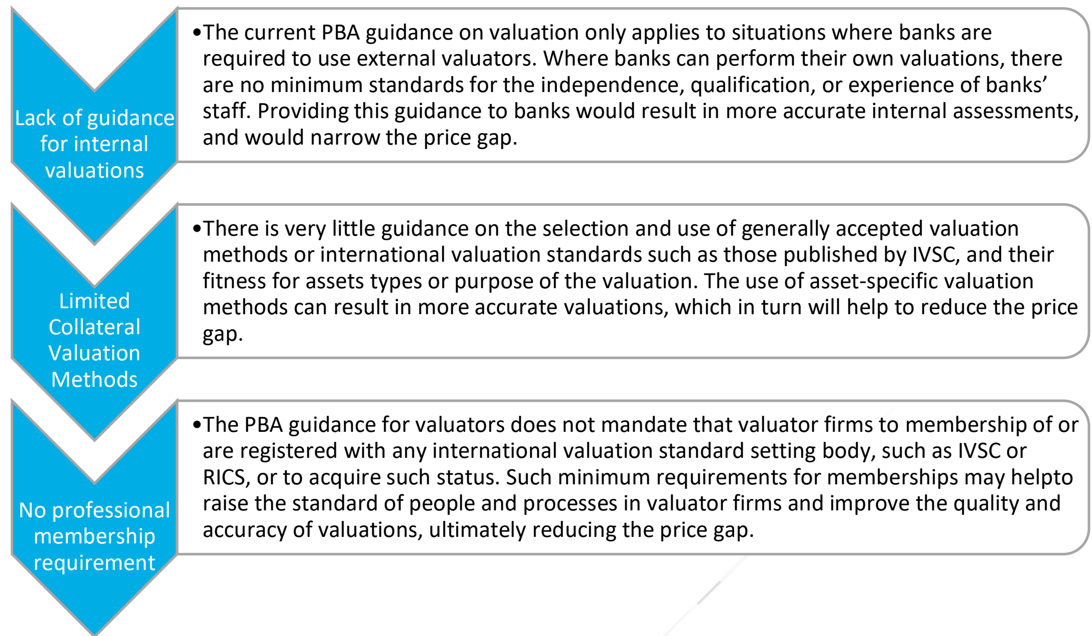
vii. There is no credible or industry-adopted property price index in Pakistan, which can serve as a benchmark for desktop valuations or be used by banks or independent reviewers to assess or challenge the valuators' values. Property indices for rentals and sale transactions in major areas of Karachi, Lahore and Islamabad are published by Zameen.com (a private property dealer, not a valuator) but it will be difficult for banks or valuators to use them without an industry standard. Further there is no central database or information exchange in Pakistan for banks to acquire information on comparative last-transaction prices for an immovable asset.

All these factors will affect the quality and accuracy of collateral valuations and could create gaps between the market values and bank values of collateral. This could result in sub-optimal recoveries against NPLs and affect investor confidence in the transparency and integrity of the NPL transactions. It is critical for the banking regulator in Pakistan to consider these shortcomings in the collateral valuation process, if it is to provide credible information to potential purchasers of NPLs from the banks.

5.12. Collateral Valuation Practices Contributing to Price Gap

Figure 21 summarizes the collateral valuation practices which contribute to a price gap for NPL transactions between buyers (investors) and sellers (banks).

FIGURE 21: COLLATERAL VALUATION PRACTICES CONTRIBUTING TO PRICE GAP



5.13. Credit Risk Management Frameworks and Practices in Banks in Pakistan

In Pakistan, Boards of Directors of FIs are responsible for ensuring there is an appropriate credit risk management framework in place. The subject is comprehensively regulated, and banks must ensure there are appropriate governance, internal controls, and risk management principles for credit risk management. SBP's risk management regulations require banks to ensure that the credit sales and initiation teams are independent from the credit review and risk monitoring teams. SBP has also issued guidelines on the credit governance and approval, usage of credit scoring models for various credit sectors, and other PRs listing transactional regulatory requirements and exposure limits.[24]

i. Credit Risk Governance

A board-level risk management committee is established by the banks to assist Boards in their risk management responsibilities. Board level risk committees are usually responsible for oversight of the bank's credit risk, and for ensuring that appropriate policies and resources are in place for prudent credit risk management.

At a senior management level, it is a general practice to create risk management or credit committees which are responsible for day-to-day credit risk oversight. An independent risk management department reports directly to the chief executive of the bank. The credit risk unit of the bank, part of the risk management department, is generally responsible for portfolio and transactional level credit risk reviews, monitoring, and reporting.

It is essential that the organizational structure of banks in Pakistan separates business development and client relationship teams from risk review and monitoring teams. The responsibilities and reward structures for both are required by the SBP's regulations to be different.

Independent internal audit functions are responsible for annual portfolio reviews, which involves thorough case-

[24] State Bank of Pakistan (2014), Risk Management Guidelines for Commercial Banks and DFIs
http://www.dcag.com/images/riskmgm.pdf

by-case reviews of sample credit transactions. The objective is to provide independent opinion on the health of the portfolio as well as the strength of the internal controls in the credit processes.

ii. Credit Approval Cycle

The typical practice for a new loan follows three phases: a pre-approval phase in which credit assessment and appraisal to decide whether or not to extend the loan; approval phase, in which the loan is reviewed and approved by the decision makers within the bank; and a post-approval phase comprising the disbursal of the loan and recovery of loan upon maturity. Annex J contains more details on the three phases.

In most commercial banks in Pakistan, paper-based documents related to loans are scanned for electronic storage before the originals are filed in a vault. Information necessary for the accounting and core banking system is populated in the system during various stages of the approval process. Some banks are more digitized than others with electronic transfer of documents, and document management systems for retrieval and record keeping. Processes for mainstream consumer financing are more digitally oriented than the customized loans common in corporate, commercial or SME financing. Pakistan's, microfinance banks have focused extensively on digitizing their loan processing procedures and journeys and some have reached the stage of a fully digital end-to-end loan application to disbursement process. Regionally, IDBI bank from India, has also fully digitized its agriculture and MSME lending system.

Reasons for commercial banks to lag on digitization include:

a) Legacy IT systems and associated costs to replace, upgrade, and launch.
b) An under-developed ecosystem which relies heavily on the manual exchange of data between banks and outside parties. For example, banks generally do not get API access to credit bureau data, data from land or other asset registries. Information received from borrowers is in unstructured formats and any form of digitization would require extra time to extract, transform and load.
c) Legal proceedings and courts often require certified true copies with wet signatures.
d) The regulatory framework is based on physical controls of authentication and approvals for example, requiring fingerprints, wet signatures and manually signed applications.
e) When compared with microfinance banks there is little appetite to reduce operational costs, acquisition costs and minimize turnaround time in commercial banks as they have healthy spreads and low transaction costs.
f) Virtually no infrastructure for electronic contracts from execution to enforcement contributes to this lack of digitization.

Creating digital loan journeys for corporate, commercial and SME loans, would greatly benefit due diligence processes in NPL transactions by improving their accuracy, auditability, and speed.

iii. Independent Risk Monitoring

In addition to the case-by-case review pre and post approval of the loan, it is a common for Pakistani banks to form independent credit risk monitoring teams. The role of these teams is to oversee portfolio and transactional level credit risks and monitor against acceptable thresholds. The teams also produce periodic credit risk exposure reporting to the management and board level risk committees.

Credit risk monitoring teams have limited experience and expertise in advanced risk quantification measures. Credit risk scoring models are generally used, however more accurate measures like Probability of Default (PD) or Loss Given Default (LGD) are not measured. Although SBP has provided extensive guidelines for stress testing, their results are often used only for regulatory reporting purposes, instead of playing a role in credit decision making and strategy formulation.

Portfolio level risk assessments normally comprise rating migration analyses, regulatory stress testing, and good-bad analysis. On a transactional level, credit case reviews are performed on a sample of credit transactions performed during a set period (commonly one year). The purpose of these reviews is to assess the credit

administration process, the accuracy of credit ratings and overall quality of the loan portfolio, independent of the relationship with the borrower, using updated information on their financial and business conditions, and the conduct of the account. Exceptions in the credit monitoring process should also be evaluated for their impact on the a borrower's creditworthiness.

iv. Provisioning and Classification

If the reviews conducted by the risk management department indicate impaired loans, then subjective provisions are made against them as per the SBP's PRs.

v. Recovery and Resolution

If a loan becomes classified (OAEM, substandard, doubtful or loss), remedial strategies such as restructuring the loan facility, enhancing credit limits or reducing interest rates are sometimes used to help improve a borrower's capacity to repay.

Bad loans can be restructured or rescheduled to facilitate or improve a borrower's financial health. Collateral liquidation and court proceedings are a last resort as there is inefficient legal infrastructure around recovery laws in Pakistan.

Banks commonly determine the recoverable loan amount by valuing available collateral. For this purpose, annual desktop valuations are conducted, and field valuations are performed at least once every three years using an external valuator.

Cases for recovery are forwarded to the Special Asset Management Department (SAM), which is a separate division of a bank which looks after NPLs that require specialized recovery skills (SAMs are independent of business functions and report either to the CRO, CEO or the COO; models vary from bank to bank). SAMs mainly look after accounts classified as default and occasionally become involved with watch list, OAEM, substandard loans, or for amounts less than the bank's own threshold. SAMs generally work with legal teams to create an account action plan or recovery strategy, negotiate with clients and relevant parties for recovery and early resolution, recommend necessary restructuring, rescheduling write offs or waivers, review transferred accounts, and file recovery suits, liquidation petitions, and liquidation of collateral.

SAMs' policies for the recovery of NPLs and write offs are often based on:

a) Channeling non-performing or high-risk credits into performing and lesser risk credits
b) Taking coercive recovery measures; and as a last resort, recommending write off

The recovery method used by SAM depends on whether the borrower willfully defaulting or not.

vi. Willful Default

The Banking Recovery Law in Pakistan defines willful default as:

a) Deliberate or intentional failure to repay any finance, loan, advance or any financial assistance received by any person from an FI after such payment has become due under the terms of any law or an agreement, rules or regulations issued by the SBP.
b) Utilization of finance, loan, advance or financial assistance or a substantial part thereof, obtained by any person from a financial institution for a purpose other than that for which such finance, loan, advance or financial assistance had been obtained and payment in part or full not made to the financial institution.
c) Removal, transfer, misappropriation or sale of any assets collateralized to secure a finance, loan, advance or

financial assistance obtained from a financial institution without permission of such institution.[25]

In case of willful default exit strategies are almost always pursued (rather than rescheduling or restructuring the loan). Exit strategies involve recalling outstanding loan amounts and initiating legal action if a borrower fails to:

a) Partially settle up-front
b) Agree on an acceptable repayment schedule and rectify the causes of problem
c) Locate absconding defaulters and / or trace hidden assets

Banks can initiate actions irrespective of the amount of default for cases of willful default. They can:

a) Issue 30-day demand notice to the sponsors / guarantor / chief executive or any other person who the bank deems to have some control in the loan account.
b) In event of failure to repay as demanded in the notices, the bank would refer the case to Governor of the SBP which would be processed by SAMG head.
c) The Governor will issue seven days' notice to the defaulters.
d) Should the alleged defaulters fail to respond the matter would be referred to the NAB Chairman for filing reference.
e) Should payments be received, the Governor office will consider the response in the context of the bank's contentions and either refer the case to the NAB or provide directives to the bank to restructure or reschedule the loan.

vii. Circumstantial/Unwilful Default

Any default that is not willful is classified as circumstantial. In these cases, banks generally try to revive the account by:

a) Recovery of overdue mark-up and / or principal
b) Strengthening security or collateral
c) Ensuring adequate cash flows to keep the account current by closely monitoring the account and if necessary, consider rescheduling or restructuring

viii. Restructuring and Rescheduling

Restructuring and rescheduling are commonly used to help a borrower improve their financial health and repayment capacity. Depending upon the situation, concessions may include:

a) Reduction in mark-up
b) Change of tenor
c) Grant of additional financing
d) Recovery through revenue authorities

When rescheduling a loan, the profit terms usually remain unchanged, but the principal repayment tenor is extended because the borrower is unable to meet the original payment schedule. Key restructuring policies and practices followed by banks in Pakistan are in Annex S.

ix. Management buy-outs

Management buy-outs include acquiring a controlling interest in a defaulting company. To implement any proposed change, a bank may play the part of an investment bank by:

a) Persuading the existing management to exit, and

[25] National Assembly of Pakistan (2001), Recovery of Finance Ordinance http://www.na.gov.pk/uploads/documents/1458282736_494.pdf

b) Identifying and encouraging suitable entrepreneurs with financial and management capabilities to take over the commercially viable business. The bank's financial involvement continues until the final settlement of bank's assets.

5.14. Summary of Key Impediments and Recommendations

Table 16 summarizes the key impediments and recommendations for managing and reporting on NPLs.

The recommendations have been rated and colored according to their priority.

High	
Medium	
Low	

TABLE 16: RECOMMENDATIONS

S No.	Impediment	Recommendation
NPL Reporting Framework		
1	SBP's NPL reporting requirements do not require banks to report any operational, qualitative, or non-financial information. Qualitative information can provide market intelligence and future predictions which the quantitative information may fail to communicate.	SBP should consider requesting non-financial information about NPLs from banks such as a bank's NPL governance model, the operating model of its SAM function, its NPL strategy or any other similar information. This would align with international best practices (EBA; ECB guidelines).
2	The SBP's NPL regulatory reporting requirements are standardized for all commercial banks in Pakistan and there is no concept of proportionality or different reporting treatments for high-risk banks and standard risk banks.	SBP should consider segregating the NPL reporting requirements between high-risk banks and standard risk banks. This is common in Europe. Proportionality in NPL reporting supervisory standards is used to enhance NPL reporting and disclosure requirements for high-risk banks (those with NPL stocks above a certain threshold) while keeping the compliance burden to a minimum.
3	In the SBP's NPL reporting framework, there are no voluntary or best practice NPL reporting requirements. This reduces the information SBP receives about NPLs and the transparency of NPL transactions.	SBP can consider introducing voluntary NPL reporting, allowing interested banks to share further details on NPLs. This is in the EBA's NPL transaction or screening templates (voluntary) which have been introduced to set market standards for granular and portfolio level reporting of NPLs and create a more efficient, transparent, and enabling market for NPL transactions.
4	The SBP's NPL reporting framework requires little information on forborne exposures (loans whether performing or non-performing which have been restructured, rescheduled or have received any other form of concession) and fair values or market values of NPLs and collaterals.	SBP should consider enhancing the scope of information it requests from banks on forborne exposures and disclosures on the assessment of fair values of NPLs and collateral. Detailed information on credit quality of forbearance, quality and effectiveness of forbearance, ageing profile of forbearance and classification of performing and non-

S No.	Impediment	Recommendation
		performing forborne exposures should be reported by the banks. The results of annual assessments (or more frequently if required) of the fair value or market value of NPLs and collateral should also be reported to the SBP.
5	Ambiguity and lack of guidance on the definition, classification, treatment and reporting of NPLs and forborne exposures (rescheduled or restructured) loans.	Basel introduced guidelines on the treatment of problem assets in 2016. With these in mind, the SBP could address the following shortcomings in Pakistan's NPL reporting framework: a. No clear guidance on exposure-basis (debtor approach) classification when multiple loans have been granted to a borrower or to a borrower in a group. b. No all-encompassing definition, classification, treatment and reporting measures for forborne exposures. c. The SBP PRs do not cover the definition, classification, treatment, and reporting criteria for forborne performing exposures which would have been classified as NPLs if they were not allowed concessions. d. Terms such as 'Concession', 'Forborne Exposure', 'Unlikeliness to pay', and 'Financial Difficulty' are not clearly defined. e. Reporting and treatment measures for loans or exposures with multiple restructurings (forbearance measures) are not defined.
Write off Requirements of SBP vs IFRS 9		
6	Under the SBP requirements banks may write off loans that are still subject to enforcement activity as the banks can seek to recover amounts they are legally owed in full, but which have been partially/wholly written off. This allows the bank to write off loans without assessing all the possibilities and chances of recovery.	IFRS 9 writing off occurs when an entity has no reasonable expectation of recovering all or part of a financial asset although it is understandable to have prudential standards which are more stringent than an accounting standard.
Collateral Valuation Framework		
7	The PBA and PRs do not provide any guidance to banks for performing collateral valuations inhouse. The banks may have the resources and expertise available to perform desktop valuations (which must be conducted annually by either the bank or an external valuator). The PBA guidance or PRs on valuation only applies to situations where banks are required to use external valuators.	SBP could consider developing a collateral valuation framework for banks to perform valuations internally.
8	The PRs or the PBA guidance provide very little guidance on the selection and use of	SBP should provide guidance on collateral valuation methods and consider introducing multiple methods

S No.	Impediment	Recommendation
	accepted valuation methods. This raises ambiguity as to which valuation method is appropriate for which asset class.	for valuing the different asset types like the collateral valuation practices in Europe. European banks use a variety of approaches such as market-, income-, and cost-based. The ECB does not allow valuations to be exclusively based on a discounted replacement cost method, whereas in Pakistan this is widely used for plant and machinery valuations. The ECB guidance on NPLs has clear expectations around the use and suitability of valuation methods and other aspects of collateral valuation for banks. Further, international valuation standards such as those published by IVSC provide guidance on valuation methods and their fitness for asset types and the purpose of the valuation which can be prescribed by SBP.
9	External valuator firms are required to perform collateral valuation assessments according to the PBA guidance. However, these firms and their staff are not the members of any recognized international valuation bodies such as IVSC or RICS. This may cast a doubt over the accuracy of collateral valuations being performed in Pakistan.	PBA could encourage professional valuator firms to become a member of a recognized valuation standard setting body.

6. SECURITY ARRANGEMENTS, INFORMATION FRAMEWORK AND RISK MANAGEMENT

6.1. Overview of Secured Transactions Regime and Related Impediments

Removing the legal and regulatory impediments to secured transactions and enforcing security interests over movable and immovable assets (from a cost and timing perspective) could have a positive impact on the pricing of NPLs by buyers and enable a secondary NPL market to be developed in Pakistan.

6.1.1 Security Interest over Movable Property

The common forms of security interests for movable property in Pakistan include hypothecation (a charge created by a borrower on movable property, without delivery of possession of the movable property), pledges, liens, assignment of receivables by way of security and title retention arrangements, such as finance leases.

Movable property comprises a wide asset base including present and future assets, tangible or intangible property, property attached to immovable property (such as plant, equipment, machinery, fixtures and fittings, cables and pipelines embedded in the earth or otherwise).

The Financial Institutions (Secured Transactions) Act, 2016 and the Companies Act, 2017 govern security interests over movable property and the registration of security interests over corporate assets.

Among other things, the Secured Transactions Act covers:

- Creating security interests over corporate and non-corporate assets. Security interest may be created over movable property by entering into a security agreement to secure obligations of a borrower. Security interests created over movable property can extend to commingled goods and the proceeds of collateral, except as otherwise agreed in terms of the security agreement

- The effectiveness of security interest against borrowers. Security interest shall be effective when the borrower and the bank or DFI have agreed to create a security interest (against value to the borrower) over collateral which the borrower has the right to create security interest.

- The perfection (making the security interest effective against third parties) of security interest over corporate and non-corporate assets. If the security interest is created by a company, it may be perfected by registering with the companies' registry under the Companies Act, and if the security interest is created by a non-corporate entity, it may be perfected by registration with the secured transactions registry set up under the Secured Transactions Act (except in the case of security interest in collateral covered by a title document, security interest in negotiable instrument or a right of payment of funds credited in a deposit account - perfection may be by way of possession/control alone (as applicable)). Both the companies registry and the secured transactions registry are under the administrative control and operation of the SECP.

- Priority of security interests over corporate and non-corporate assets. The general priority is: (i) between unperfected security interests, the first to create security interest; (ii) a perfected security interest has priority over unperfected security interest; and (iii) between perfected security interests, the first to perfect the security interest.[26]

- Enforcement of security interest. A security interest may be enforced through a recovery suit while some. security interests can be enforced without the intervention of a banking court. Security interests that can be

[26] Under Chapter 11 of the Secured Transactions Act, certain special priority rules have also been prescribed.

enforced without a banking court include pledges, assignment of receivables by way of security,[27] perfected security interest in negotiable interest,[28] a right of payment of funds credited in a deposit account, and security interests based on retention of title or title documents.

- Enforcement of pledges: Pledges may be enforced without court intervention after a notice has been issued to a borrower after default. The notice may be waived if the collateral is in danger of being wasted, misappropriated or is perishable, or the amount of finance exceeds 10 million rupees.

- The duty of borrowers over non-possessory security interests. Borrowers are obligated to exercise care in the custody, preservation, maintenance or exploitation of the collateral.

- Rights of secured creditors in case of insolvency of borrower. Secured creditors have the right to stand outside of insolvency proceedings and a secured creditor's claim has priority over any preferential claim irrespective of whether the claim was made before or after the security interest was created. There are several aspects of legislation requiring clarification before establishing an NPL market in Pakistan. Since the Companies Act and the Secured Transactions Act were enacted at different time, it is necessary to align some of their provisions to ensure clarity. For example, the concept of perfection of a pledge through possession alone under the Secured Transactions Act, is contrary to the pledge registration requirement under the Companies Act.

- Pakistan's Secured Transactions Act does not override anti-assignment clauses which is contrary to the UNCITRAL Model Law on Secured Transactions. This means where the underlying contract has an anti-assignment clause, the rights under a contract cannot be assigned without the consent of the account debtor.
    - An amendment ordinance to partially align the Secured Transactions Act with the UNCITRAL Model Law on Secured Transactions solved some of the issues relating to contractual limitation on absolute assignment or assignment by way of security but it has now lapsed and has ceased to have any legal effect. Fresh legislation to make the necessary changes is currently before Parliament.

- Further amendments to clarify some legislation in the Secured Transactions Act or insolvency laws may be considered.

    - Judicial precedents have confirmed that secured creditors can stand outside of insolvency proceedings, however that principle will cease to have statutory force once the Secured Transactions Amendment is enacted.

    - The question of priority of a secured creditor's claim over preferential payments owed by the borrower to government authorities (such as tax) that arose prior to creation of the security interest has been the subject of some litigation. The courts have consistently held that a secured creditor takes precedence over all government claims created or accrued after the security interest of the secured creditors with some exceptions.[29]

- In the banking industry, pledges were mostly created by way of constructive possession held by the muqaddam (third parties appointed by banks or DFIs for constructive possession of secured movable assets). The risk with

[27] The right to enforce any assignment of receivables by way of security also includes the right to enforce security over movable or immovable property that secures the payment of receivables,

[28] A security interest in negotiable instrument includes security interest over asset securing amount payable under the negotiable instrument.

[29] In the case of floating charge, the matter of priority of secured creditors over Government claims created or accrued prior to the security interest may be addressed and resolved through the noted amendments. Section 65-A (as had been inserted vide the Secured Transactions Amendment) confirms the priority of secured claims over all claims (including Government claims), in view of the aforementioned judgments, it may be clarified that secured claims (unless otherwise provided for) shall not be subject to any preferential claim (whether arising before or after creation of security interest) by any person or authority. For example, see Habib Bank Ltd. v Messrs Rudolf Donhill (1999 PTD 2940 (Karachi High Court)) and Kenhill Limited, Karachi v. I.T.O., CO.CIR.A-3 (2000 PTD 1193 (Karachi High Court)).

this practice is the muqaddam creates multiple pledges over the same goods in collusion with borrowers and releases pledged goods without authorization. Although recent changes to legislation means pledges must be registered, the practical risk of collusive behavior between the borrowers and muqaddam and improper release by muqaddam remains.

- The Collateral Management Companies Regulations, 2019, issued by the SECP covers the registration, management and reporting requirements for collateral management and warehousing activities. Naymat Collateral Management Company Limited is the only collateral management company licensed with the SECP. The scope of these regulations is limited to managing and warehousing agricultural produce. A separate legislative framework may be required for collateral management activities for other types of movable assets.

6.1.2 Security Interest over Immovable Property

There are many ways that security interest may be created over immovable property in Pakistan., the most ones commonly used are simple mortgage and mortgage by deposit of title deeds, with the lender as security against default by the borrower.

Some of the issues relating to immovable property include land title system and disputes in Pakistan, mortgage by deposit of title deeds, and feasibility of English mortgage.

Land Title System and Disputes

The legal framework governing the ownership, transfer, acquisition, taxation, registration, tenancy of immovable property across Pakistan includes several Acts.[30] The title system associated with purchasing immovable property is both laboriously complex and very insecure. Apart from issues relating to court procedures and the difficulty in enforcing mortgages, other issues with the land titling system and ensuing disputes impede and delay the enforcement of security interests over immovable property (either through or outside of court proceedings).

- The title system still largely based on the traditional deeds registration system where a sale deed serves as the document of title and must be manually registered with the registrar of the locality where the immovable property is situated.
- The onus of investigating the 'good and clean chain of title' is on the prospective purchaser. The purchaser must approach the local patwari or registrar of the immovable property's locality and search through a vast paper-based record to verify the validity of the sale deed to the present owner.
- Land disputes are prevalent in Pakistan, many of which may, as acknowledged by courts, government officials and authorities, include frivolous claims.

The legal issues relating to land titles are especially relevant to mortgages and the recovery of NPLs secured through mortgages on immovable property.

To streamline the land title system and iron out these legal irregularities, the Government of Pakistan has set an agenda to reform the land title system by establishing a centralized and digitized system of land records. The provinces of Sindh, Punjab and Khyber Pakhtunkhwa have provided complete land records of state-owned land to begin the digitizing process of land records.

The United Nations HABITAT in Pakistan has also started a pilot program with the Board of Revenue for improving land records service delivery and enhancing the land management system in Khyber Pakhtunkhwa. A Digital Land Information System using a Management Information System (MIS) and a Geographic Information

[30] Transfer of Property Act, 1882; Punjab Tenancy Act, 1887; Government Tenants Act, 1893; Registration Act, 1908; Land Acquisition Act, 1894; Colonization of Government Lands Act, 1912; Sindh Tenancy Act, 1950; Khyber Pakhtunkhwa Tenancy Act, 1950; Provincial Land Revenue Act, 1967; Balochistan Tenancy Ordinance, 1978; Land Records Manual; Land Administration Manual; and Settlement Manual.

System (GIS) has been provided to the Board of Revenue to replicate across other provinces. To date there has been little progress in sharing the system across provinces.

Mortgage by Deposit of Title Deeds

The most common type of security interest over immovable property in Pakistan is a mortgage by deposit of title deeds.

As a general rule, any document that creates an interest in immovable property must be registered with the sub-registrar local to the property. If not registered, the document fails to create any right or interest in immovable property.

A mortgage by deposit of title deeds, on the other hand, is an oral transaction and no document is legally required to be executed or registered. Corporate borrowers are an exception – they must register mortgages and charges over immovable property with the SECP. Although not a legal requirement, it is an established practice to obtain a memorandum in writing from the mortgagor recording that the borrower has deposited the title deeds with a bank or DFI with the intention to secure its obligations. These memorandums are a private document between the bank or DFI and the borrower and are not registered.

To make these mortgages public and to protect against sale to third parties, it is common to create a mortgage by deposit of title deeds and couple it with a token registered mortgage. A token mortgage is registered for a small percentage of the loan, while to cover the remaining portion of the loan, a mortgage by deposit of title deeds is created on the property as security. Legally, the token mortgage adds nothing to the security interest when a mortgage by deposit of title deeds has been created, and they can only be enforced for the amount secured under the token mortgage.[31]

It is important to note that for the purposes of recovery proceedings banking courts (and the High Court) must accept any document that creates a security interest regardless of whether it requires registration by law. This requirement is under the Banking Court or High Court Section 18(4) of the Recovery Ordinance. Similarly, if a financing document or a security document that requires registration has not been registered, it can still be admitted and recognized in evidence.

It remains to be determined whether the effect of Section 18(4) is to only admit unregistered instruments in the Banking Court or High Court or, it goes beyond that, to treat unregistered documents as creating rights in property even when they have not been registered. If the latter is adopted, it means that Section 18(4) renders the Registration Act redundant as far as financing by banks or DFIs is concerned.[32]

English Mortgage

It needs to be determined whether a mortgagee bank or DFI can acquire the mortgage property in its own name at the time of granting a mortgage, and where whether the property can further the interest of a mortgagee for enforcement purposes.

While it may be legally feasible, it could be argued that it is not likely to further the interests of the mortgagee bank or DFI.

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[31] As currently, there is no registration of mortgage by deposit of title deed, registration of token mortgage under the Registration Act can technically serve to put the public to notice. Given, however, the flaws in our land titling system (as noted above) the practical utility of such notice is unclear.

[32] At least two decisions of the Karachi High Court support the latter interpretation on the basis that the Recovery Ordinance was special law and hence it prevailed over the provisions of the Registration Act (a general law). [32] However, both decisions dealt with a mortgage created by deposit of title deeds which, as a matter of law, is not required to be created through a registered instrument. See Muhammad Sarwar Khan v Habib Bank Limited) (2004 CLD 881) as followed in Mubarak Ali vs. First Prudential Modaraba (2006 CLD 927 (Karachi)).

The Transfer of Property Act defines an "English Mortgage".

> "Where the mortgagor binds himself to repay the mortgage-money on a certain date, and transfers the mortgaged property absolutely to the mortgage [mortgagee], but subject to proviso that he will re-transfer it to the mortgagor upon payment of the mortgage-money as agreed, the transaction is called an English mortgage."

When taken literally, an English Mortgage is an absolute transfer. However, it can also be understood to be a mortgage with the caveat of the mortgagor having the right to retransfer upon payment of the mortgage money. While reported Pakistani judgments on the subject have not been found, there is a question of interpretation in similar Indian legislation which have gone to court. There is one line of cases where the courts have treated an English Mortgage as an absolute transfer,[33] and others that have held that an English Mortgage cannot be substantively considered an absolute transfer.[34]

While resolving the controversy by amending the TP Act is possible, on balance, it would be better not to do so.

- For example, if the English Mortgage is treated as an absolute transfer, there could be privity of contract between the mortgagee bank or DFI and say, a tenant on the mortgage property This can effectively make the mortgagee bank or DFI liable in relation to the mortgage property as its owner, a level of risk that most banks would be unwilling to take.[35]
- If the English mortgage is not treated as an absolute transfer, then it would be a mortgage and its efficacy of enforcement would face similar land titling system constraints that are prevalent in Pakistan as other mortgages.

6.1.3 Syndicated Security Arrangements

Many financing or security arrangements in Pakistan are based on trust. For example, financing raised through debt security instruments or trust arrangements for custody and the enforcement of security interests in the case of syndicated financing. A recent overhaul of trust laws set out the detailed process registering trusts in Pakistan. This market diagnostic, briefly highlights: (i) the requirements of the revamped trust laws; (ii) the impediments in creation of syndicated security arrangements under trust structures that may ultimately have implications for servicing of NPLs acquired by buyers as well as pricing of NPLs in the primary and secondary markets; and (iii) makes related recommendations.

Security interests created through a trust instrument in favor of a trustee, for the benefit of banks or DFIs (Security Trust Instruments) are commonly adopted for large-syndicated financing provided to corporate borrowers.

Security Trust Instruments must be registered with the Assistant Director in each District under the Industries and Commerce Department of Sindh, within a period of time to be notified by the Sindh Government (to our knowledge this timeframe has not yet been issued). Trusts not registered will stop functioning or operating.
Trusts' registrations must be renewed annually, and trustees should apply for renewal 30 days before the registration expiry date.

This registration under the Sindh Trust Laws is cumbersome and the requirement to renew annually is likely to create concerns for secured creditors. Changes to legislation would help to alleviate this challenge.

- Under the Sindh Trust Laws, given that they are otherwise regulated, 'specialized trusts' (including trusts for creating collective investment schemes and vehicles, debt securities, employee benefit funds, provident, pension and gratuity funds) are treated differently. Security trust instruments in the context of syndicated financing are not classed as 'specialized trusts'.

[33] Bengal National Bank v Janaki Nath Roy (AIR 1927 Cal 725).
[34] Falakrishna Pal v Jagannath, (AIR 1932 Cal 775).
[35] Ramkinkar v Satyacharan (AIR 1939 PC 14).

- A ‘no-objection certificate’ from the relevant regulator satisfies the registration requirements for specialized trusts and it is not necessary to annually renew a specialized trust.
- –To be treated as a specialized trust where the security is held for and on behalf of banks or DFIs, the following is required:

  - Certain directives to be issued by the SBP to regulate the creation of security interests in favor of a security trustee; and

  - A notification (published in the official Gazette) from the Sindh Government.

6.1.4 Multiple borrowings

It is common in Pakistan for multiple banks or DFIs to simultaneously lend to borrowers on the condition that a bank or DFI procures a no-objection certificate (NOCs) from the bank or DFI that has already lent to the borrower. The NOC is intended to ensure that both lenders hold the underlying security equally. In many of these cases lenders do not enter security sharing agreements. This means there is often no understanding among the banks and DFIs of how to enforce the security upon a default which can cause delays in enforcing or settling NPLs. Where the security is held on a ranking basis the problem becomes more acute where the inferior charge holder wishes to enforce, and the superior charge holder does not.

To alleviate this problem, banks and DFIs should draw up suitable agreements as guided by the PBA through suggested drafts or example templates.

6.2. Registries and Information Framework

The credit information system in Pakistan is based on the eCIB, which is operated and maintained by the SBP, and licensed private credit bureaus, which are regulated by the SBP.

6.2.1 Credit Information System - eCIB

The first credit information bureau was established by the SBP in 1992 and was made electronic in 2003 through the eCIB.

- All banks, DFIs, non-bank financial companies and micro finance banks of Pakistan are members of the eCIB.
- The eCIB collects and collates credit data about borrowers (including corporate borrowers) which it uses to create credit reports of borrowers
- Various PRs issued by the SBP require banks and DFIs to assign a weighting to the credit reports whilst considering proposals for any exposure (including renewal, enhancement and rescheduling or restructuring). A negative credit report does not prevent lending to a borrower, provided that a bank or DFI strictly follows its own risk management policies and credit approval criteria and properly records the reasons for the approving the financing.
- If borrowers are 90 days’ overdue on repayment, banks and DFIs are required to notify borrowers they have 15 days to reconcile or settle liabilities before reporting the name of the borrower to eCIB’s list of defaulters.
- Borrowers can approach their bank or DFI for complaint resolution. If the matter remains unresolved, they can lodge a complaint with SBP and subsequently the banking mohtasib. After exhausting these options, borrowers aggrieved by a Credit Report (or who distrust the genuineness and truthfulness of information supplied by any bank or DFI) may challenge the report before High Court.[36]

[36] The Lahore High Court[36] (Messrs Yousaf Sugar Mills vs. Trust Leasing Corporation and others (2006 CLD 1191).)
whilst deliberating upon the issue of placement of a person on the defaulter list of the SBP held that such an action was unmerited prior to determination of the genuineness of the information received. Subsequently, this reasoning has been applied in various cases where the veracity of a Credit Report was challenged by a borrower and the High Court held that the SBP is required to ascertain the genuineness and truthfulness of the information provided by a financial institution before making it available to other financial institutions. Placing a person on eCIB’s list of defaulters can negatively impact a business’ ability to enter freely into a contract with financial institutions and impedes the right to free trade (Tanveer Shakoor vs. FoP etc. (2020 CLD 728) and Messrs Yousaf Sugar Mills vs. Trust Leasing Corporation and others (2006 CLD 1191)).[36]

- There are other laws that provide protection against the dissemination of false information, however, to date no proceedings against a bank or DFI for dissemination of false information have been initiated under these laws.

6.2.2 Credit Bureaus

The e-CIB is the only credit information bureau that provides a comprehensive report for borrowers as all banks and DFIs are members. Apart from e-CIB, there are two other licensed private credit bureaus operating in Pakistan. Based on discussions with the SBP, private credit bureaus have recently been authorized to collect credit information from utility and telecommunication companies.

All Banks or DFIs are required to become members of and provide credit information to at least one private credit bureau. This means private credit bureaus may not have complete credit information about borrowers as not all banks and DFIs are their members.

- Private credit bureaus collect information from various sources including credit institutions, persons, entities (non-financial companies and bodies, lenders and authorities), and include any court judgements related to a borrower in their records.
- Banks or DFIs are required to send intimation letters to borrowers before reporting them as defaulters to private credit bureaus and provide them with at least 15 days for reconciliation or settlement of overdue liabilities.
- Unlike the eCIB (where credit reports are only available to the members of the eCIB) any person may obtain and pay for a credit report from a private credit bureau.
- Private CIBs are obliged to take reasonable steps to ensure the credit information they collect and disseminate is accurate, complete, and not misleading and they have a duty to disclose the source of their information should borrower request.
- A borrower may file a complaint with the SBP against a private credit bureau for disseminating false information, and if aggrieved by the outcome of their complaint, may appeal to the High Court.

6.3. Recommendations

Table 17 presents a summarized list of key impediments and related recommendations relating to security arrangements, information frameworks and risk management.

The recommendations have been colored according to their priority.

High	
Medium	
Low	

TABLE 17: RECOMMENDATIONS

S No.	Impediment	Recommendation
1	Certain provisions of the Companies Act are not aligned with the Secured Transactions Act.	Enact of fresh legislation (currently pending before Parliament) to effect the changes proposed under the Secured Transactions Amendment.

S No.	Impediment	Recommendation
2	Contrary to the UNCITRAL Model Law on Secured Transactions, the Secured Transactions Act does not override contractual anti-assignment clauses.	Enact fresh legislation (currently pending before Parliament) to effect the changes proposed under the Secured Transactions Amendment.
3	While ever the practice of constructive possession of pledged assets through muqaddams continues, there is a practical risk of collusive behavior as between borrowers and muqaddams and improper release by muqaddams.	A separate legislative framework may be required for collateral management activities for movable assets as the existing framework focuses primarily on agricultural produce.
4	The land title system in Pakistan is still largely based on manually registered sale deeds which is a time consuming and unreliable process and does not facilitate public access to reliable land records.	The process of centralization and digitization of land title system across Pakistan needs to be completed in urban as well as rural areas.
5	With the recent revamping of trust laws in Pakistan, creation and registration of syndicated security arrangements has become complex and could have implications for the servicing of NPLs acquired by buyers and the pricing of NPLs in the primary and secondary markets.	To help create and register trusts for holding security interests for financings, and to bring them in line with financing raised through the issuance of debt securities, it is recommended that security trusts created as part of syndicate financings should be classed as specialized trusts for which the registration requirements under trust laws have been relaxed.
6	With respect to multiple borrowings, in many cases, there is no understanding among the banks or DFIs as to how to manage or enforce the security upon a default – which contributes to delays in enforcement or settlement of NPLs.	Banks and DFIs should be encouraged to enter intercreditor and security arrangements.

7. TAXATION LAW AND PRACTICE FOR NPLS IN PAKISTAN

7.1. Overview of NPL Taxation in Pakistan

The income and profits of a banking company in Pakistan are taxed as per the provisions of the 7th Schedule of the Income Tax Ordinance, 2001 (ITO). There are some sections in the Ordinance such as those relating to tangible assets, and disposals which apply to the taxation of banks. It also states that all matters not specifically covered by the 7th Schedule, will be dealt with according to the relevant section in the Ordinance.

The over-arching provision (with some exceptions) requires banking profits are taxed based on their annual financial statements. In Pakistan, banks are incorporated as public and/or public listed companies and their financial statements are prepared according to the format of financial statements prescribed by SBP through BPRD Circular No. 02 of 2018 and in accordance with IFRS, IFAS as notified by the Companies Act, 2017 and the provisions of the Banking Companies Ordinance, 1962.

The rules of allowance or deductibility of provisions are:

- Provisions for advances and off-balance sheet credits for consumer and SME portfolios (gross of any reversals) classified as 'loss' are allowed at a maximum of 5 percent of the total advances for a bank, subject to an external auditor's certificate.
- Provisions for all categories of advances and off-balance sheet credits classified as 'loss' except for consumer and SME financing, gross of any reversals, are allowed at a maximum of 1 percent of the total advances for a bank, subject to an external auditor's certificate.
- Provisions exceeding 1 percent or 5 percent for specific portfolios may be carried forward by banks.

The 7th Schedule was introduced to harmonize the taxation of banks with the rules of computation provided by the PRs and the relevant accounting framework. However, subsequent amendments have introduced inconsistencies between the tax computations, PRs, and the accounting computations. For example, the Schedule initially provided thresholds based on classified advances, which was later changed to gross advances. Initially loan loss deduction limits were applicable to the doubtful category, and this was removed to restrict the allowance to only loss categorized advances.

Comparing the tax laws in Pakistan, with others globally, there are two methods to tax loan losses. The first is the charge off or write off method where loan losses only become tax deductible when the debt is deemed fully uncollectible, written off in the accounts, and legal or prudential criteria are satisfied. The second is a reserve or provisioning method where a loan loss provision either in full or in part (subject to a limit) is allowed. These criteria apply to specific provisions, as general provisions or floating provisions are not allowed in many countries.

The tax treatment of loan losses and provisions in Pakistan follows the reserve method. This practice is consistent with the methods of tax treatment of loan losses globally. For example, in India, banks are allowed a tax deduction for provisions for doubtful and bad debts to the extent of 8.5 percent of adjusted total bank income with an additional 10 percent of the total average advances of the bank's rural branches.

7.2. Taxation of Loan Provisions, Deductibility and Reversals

The thresholds for allowing a tax deduction for provisions should be reviewed to ensure that tax deductions cover the loss accrued by a bank as result of a loan becoming non-performing without delay or advance. The tax law in Pakistan does not allow for a provision to be deducted until the loan has reached a stage where it is classified as 'loss' – typically at least one year from when it was first classified as an NPL.

- Generally, as per the SBP's PRs, a NPL is classified as 'loss' when it is 365 days or more overdue but it must be classified as an NPL in the 'sub-standard' category soon as it is 90 days overdue. This means from the date that an exposure is classified as non-performing, there is an approximate lag of 275 days before it can avail a corresponding tax deduction. And, when available, such deduction is subject to maximum limits, causing the spill-over to be carried forward.
- These provisions would make it desirable (not necessarily possible) for a bank (purely from a tax perspective) to delay a provision until either the exposure becomes performing, or it qualifies as 'loss' or for write off.
- For deductibility the tax treatment of 'loss' NPLs and written off loans is similar because the tax benefit or deduction becomes available as soon as a loan is loss classified or written off. The only difference between

the two is that the maximum limits of 1 percent or 5 percent do not apply to write offs, making them the only scenario where the full benefit of tax deduction is available to a bank.

Thresholds need to cover all types of portfolios of a bank to stay relevant. The SBP has issued PRs for corporate and commercial banking, agriculture finance, housing financing, infrastructure finance, consumer finance, microfinance and SME finance. However, the ITO only provides specific deductibility criteria for SME finance and consumer finance, leaving all other classes of advances with the 1 percent deductibility limit or to be adjusted to fit the definition of a consumer or SME.

The tax provisions for deductibility thresholds need to evolve based on Pakistan's economy and to make sure that tax deduction is allowed timely and substantially covers losses accrued by a bank when loans become non-performing.

The implementation of IFRS 9 is expected by January 2022. The existing tax framework provides limits that are designed to ensure that loan losses are only fully allowed for tax purposes when a loan has become uncollectible or bad. On the contrary, IFRS 9 requires early recognition of provisions based on the probability of default determined at the time a loan is booked. and for the complete life of the loan. It is expected that post-implementation, the stock of general provisions for banks will increase as banks recognize additional provisions for the performing category of loans required under IFRS 9. General provisions are not tax allowable and are seen as immaterial compared with the size of specific provisions. However, when general provisions increase on an industry level and continue to be disallowed in the tax framework, there is a pressing need to revise, expand and harmonize the tax deductibility limits with those in the prudential and accounting frameworks.

Reversal of provisions for loans which are loss categorized are treated as income in the tax year in which the reversal occurs. In practical terms, it is common for tax authorities in Pakistan to pick up provision reversal transactions for previously disallowed provisions, designate them as income and re-determine a bank's tax liability, causing double taxation. These are often successfully challenged by banks in Income Tax Tribunals which wastes considerable time and effort.

For financial reporting and accounting, it makes sense for banks to book provisions in a given financial year, net of provision reversals. Historically, banks have submitted provisions for tax deduction net of reversals as per their accounting practice. This resulted in challenges for banks when provision reversals (which had already been netted) were taxed as income. Amendments in 2019 to the Finance Act clarified that provisions would be allowed gross of reversals (with the aim to tax provision reversals as income separately to when the reversal took place). The impact of this is as yet unknown, but it is likely that the amendments which create another disparity between the tax law and accounting practice, will add complexity to the tax assessment process when there are different tax periods involved, and require banks to maintain excessive internal records and reconciliations to satisfy the needs of tax authorities. These issues could be avoided if more harmonized and simplified tax rules were introduced.

7.3. Taxation of Loan Write offs

Advances written off by a FI are allowed as a deduction with the condition that 'there are reasonable grounds for believing that the debt is irrecoverable'. This provision seems excessive and has the potential to hamper genuine deductions to banks whose write offs are approved by its Board of Directors and meet the minimum criteria provided by the regulator. Write off proposals to the Board are certified by a bank's internal audit department and the write off transaction is later audited by external auditors. Tax authorities demand extensive evidence to allow write offs, disregarding the fact that there are multiple regulatory, policy and third-party checks that a bank must complete before it can book a loan write off. The tax law should be updated to rely on those checks and introduce loan write off provisions which are less cumbersome for banks.

7.4. Tax Treatment – Fair Value Considerations in Sale of NPL

As discussed above, the income and profits of a banking company in Pakistan are taxed as per the provisions of the 7th Schedule of the Income Tax Ordinance, 2001. This includes profit and/ or losses arising from all the revenue streams in a bank. As described earlier, these profits and/or losses are determined based on the annual audited accounts of banks prepared in accordance with the applicable accounting framework in Pakistan (with some exceptions or disallowances) and submitted with the State Bank of Pakistan. Further, the 7th Schedule disallows recognition of any notional losses or gains by a bank unless the actual event of the gain or loss has occurred. Therefore, any gains or losses recognized as a result of book entries (such as fair valuation or impairment) are disallowed.

The ITO (including the 7th Schedule) does not cover the tax implications of an NPL portfolio sale, transfer, securitization, fair valuation, and deductibility or gains or losses arising from an NPL transaction. In the absence

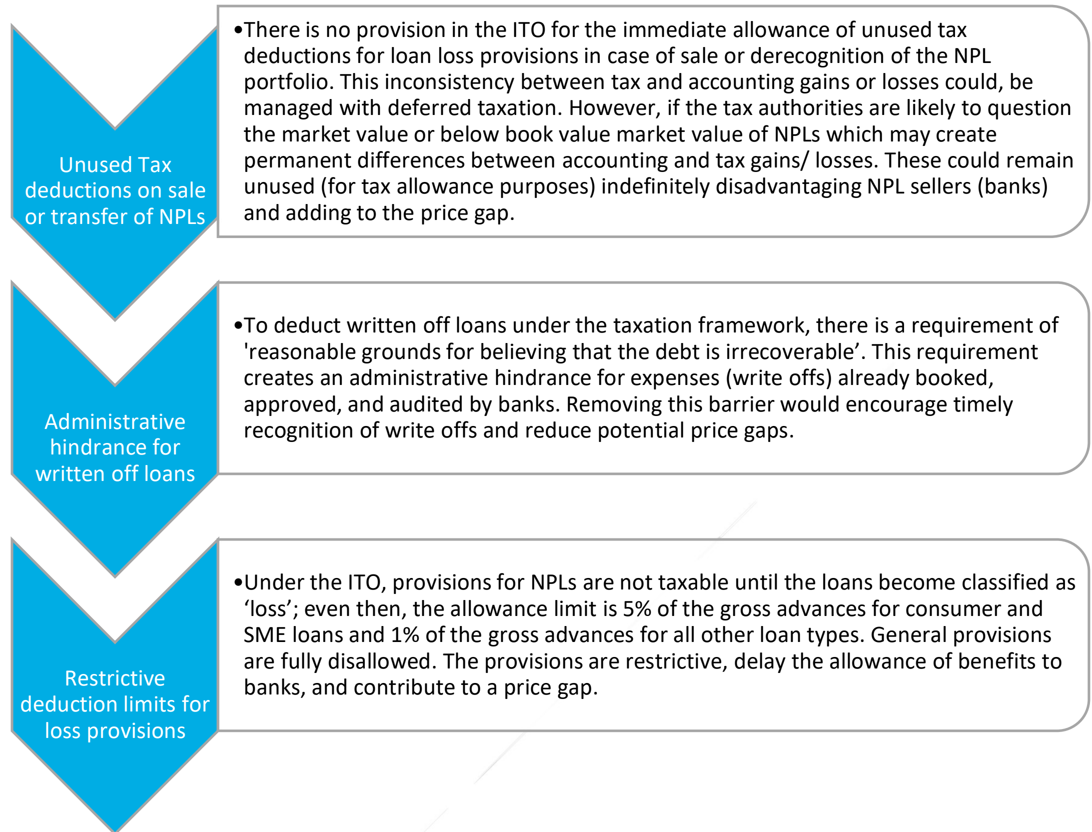
of specific tax provisions, transactions involving NPLs will be tax based on the existing tax framework and rules in the applicable accounting framework. This may create interpretational issues between banks and tax authorities.

- Where NPL portfolios are sold or transferred to Special Purpose Vehicles (SPVs), the transactions might not be counted as a tax liability as they do not meet the criteria of a true sale or an outright sale. The Commissioner Inland Revenue Commissioner can re-characterize a transaction or an element of a transaction that was conducted as part of a tax avoidance scheme. The Commissioner can also disregard an entity or a corporate structure that does not have an economic or commercial substance or was created as part of a tax avoidance scheme. It would be prudent for the taxation framework in Pakistan to recognize special transaction structures as acceptable means of NPL market transactions.
- The book value of an NPL portfolio at the time of sale or transfer will be another point of confusion. The ITO does not recognize book entries or provisions against NPLs except for those categorized as 'loss' and deductions are subject to maximum ceilings of 1 percent or 5 percent of gross advances. The result is that the NPL book value for taxation purposes is likely to be higher than the accounting book value. Currently, there is no provision to immediately allow unused tax deductions for loan loss provisions in the case of the sale or derecognition of the NPL portfolio. This inconsistency between tax and accounting gains or losses could be managed with deferred taxation. However, it is likely that tax authorities will question the market value or below book value market value of NPLs which could create permanent differences between accounting and tax gains or losses. These would remain unused (for tax allowance purposes) indefinitely disadvantaging NPL sellers. In other words, these permanent differences will arise and continue to exist if the un-used or disallowed provisions in the excess pool are not allowed to be deducted at the time of sale or transfer. The impact of these differences could be rising NPL price gaps which are known to be a detriment to the development of a secondary market.
- Permanent differences of tax consequences may also arise where the NPL book value for a bank includes principal receivables, mark-up receivables, any contractual penalties or surcharges, and any impairment or fair valuation losses, while the tax law only recognizes the principal receivable as the tax book value of a loan.
- Where an NPL sale transaction is received other than in cash (for example against issuance debt or equity interest, which is not publicly traded), it will be difficult to determine the fair value of the payment in the existing taxation framework without guidance. The ITO should allow generally accepted fair valuation methods to be used to determine the value received in an NPL sale. It currently says that if the price of an asset, except immovable property, is not ordinarily ascertainable, then the price may be determined by the Inland Revenue Commissioner. The Commissioner's discretion in this case may create challenges for buyers and sellers of NPL portfolios, where fair values are determined and negotiated based on internal cash-flow models and not by reference or comparison to an active market.

7.5. Shortcomings in the Taxation Framework Contributing to a Price Gap

Figure 22 summarizes the shortcomings in the current taxation framework which may contribute to a price gap for NPL transactions between buyers (investors) and sellers (banks).

FIGURE 22: SHORTCOMINGS IN TAX FRAMEWORK CONTRIBUTING TO PRICE GAP



7.6. A summary of key impediments and recommendations

Table 18 summarizes the key impediments of taxation law to creating a secondary NPL market and related recommendations. The recommendations are colored according to their priority.

High	
Medium	
Low	

TABLE 18: RECOMMENDATIONS

<table>
<tr><th>S no.</th><th>Impediment</th><th>Recommendation</th></tr>
<tr><td>1</td><td>Delay and limitation in the tax allowance of loan provisions.

Provisions for NPLs are not tax allowable until loans become classified as ‘loss’. When loans are classed as a loss, the provisions are tax allowed at 5% of gross advances for consumer and SME loans and 1% of gross advances for all other types of loans.

This delays and limits the tax deduction benefits available to banks for loan loss provisions. The need for an auditor’s certificate to be able to claim a tax deduction exacerbates this issue.

Implementing IFRS 9 in 2022, is likely to add to the stock of general provisions for the banking industry and increase the number of disallowed deductions to banks.</td><td>i. Loan provisions should be treated in the same way as they are in the Prudential Regulations and the accounting framework.

ii. Limits and allowable provision categories in the tax framework should be revised to allow sufficient and timely deduction of provisions given the likely uncollectible cash flows in each of the categories.</td></tr>
<tr><td>2</td><td>Ambiguities and interpretational issues in the tax framework.

One of the practical challenges in determining tax allowable provisions is when a reversal of a disallowed tax provision (from a past tax year) is erroneously assessed as income in the year of reversal. This causes double taxation. These instances are often corrected but not without considerable time and effort.</td><td>i. In the short term, these ambiguities or interpretational issues may be resolved by explanatory provisions or amendments in the tax law which are clear and back-tested.

ii. In the long term, harmonizing the tax framework with the accounting and prudential framework applicable to banks, will eliminate any room for misinterpretation.</td></tr>
<tr><td>3</td><td>Administrative difficulties in the tax allowance of write offs.

Banks can write off loans only after complying with strict internal policy and regulatory requirements. Despite these, the ITO, allows a deduction for written off loans when ‘there are reasonable grounds for believing that the debt is irrecoverable’ and tax authorities demand extensive evidence and documents to allow write offs ignoring the multiple regulatory, policy and third-party checks for a bank before it can book a loan write off.</td><td>Simplify the taxation of write offs for banks by harmonizing the ITO with the prudential and accounting frameworks applicable to banks. This will allow both provisions and write offs to be recognized the same way and satisfy the same standards as required by the prudential and accounting frameworks.</td></tr>
<tr><td>4</td><td>No specialized tax framework for NPL sale, transfer or securitization transactions.

The ITO does not specifically cover the tax implications of an NPL transactions. In their absence, special legal structures such as SPVs may be re-characterized to prevent tax avoidance. Below-book value NPL</td><td>Introduce specialized provisions that address the tax impacts of portfolio sale, transfer, agency or securitization transactions especially with respect to recognition of specialized legal structures and the use of generally accepted fair valuation models to the</td></tr>
</table>

S no.	Impediment	Recommendation
	transactions, complex instrument transactions or transactions through instruments not publicly traded, may be dis-allowed for not having a commercial purpose or being a true sale. This is a major impediment to developing secondary NPL market.	ITO. For the tax framework to be conducive to developing a secondary NPL market, a more principle-based approach should be followed in setting this framework, so it is not overly restrictive.

8. NPL RESOLUTION – A REVIEW OF LEGAL REQUIREMENTS AND PRACTICES IN PAKISTAN

8.1. Recovery by Banks or DFIs

There are various options available to banks and DFIs for recovering NPLs. The various resolution strategies will be important for primary or secondary investors looking to invest in Pakistan's NPL Market with a view to maximizing recovery or returns through NPL assets.

8.1.1 Enforcement of Security Interest through Court Intervention

Recovery Proceedings under the Recovery Ordinance

The recovery laws in Pakistan have been constantly evolving and despite a series of laws enacted to address delays and offer fast track recovery avenues, disposal of recovery cases remains a time-consuming process.

The Recovery Ordinance primarily provides a summary procedure for recovery of bank or DFI loans and loan defaults before the Banking Courts or High Court. Salient features of the Recovery Ordinance, are in Annex K (Salient Features of the Recovery Ordinance).

Given the number of recovery proceedings under the Recovery Ordinance and the technical aspects surrounding NPLs, resolving recovery cases is a lengthy and cumbersome process as shown in Table 19.

TABLE 19: PROCEEDINGS, COURT AND TIMELINE

Proceeding	Court[37]	Timeline
Recovery Suit under Section 9 of the Recovery Ordinance	Banking Court	2-3 years
	High Court	Over 7 years
Execution proceedings	Banking Court	1.5-3 years
	High Court	3-5 years

Criminal proceedings against borrowers under various criminal laws

Various statutes provide for criminal proceedings against borrowers who default on loans obtained from banks or DFIs. The most typically used are:

(a) A bank or DFI initiates criminal proceedings against an alleged willful defaulter as defined under the Recovery Ordinance.[38] The Federal Investigation Agency (FIA) is the designated agency to inquire and/or prosecute these matters. To initiate criminal proceedings under the Recovery Ordinance, a 30 day notice is served to defaulter, and after this, the bank or DFI can request to begin criminal proceedings through a complaint made to FIA.

(b) Until recently, the National Accountability Bureau (NAB) (subject to approval of the Governor, SBP) may have inquired into and investigated *inter alia* any willful default by a borrower to pay any amounts due to any financial institution under Section 5(r) read with Section 31D of the National Accountability Bureau Ordinance, 1999 (NAB Ordinance). Recently, with the promulgation of the National Accountability (Second

[37] Based on the discussion with litigators, recovery and enforcement proceedings instituted in Islamabad and Punjab are relatively speedier than in Sindh.

[38] The offence of willful default has been defined under Section 2(g)(i) of the Recovery Ordinance, to include *inter alia* deliberate or intentional failure to repay any loan received by any person from a financial institution after such payment has become due under terms of an agreement or applicable laws, improper utilization of any finance and/or improper use, transfer or sale of collateralized assets without consent of financial institution.

Amendment) Ordinance, 2021 scope of the said law has been revised to exclude from its ambit any persons not directly or indirectly connected with the holders of a public office (Section 4(2)(c)).[39]

(c) Certain criminal offences in connection with banking/financing matters tried before courts constituted under the Offence in Respect of Banks (Special Courts) Ordinance, 1984 (ORBO).[40]

When initiating and pursuing criminal proceedings in connection with NPLs, the Recovery Ordinance overrides the ORBO, the FIA Act and the PPC so any criminal proceedings against a defaulting borrower for 'willful default' cannot occur at the same time as those under the ORBO, FIA Act and PPC.[41] The law relating to concurrent criminal and civil proceedings has been the subject of some legal debate with conflicting case law on the subject.[42]

8.1.2 Enforcing Security Interests without Court Intervention

Enforcing security interests over immovable property

If a mortgagor fails to pay the amount demanded after the bank or DFI has issued the required notices, within the prescribed period, the bank or DFI can sell the mortgaged property or a part of it by public auction and use the proceeds as the repayment of the outstanding mortgage. They must send notices to all interested parties and publish these in newspapers with wide circulation.

The Recovery Ordinance was intended to allow banks or DFIs to foreclose on mortgages without going to court. Unfortunately, the relevant section of the Ordinance (Section 15) was declared unconstitutional by the Lahore High Court and later the Supreme Court of Pakistan[43] on the grounds that banks or DFIs were not entitled to sell mortgaged property unless and until the amount in dispute had been finally determined by a court. The Supreme Court also had concerns about the procedural safeguards available to a mortgagor in the case of an out-of-court sale by bank or DFI. Banks and DFIs were left with no option but to file suits for the determination of disputes and then proceed with the sale of property through execution proceedings (a process which can take years to complete). Further amendments and constitutional challenges have been made to the Ordinance, the result of which are that a detailed procedure for the foreclosure of mortgaged property (without court intervention) was introduced to cure the defects in the old legislation. A brief on the procedure prescribed for foreclosure is in Annex L (Foreclosure Process). In a separate judgment, the Lahore High Court[44] struck down the rule allowing banks or DFIs to sell to a single bidder, which is incongruous with the concept of a public auction. The Recovery Rules in the Recovery Ordinance Amendment have used the term "public auctions".

Observations with respect to sale of immovable property without court intervention are:

(a) One of the objectives of the Recovery Ordinance is to provide for the sale of mortgaged property by a bank or DFI without intervention of the court. However, Section 15 of the Ordinance also vests the Banking Court with the power to grant injunctive orders restraining the sale or proposed sale of mortgaged property and in practical terms, it is easy to obtain injunctive relief from the courts in Pakistan. The result is that the Ordinance's objective cannot be achieved when the Banking Courts grant injunctive orders in favor of mortgagors, rendering the auction or sale process fruitless.

(b) Whilst the revised auction process may be time consuming and cumbersome, the requirements have been

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[39] It may, however, be noted that the NAB Amendment Ordinance (unless approved by the Parliament or extended in accordance with the requirements of the Constitution of the Islamic Republic of Pakistan, 1973), shall, upon expiry of one hundred and twenty days from the date of promulgation thereof, lapse and cease to have any force and effect.

[40] Examples of offences triable before special courts set up under ORBO include *inter alia* offences under Sections 403, 406, 408, 467, 468, 471, 472, 473, 475 and 477-A of the PPC (that *inter alia* relate to dishonest misappropriation of property, criminal breach of trust, forgery and falsification of accounts).

[41] Syed Mushahid Shah v Federal Investment Agency (2017 SCMR 1218); Mian Ayaz Anwer v. State Bank of Pakistan (2019 CLD 375).

[42] (Abdul Shakoor Kaloodi v The State (2003 PcrLJ 626)). Some jurisprudence on the subject has upheld the position that civil and criminal proceedings may be pursued concurrently (Seema Fareed v. The State and another (2008 SCMR 839); Muhammad Aslam v The State (2017 SCMR 390); Muhammad Akbar v The State and others (PLD 1968 Supreme Court 281)). Having said that, in more recent jurisprudence of Pakistan Courts, it has been clarified that Sections 5(r) and 31D the NAB Ordinance and any other related proceedings cannot be invoked by NAB simultaneously with the Recovery Ordinance or prior to the determination of default of an obligation to pay under the Recovery Ordinance. Similarly, any proceedings of 'willful default' under the Recovery Ordinance (where dependent on any determination of default by the borrower to pay) may only be invoked after determination of borrower's default of its payment obligations under the Recovery Ordinance (Mian AYAZ ANWAR versus STATE BANK OF PAKISTAN (2019 CLD 375). We may note, however, that an appeal against the noted judgment has been filed and is pending adjudication).

[43] Muhammad Umer Rathore v. Federation of Pakistan (2009 CLD 257) and in National Bank of Pakistan v. SAF Textile Mills (PLD 2014 SC 283).

[44] Muhammad Shoaib Arshad v. Federation of Pakistan (2020 CLD 638).

prescribed to ensure the constitutionality of the legislation after lengthy court battle. Any deviation or legislative changes to alleviate the prescribed requirements will run the risk of being struck down on constitutional grounds and may open the subject again to a legal dispute.

(c) While Section 15 of the Recovery Ordinance provides a speedy alternative to recovery proceedings, defects in the land ownership and transfer system in Pakistan create title disputes over mortgaged property, causing delays to recovery.

Enforcing security interests over movable property

Parties may contractually agree to an out of court settlement for certain types of security interests over movable property. Pledges, the assignment of receivables by way of security and perfected security interests can be enforced outside of court. Section 2.1 of this report provides more detail on security interests.

Section 16(3) of the Recovery Ordinance, allows a secured creditor to directly recover or take over possession of movable property where the security agreement permits. However, Section 19(3) of the Recovery Ordinance, allows post-decree mortgaged, pledged or hypothecated property to be sold by a bank or DFI with or without the intervention of a Banking Court either by public auction or by inviting sealed tenders.

Whilst Section 16(3) of the Recovery Ordinance, on a literal read, permits out of court enforcement for all types of security interests, a specific process for his has not been prescribed for all practical purposes, Section 16(3) is only used by order of the Banking Court.

8.2. Winding-up

8.2.1 Limitations and obligations surrounding insolvency

There are limitations and obligations related to insolvency, including surrounding the duty of directors towards the creditors, and general restrictions on a company that is insolvent.

Directors' duties

General duties of the directors of a company include the duty to act in accordance with the charter of the company, duty to act in good faith to promote the objects of the company and to act in the best interests of the company, its employees, the shareholders, the community and for the protection of environment. A director, in discharge of his or her duties, must also exercise reasonable care, skill and diligence, exercise independent judgment and avoid conflicts of interest (Section 204 of the Companies Act).

While it is not specified that directors owe a duty to creditors, in view of the general language in the statute it could be argued that directors also have an obligation to consider the interests of creditors.

This is especially relevant when a company is insolvent. Under English and Commonwealth decisions (that may hold persuasive value in Pakistani courts), directors are required to take creditor interests into consideration when a company is insolvent.[45]

The Companies Act also contains statutory duties and liabilities of directors related to insolvency.[46]

General restrictions

Some circumstances allow transactions to be set aside upon the insolvency or liquidation of a borrower.

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[45] Decision of the Supreme Court of New South Wales in the case of *Kinsela v. Russell Kinsela Pty Ltd, (1986) 4 NSWLR 722* and West Mercia Safetywear Ltd. v. Dodd (1986) 4 ACLC 215.

[46] A summary of the provisions relating to director duties relating to insolvency in the Companies Act.

a) Courts, on an application by the liquidator, creditor or contributory of the company in the course of a winding up, have the power to compel directors to repay or restore the money or property with surcharge or contribute such sum to the assets of the company by way of compensation where the director has "*misapplied or retained or become liable or accountable for any money or property of the company*" or "*has been guilty of any misfeasance or breach of trust in relation to the company*." Any director who is knowingly a party to the carrying on of the business of the company in the manner aforesaid, shall be punishable with imprisonment for a term which may extend to two years, or with fine which may extend to twenty thousand rupees, or with both (Section 397 of the Companies Act).

b) The courts in the course of the winding up of a company, may order that directors are personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company where it is clear that the business of the company was carried on with the "*intent to defraud creditors of the company or any other persons or for any fraudulent purpose*" (Section 398 of the Companies Act).

a) Avoidance of transfer. Where a borrower is a company, a transfer of property made within a one year before a petition for winding up or a resolution allowing voluntary winding up, shall be void against the liquidator if it is not "in the ordinary course of its business or in favor of a purchaser or encumbrancer in good faith and for valuable consideration" (Section 391 of the Companies Act).

b) Fraudulent preference. Any act relating to property by or against a borrower, that occurs where winding up or insolvency proceedings are imminent, may fall foul of the law relating to "fraudulent preference". The combined effect of the relevant statutory provisions is that to be considered fraudulent preference, a property must have been transferred within six months of the commencement of winding up for companies, and within three months for individuals, and that the transfer was made with a view to giving a secured creditor preference over other creditors.

8.2.2 Legal and regulatory framework for the liquidation of an insolvent borrower

With the approval of creditors, an insolvent company may be wound up voluntarily, or by order of the court (Section 293 of the Companies Act).

Creditors' voluntary winding-up

An insolvent company may be wound up voluntarily, if in addition to the shareholders' resolution, creditors also grant approval for winding up after a voluntary winding up is proposed by a company's members. A creditors' voluntary winding up entails the following:

a) The creditors and the company may nominate a person to be liquidator (from a panel of liquidators maintained by the SECP) to wind up the company. Liquidators nominated by the creditors have preference. Although the liquidator is required to be appointed from the list maintained by the SECP, based on stakeholder feedback, there is a need to build capacity and train liquidators.

b) Once a liquidator is appointed, they take the place of the company's board and chief executive.

c) After statement of affairs regarding the company's assets and liabilities, the liquidator determines the company's viability or the steps necessary for maximizing value of assets of the company. The liquidator's report detailing the company's assets and liabilities is submitted to the SECP.

d) The property of the company will be applied firstly, to satisfy preferential payments, second satisfy the company's pari passu liabilities, and finally towards payment to members according to their rights and interests in the company.

e) The liquidator holds an annual general meeting of the company within a period of 60 days from the end of first year after winding up began.

f) As soon as the company's affairs are fully wound up, the liquidator prepares final accounts which are then audited and a report of the winding up is prepared, showing that the property and assets of the company have been disposed of and its debts fully discharged.

g) A final general and creditors' meeting is called to present and explain the final report.

h) If satisfied with the report and accounts, the SECP registers them. Three months after this, the company is deemed to be dissolved.

Winding up on the order of the Company Court[47]

A company may also be wound up by the companies bench of a High Court in Pakistan (Company Court) if it is unable to pay its debts and where despite a 30 days' notice from the bank or DFI, refuses or neglects to make a payment or to secure or compound to the reasonable satisfaction of the bank or DFI.

Albeit, on a literal read, the Companies Act does not require a company's insolvency to be established to wind it up on the ground of inability to pay debt, there are strict principles for winding up a company that is unable to pay debts.

a) The amount claimed by the bank or DFI must be genuine and acknowledged by the company and should not have been disputed or challenged by the company.

[47] While there are various other grounds on which winding up through Court could be sought (such as mismanagement), given the purpose of this report, we have limited our overview to winding up of company on ground of its inability to pay debts.

b) There is a distinction between companies that are "merely unwilling to pay its debts" from those that are insolvent. If a company is unwilling to pay its debts, the courts order the bank or DFI to file a suit for recovery.

c) The courts use the financial statements of the company to determine whether the only way to recoup the company is to sell off its assets if the company is no longer generating revenue.

d) The courts would not reject a bank or DFI's petition merely on the grounds that the FI has an alternative remedy available.

Any winding up petition by a bank or DFI on the ground of a company's inability to pay its debts is subject to proving the company's insolvency and where it is, will not be prejudiced by the remedies available to the bank or DFI.

Winding up of company unable to pay its debts involves:

a) Once a company is determined to be insolvent, the Company Court passes a winding up order and appoints an official liquidator from the SECP's panel[48] of liquidators[49] who is required to complete the process within 12 months from the date of the winding up order.

b) All company property is taken into the custody and controlled by the Company Court, all litigation against it is automatically stayed and may be transferred to and disposed of by the Company Court.

c) A statement of affairs is submitted to the official liquidator, within 60 days of which the official liquidator must submit a report to the Company Court, after this, the Company Court fixes a time period within which liquidation proceedings must be completed and the company dissolved.

d) Within 30 days of receipt of funds from disposal of all assets, the funds will be applied first to satisfy preferential payments, second, to satisfy the company's liabilities, and finally, subject to constitutive documents, towards payment to members according to their rights and interests in the company.

Winding up is a last resort and attempts to revive an insolvent company are entertained by the courts even after a winding-up order has been passed. A few examples of where insolvency proceedings may be stayed by the courts include where there is an improvement in a company's commercial viability,[50] a company acquires the funds to be able to discharge its liabilities,[51] or the company is able and willing to revive itself either by arrangement, compromise, or settlement.

8.2.3 Rights of secured creditors in relation to insolvency proceedings

Preferential payments are made to certain persons in priority to other debts, but this does not include secured creditors (except where secured creditors have a floating charge and the assets of the insolvent company are insufficient to meet preferential claims, in which case, preferential claimants have priority over secured creditors).

This is because the interests of secured creditors are protected by legislation.[52]

Under the relevant laws, (and in view of the jurisprudence of superior courts),[53] secured creditors have options including to remain outside of the winding up and proceed based on their security.

The process for an out of court enforcement of a security interest over movable and immovable properties in Annex L applies where the secured creditors choose to enforce their security interests outside of insolvency proceedings.

A secured creditor does not have claim on payments of liquidation proceeds in priority to preferential payments, if the secured creditor had neither realized nor exercised its option to remain outside the winding up process, but rather relinquished its security for general benefits of creditors by filing its total claim with official liquidator.[54]

Our key observation in relation to secured creditors' rights regarding insolvency proceedings is that the official

[48] The Companies Act prescribes that the panel should consist of individuals with at least ten years' experience in the field of accounting, finance or law and as may be specified by the SECP such other persons, having at least ten years professional experience.
[49] A person cannot be appointed as an official liquidator for more than three (3) companies at one time.
[50] Additional Registrar of Companies, Securities and Exchange Commission of Pakistan vs. Messrs Schon Textile Limited ([Sindh High Court] 2008 CLD 475).
[51] National Bank of Pakistan vs. the Punjab National Silk Mills Ltd. and 2 Others (1989 MLD 2963).
[52] Section 47 of the Provincial Insolvency Act, 1920 (as applicable), Section 48 (read with item 9 of Schedule 2) of the Insolvency (Karachi Division) Act 1909.
[53] *United Bank Limited vs. PICIC and others (1992 SCMR 1731)*; *Siemens Pak Engineering vs, Japan Power Generation Limited, (2020 CLD 619);* Union Leasing Limited v. Pakistan Industrial Credit and Investment Corporation Ltd. through Deputy Managing Director and 8 others, (2005 CLD 958); Orix Leasing Pakistan Limited vs. Sunshine Cloth Limited, (2001 PTD 3146).
[54] Securities Exchange Commission of Pakistan vs. Innovative Investment Bank Limited (2020 CLD 766).

liquidator is required to be appointed from the list of liquidators maintained by the SECP. However, there is a need to improve the skills of liquidators to avoid delays and shorten timelines for liquidation proceedings.

8.3. Debt Rescheduling

Conventional financing is based on a "mark-up" or "buy back" system of lending with the intention to shift to an Islamic and non-interest-based system of banking. Under the mark-up system, conventional financing is structured by way of a mark-up agreement under which the bank or DFI advances a sum of money to the borrower as the sale price of certain goods sold by the borrower to the bank or DFI. There is a simultaneous buy-back of the goods by the borrower from the bank or DFI at a marked-up price which is payable on deferred basis. Finance agreements are structured this way to address the restriction prohibiting local Banks to extend interest-based financing. However, unlike Islamic murabaha financing documents, where the assets are identifiable and specifically stated, the assets in conventional mark-up financing are fictional and there is no physical sale or purchase of assets.

Under the interest-based system, restructuring can be carried out using an amendment to the original finance agreement to modify interest payments and tenor. In contrast, restructuring under the mark-up system cannot be done by amending the original mark-up agreement or by enhancing the purchase price) under the original mark-up agreement by charging additional mark-up upon default by the borrower. This is because the original mark-up agreement represents a past and closed sale, repayment terms of which cannot be modified. To overcome this hurdle, conventional banks under the mark-up system commonly restructure loans through a new finance facility with a fresh mark-up agreement with a fresh repayment schedule, effectively extending the maturity of the loan. Under the new mark-up agreement, the bank and the borrower execute another fictional sale and purchase of assets on a deferred payment basis, and the original outstanding amount is carried forward as the principal amount under the new mark-up agreement.

Various prescriptions of the SBP[55] suggest that restructuring, rescheduling and renewing loans is permitted, court jurisprudence varies. Judicial pronouncements testing the validity of a restructuring arrangement by way of a fresh finance facility focus on two major aspects of the fresh mark-up agreement. The first is the actual disbursement or lack thereof under the fresh mark-up agreement, and the second is the charging of additional mark-up on the principal amount under the fresh mark-up agreement. Such pronouncements are contradictory, confusing and create uncertainty around debt rescheduling.

Disbursement

In some cases, judgments respect the sanctity of the commercial agreement between the borrow and banks and support the proposition that disbursement under the new mark-up agreement is not necessary. There is other case law where banks are denied recovery for lack of actual disbursement of funds under the new mark-up agreement. Even where banks make actual disbursements under the fresh mark-up agreement which are subsequently used to settle earlier loans, recovery is not permitted.

Additional mark-up

Although charging additional mark-up (mark-up on mark-up) is illegal and viewed as un-Islamic by the SBP and various courts in Pakistan, there are instances where courts have adopted a lenient and flexible approach when enforcing the principle prohibiting additional mark-up.

8.4. Debtor Rehabilitation and Restructuring

Corporate laws have historically focused little on recovery through corporate rehabilitation. The options available to creditors of distressed entities to recover an NPL through debtor rehabilitation are:

- a scheme for rehabilitation of distressed entities introduced under the Corporate Rehabilitation Act, 2018
- a creditors scheme of arrangement
- the rehabilitation, reconstruction and reorganization of a public sector company declared as a sick company.

Each of these options have their own limitations.

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[55] BCD Circulars 13 and 32 of 1984, BCD Circular No. 27 dated 12.11.1984, BCD Circular No. 37 dated 10.12.1984, BCD Circular No. 23 dated 25.5.1985, BCD Circular No.4 dated 30.6.1988, BPD Circular No. 24, BPD Circular No. 37 BID Circular No. 3, dated 20.2.1989, Circular No. BID (Gen) 2470/601-Q4-90 of 17.6.1990, BPRD Circular Letter No. 27 of 22.6.1999, SD Circular No. SD 2/99 of 16.7.1999 (para 3), BPRD Circular Letter No. 02 of 29.1.2000, BPRD Circular Letter No.4 of 17.2.2000, BPRD Circular No. 9 of 27.4.2000, BPRD Circular Letter No. 16 of 5.6.2000, BPRD Circular Letter 34 of 13.12.2000, BPRD Circular No. 06 of 5.6.2007 and the PRs for Corporate/Commercial Banking.

8.4.1 Corporate Rehabilitation Act

The Corporation Rehabilitation Act facilitates the rehabilitation and reorganization of distressed entities. It enables a borrower or qualifying creditors (a bank or DFI holding unpaid and overdue claims for an aggregate amount of not less than two third of the value of the assets of the borrower) to file a petition for an order of mediation to agree on a rehabilitation plan. Salient features of the Corporate Rehabilitation Act include:

- The High Court can order insolvency experts[56] to be appointed to mediate between the borrower and the creditors to achieve an acceptable plan of rehabilitation.
- There is no automatic stay (unlike in India and the United States). Borrowers or interested parties must apply to the High Court, and after issuing an initial notice to the opposing party and a hearing, a stay order may be passed by the High Court. The Court may also grant relief to a qualifying creditor from this stay order.
- In situations involving mismanagement or actions that have had an impact on creditor rights or a borrower's financial condition, the High Court may appoint an administrator before a plan of rehabilitation has been confirmed.
- A rehabilitation plan must be accepted by each class of creditors holding at least two thirds of value of interest and each class of interests of the borrower, before the High Court. The High Court, after a notice and hearing and being satisfied that the plan is in accordance with the requirements of the law, accept the plan making it binding on the parties.
- The High Court could declare the plan void if any aggrieved party filed an application within 12 months of the plan's confirmation.
- Either borrowers, qualifying creditors, or an appointed administrator can apply to the High Court to convert the case into winding up proceedings. They can do this if the rehabilitation plan is not accepted within 12 months of an administrator being appointed, or if a petition under the Corporate Rehabilitation Act was filed by the borrower for fraudulent purposes.

Although the Corporate Rehabilitation Act was promulgated over three years ago, the framework remains largely untested. A few observations about the Act include:

- There is no time frame for completing a corporate rehabilitation process
- A corporate rehabilitation plan is subject to approval by any class of persons holding any interests not impaired by the plan. The concept of an 'impaired class' has not been defined.
- Unlike the Title 11 bankruptcy under the laws of the United States, the concept of an "automatic stay" upon beginning a rehabilitation process is not included.

8.4.2 Creditors' Scheme of Arrangement

A compromise or scheme of arrangement may be proposed between a company and its creditors. A Scheme must be approved by at least three quarters of all creditors and the High Court. Once sanctioned by the High Court or the SECP,[57] the Scheme is binding. The commercial wisdom behind a Scheme is not questioned, however, a Scheme may be refused where it is unreasonable or unfair, it is not in the best interests of the company, creditors are not acting bona fide and in good faith and are adversely coercing the minority, and that the plan does not adhere to the law and directions of the sanctioning authority.[58]

A few case examples where a Scheme may successfully be affected (along with questions of law raised and principles developed by the High Court) are in Annex M (Examples of Creditors' Scheme of Arrangement).

Issues regarding the legal framework for creditor schemes of arrangement have raised important questions and some controversy as to whether stamp duty is payable on transfers following Schemes sanctioned by High Court

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[56] Pursuant to Section 5 of the Act, the SECP in consultation with the SBP are required to maintain a panel of insolvency experts in accordance with the terms mentioned therein.

[57] To facilitate the corporate sector as well as secure the interest of creditors, jurisdiction to approve reorganization and reconstruction under Sections 279-283 of the Companies Act of small sized companies vests with the SECP. Jurisdiction for approving compromises and arrangements for medium sized and large sized companies lies with the Company Bench of the High Court (S.R.0. 840(i)/2017 dated 17.8.2017 issued by the Finance Division, Government of Pakistan).

[58] Presson-Descon International (Private) Limited etc. vs. Joint Registrar of Companies (2020 CLD 1128), Paramount Spinning Mills Limited v. Bank of Punjab (2019 SHC 420), Gulshan Bibi and Others Vs Muhammad Sadiq and Others (PLJ 2016 SC 776), Caravan East Fabrics Limited vs. Askari Commercial Bank Ltd., Al-Baraka Islamic Bank Ltd., (2006 PTCLR 992).

or SECP. Historically, stamp duty has never been paid on Scheme orders in Pakistan.

The matter was addressed by Companies Act exempts stamp duty on transfers of sanctioned schemes of compromise or arrangements. However, this exemption is only applicable in the Islamabad Capital Territory and notification or legislation by other Provincial Governments is required. Until such notifications are issued, ambiguity of whether stamp duty is required will continue.

8.4.3 Rehabilitation of Sick Public Sector Companies

The Companies Act provides a process for rehabilitating a sick public sector company which involves drawing up a plan to rehabilitate, reconstruct and reorganize the company.

A plan for rehabilitation can include reducing of capital, issuing further capital, acquiring shares, altering a debt structure or rescheduling, and changing the board of directors, any existing contract or constitutive document. Once approved by the relevant Minister-in-Charge of the Federal Government, who also supervises its implementation, the Plan is valid, binding and enforceable, notwithstanding the Companies Act, any other law or constitutive company documents, or any other company agreement.

The Corporate Rehabilitation Act does not override Section 292 of the Companies Act, rather it is in addition to other laws regarding company rehabilitation. This makes it questionable as to whether rehabilitation of a public-sector company could also be agitated under the Corporate Rehabilitation Act.

8.5. Write off

There is little doubt that when a debt is written-off from a bank or DFI's accounts following an agreement, compromise or other understanding with the borrower, the bank or DFI, forgoes its rights to recover the written-off amount from the borrower. However, where there has been no agreement with the borrower, a "write off" is solely an accounting procedure where the bank or DFI takes the asset off its books.

Writing off a loan is therefore an internal accounting matter to present an accurate picture of the bank or DFI's financial condition. It does not amount to a conscious voluntary act by a bank to give up its rights of recovery from a borrower. As such, in the absence of an agreement with the borrower or any other voluntary, conscious act by the bank or DFI amounting to a discharge or a release, writing off of loans should not affect a bank's legal right to recover from the borrower.[59]

Writing off NPLs has been the subject of judicial scrutiny and oversight. After one such case,[60] the Supreme Court constituted a commission to examine as to whether the writing off was valid and for bona fide business considerations. Following this, banks and DFIs were instructed to submit the entire record of all written off, remitted, reversed, and or waived off NPLs of Rs. 2.500 million and above, for the period from 1971 to 1991, and Rs. 25 million and above from 1992 onwards. After the inquiry, the prerequisites for writing off NPLs were made stricter by the SBP, the risk of legal challenges for public sector banks remains.

8.6. Sale or Transfer of NPL

Various options are available to a bank or DFI to offload its NPL assets although there are some impediments which may have an impact on the development and success of NPL markets in Pakistan.

8.6.1 Securitization

In this section, transfer of NPLs by a Bank/DFI using a typical securitization structure is dealt with. The regulatory framework for the securitization structure is governed by BPRD Circular No. 31 of 2002("SBP Circular"), as amended by BPRD Circular No. 3 of 2021 ("Amended SBP Circular") and The Companies (Asset Backed Securitization) Rules, 1999 ("SECP Securitization Rules").

The SECP Securitization Rules defines a 'securitization' as:

""Securitization" means a process whereby any Special Purpose Vehicle raises funds by issue of Term

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[59] In view of ordinary meaning and definition of "wrote-off" under the "Write-off Circulars' and Section 63 of the Contract Act, 1872 read with the Phoenix Mills Ltd. vs. M.H. Dinshaw & Co. AIR 1946 Bom 469, at page 476. BPD Circular No. 29 of 2002 dated 15.10.2002. Said views are reinforced by State Bank of Pakistan as well as the provisions of the Recovery Ordinance which permit banks to sue for the recovery of written-off loans even after the limitation period has expired where the write-off was procured through political pressure. It may be noted that the section does not apply to amounts written-off by banks without the agreement or consent of the borrower. The implication is that amounts so written-off do not in any event affect the bank's right to recover against the borrower

[60] S.M.C._26_2007_02082018.pdf (supremecourt.gov.pk), BPRD Circular Letter No. 28 of 2011 dated 30.12. 2011.

Finance Certificates or any other instruments with the approval of the Commission, for such purpose and uses such funds by making payment to the Originator and through such process acquires the title, property or right in the receivables or other assets in the form of actionable claims;"

A typical securitization structure involving NPLs can be:

- A special purpose vehicle (SPV) incorporated as a public unlisted company will issue asset-backed securities (ABS) in the form of redeemable capital (for example term finance certificates) under Section 66 of the Companies Act. The ABS will be listed and will be subject to the Structuring of Debt Securities Regulations, 2020 and any provincial trust laws depending upon whether the security interest is held by a trust.
- The SPV will acquire the NPLs from a bank or DFI using the funds generated from the ABS and does not need the borrower's consent unless the NPL documentation between the bank or DFI does not allow NPL transfer without the borrower's consent.
- The SPV may appoint the originator as a servicing agent to coordinate the fund flows (including the collection or recovery of NPLs) and advise on enforcement actions. An originator can be the servicing agent.
- Where the originator is a bank or DFI there will need to be a 'true sale' of the NPLs which will generally be in the form of an absolute assignment of receivables.
- Banks or DFIs may securitize their assets relating to lease financing (with acknowledged assignment of lease rental proceeds), mortgage financing, and toll financing (for infrastructure developmental projects). Other assets, however, may be securitized by banks or DFIs with the prior approval of the SBP, on an individual basis.

Certain concerns and observations relating to securitizations are:

- The SBP's 'true sale' standard, which applies when financial institutions are originators, is more stringent than the IFAS, as no recourse against the originator is permitted. Generally, some limited recourse should be permitted where the originator breaches a warranty that the SPV was relying upon to purchase the NPLs. For example, if the originator falsely or erroneously affirms the accuracy of past defaults, some recourse against the originator should be permitted.
- To the extent of residential and commercial mortgage-backed securities, the SBP now permits banks or DFIs with having capital adequacy ratio of at least 1.3 times of existing regulatory requirements to set up a 100 percent owned SPV. SECP Securitization Rules however provide that the "Originator shall not be a connected person to the Special Purpose Vehicle".
- The Islamabad Capital Territory (ICT) stamp duty and registration fee are each capped at PKR 100,000, removing a major obstacle to securitization by allowing a transaction to be structured to avoid stamp duty and registration fees in other provinces. There are several scenarios where this applies.[61]
  a) Subject to second bullet point below, where the security interest securing the receivables being transferred does not involve immovable property or involves immovable property located only in ICT, so long as all relevant documentation is executed in ICT (and preferably the SPV is incorporated in ICT).
  b) Where the security interest securing the receivables (whether moveable or immovable) is held by a trust for the benefit of the present and future beneficiaries. In other words, upon a transfer of the receivables, the transferee will automatically become a beneficiary under the trust. In Pakistan, for sophisticated syndicated transactions, such a trust arrangement is common. (Provinces have recently trust laws and its practical implications are not entirely clear at this stage, but the matter is expected to settle down.) While the underlying legal principles that underpin the above are somewhat complicated, they stem from the following principles (generally stated).
  c) The transfer of an interest in an immovable property can only be affected in writing and attracts registration under the Registration Act.

[61] Under certain very limited circumstances, stamp duty can possibly be avoided by affecting a transfer orally. As this route may not be otherwise advisable, the same has not been elaborated upon any further.

d) Upon a transfer of receivables that are secured, the secured properties travel with the receivables.[62] Thus, where the security interest includes immovable property, the transfer document would become registerable (even where the underlying security over such property was not registerable as in the case of creation of mortgage over immovable property by way of deposit of title deeds.[63]

e) Under Section 28 of the Registration Act where the document affects immovable property, the document needs to be presented in the office of sub-registrar where whole or some portion of the property is located. Thus, in such case so if the immovable property is in ICT, the ICT notification will apply. For documents affecting properties other than immovable properties, under Section 29 of the Registration Act, the document needs to be presented for registration in the office of the sub-registrar where the same is executed. Thus, in such case, the ICT notification will apply so long as the relevant documentation is executed in ICT.

- An ABS must have a minimum credit rating of 'A', be listed, and comply with other regulatory requirements prescribed by the Pakistan Stock Exchange Limited (PSX) which may impede the development of NPL market. For example, in terms of Regulation 5C.3(iv) of the PSX Rule Book, a company may only apply for OTC listing of debt securities offered and issued through private placement if its paid up capital is at least Rs. 25,000,000. These may add an unnecessary compliance burden to securitizations.

8.6.2 Pakistan Corporate Restructuring Company Limited (PCRCL)

CRC Act is a law intended "to provide for the establishment and regulation of corporate restructuring companies", pursuant to which the SECP has notified the Corporate Restructuring Companies Rules, 2019 (CRC Rules) and in respect of which the SBP has issued the 'Guidelines – Transfer and Assignment of non-performing assets to Corporate Restructuring Companies' (SBP NPL Guidelines).

Currently, there is one restructuring company, the Pakistan Corporate Restructuring Company Limited (PCRCL) that has been licensed by the Securities and Exchange Commission of Pakistan (SECP) under the CRC Act. Its shares are held by ten financial institutions — Allied Bank Limited, Bank Alfalah Limited, Bank Al Habib Limited, Faysal Bank Limited, Habib Bank Limited, Habib Metropolitan Bank Limited, MCB Bank Limited, Meezan Bank Limited, National Bank of Pakistan and United Bank Limited.

PCRCL was preceded by a similar organization, the Corporate and Industrial Restructuring Corporation (CIRC) which was established with the mandate to acquire, restructure, rehabilitate, manage, dispose and realize non-performing loans and other assets of specified banks and financial institutions. For an overview of rights, powers and functions of the CIRC, please see Annex N (CIRC).

The CRC Framework

The SECP regulates and licenses corporate restructuring companies (CRC). Functions and powers of the CRC under the Act include acquiring, restructuring, rescheduling and disposing of NPLs.

The CRC Act provides for the transfer of NPLs by a bank or DFI to a corporate restructuring company, which shall take effect "notwithstanding anything to the contrary contained in any law, decree, judgment, order, contract, instrument or document". This means while it is likely for the parties to enter into a contract for purchase of NPLs, the transfer of these NPLs will be affected by the law and not of the parties' contract.

One aspect of the CRC Act (Section 6(1)(a)) requires elaboration. This Section does not permit financial institutions to transfer their NPLs to an entity that is "established, owned or controlled by such financial institution or its affiliates". There is some ambiguity about whether 'established' is to be read with 'control', or independently. Reading the two words independently would have prevented the establishment of PCRCL. SECP facilitated the incorporation of PCRCL by issuing a clarification in December 2019:

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[62] Where the assignment of receivables by way of security is pursuant to the Secured Transactions Act, please see Section 59(3) of the Secured Transactions Act, and in the case of assignment of receivables by way of security pursuant to Section 134 of the TP Act, please note that in terms of Section 8 of the TP Act, a transfer of property (such as debt) to the transferee, transfers all the interest of the transferor and legal incidents thereof. Such incidents, in the case of a debt, includes securities therefor (except where such securities are also securing other debts not being transferred). Accordingly, on a plain reading of Section 8, the assignment of receivables under Section 134 of the TP Act should result in the transfer of underlying security as well.

[63] While there is no Pakistani decision on this point, plethora of Privy Council and Indian judicial pronouncements have confirmed this position (Elumalai Chetty v. P. Balakrishna Mudaliar (AIR 1922 Mad 344); Benares Bank Ltd. vs. Bank of Bihar Ltd. and others (AIR 1947 All 117); Maheshwari Rros v. Indra Sugar Works Ltd (AIR 1938 (All) 574); Company Bank, Bangalore v. Lalitha H.Holla and Others (AIR 1994 (Kant) 133) and Gopi Nath v. Mt. Bekali and Ors (AIR 1935 (All) 837).

"...we are of the view that restriction imposed under section 6(1)(a) of the Act only applies to such CRC where a financial institution, directly or indirectly holds fifty percent or more shareholding."

Section 7 of the CRC Act stipulates that all legal proceedings in connection with the NPLs initiated by or against a transferor shall automatically stand transferred in the name of CRC and all new legal proceedings by or against the CRC may be instituted and adjudicated upon and disposed of, which proceedings were authorized to be instituted by or against the transferor, including the proceedings under the Recovery Ordinance, ORBO, CPC and the CRPC.

The CRC Act empowers the SECP to procure information from CRCs and conduct special audits and inquiries.

In view of the SBP NPL Guidelines:

- Banks or DFIs should develop a policy for transferring and assigning NPLs to corporate restructuring companies and provide guidance on the types of NPLs eligible for transfer, the process and technique for determining the value of NPAs, general terms and conditions for transferring and assigning NPLs, and the classifying, provisioning, and accounting treatment of financial instruments received from CRCs.
- Certain single borrower and group exposure limits prescribed under the PRs do not apply to the transfer and assignment of NPLs to CRCs until specified by the SBP.
- The transfer and assignment of NPLs from banks or DFIs to CRCs should be a true sale, on nonrecourse basis, with all the risks and rewards of the NPLs transferred and assigned to the CRCs. This means the NPLs are derecognized from the books of the banks and DFIs.
- The banks and DFIs may accept cash and/or financial instruments, for the transfer and assignment of NPLs to CRCs.
- The banks and DFIs will record the financial instrument received from the CRCs at the fair value.
- While negotiating terms and conditions of transfer and assignment of NPLs to CRCs, banks and DFIs should ensure to protect their financial and legal interest.
- The banks and DFIs, that transfer and assign the NPLs to the CRCs should provide certain disclosures in the annual audited financial statements.

Amendments to the CRC Act (CRC Amendment Act)

- The CRC Amendment Act was recently passed, improving certain aspects of the CRC Act including:
  - clarifying that financial institutions may transfer their NPLs to any CRC in which it does not have a controlling interest.
  - fortifying that a transfer of NPLs is by operation of law. It is also designed to repel any argument that the transfer attracts stamp duty, particularly considering case law[64] relating to schemes of arrangement under company laws.
  - permitting the CRC to acquire NPLs from financial institutions through one or more trusts constituted and managed by it. This will enable the CRC to act as an asset management company and acquire NPLs which it would then manage. This would allow segregating NPLs based on their nature or characteristics. For example, housing NPLs could be segregated from other NPLs.
  - enabling the CRC to act as a recovery agent where financial institutions do not wish to sell the NPLs to CRC. Currently PCRCL (the only CRC licensed) does not have the financial strength to buy the NPLs. The agency relationship (which does not entail any sale of NPLs to CRCs) would enable CRCs to build knowledge and capacity and eventually buy and manage NPLs. PCRCL has entering into agency arrangements with various financial institutions where PCRCL will exercise powers (on behalf such financial institution) and bind them accordingly. A regulatory framework to provide the broad parameters for this agency relationship may be useful.
  - introducing scheme to revive distressed entities. The intent is to make a scheme of rehabilitation/revival of a distressed entity prepared by the CRC to be binding on all creditors (secured or unsecured) adding the concept of a scheme to cater for situations where a distressed entity is revivable, but due to multiple

[64] The judgement of the Lahore High Court in the case of Fatima Sugar Mills Limited etc. in C.O. No.10 of 2012 dated 16.03.2015, an intra court appeal against which is presently pending before the Lahore High Court.

creditors being involved, a revival remains inconclusive or takes considerable time. The proposed reform will enable prompt debt aggregation, allowing CRCs to negotiate bilaterally with the borrower and hopefully reach a quicker conclusion.

- requiring the High Courts to constitute one or more special benches to adjudicate cases under the CRC Act. It also specifies that the special benches shall decide cases within 90 days of the institution of the case, however this time limit has not been considered mandatory.

Practical and other observations in relation to PCRCL

- Low levels of capitalization and other funding available to PCRCL appears to be a significant hindrance to an outright assignment or sale by any bank or DFI to PCRCL. Structuring payments on a deferred basis and making them contingent upon recoveries made by PCRCL prevents them being commercially viable for both parties. Also, these types of structures create accounting concerns in relation to off-balance sheet treatment in banks' or DFIs' books.
- Assuming the CRC Amendment Act (which is pending) is enacted, it will enable financial institutions to appoint PCRCL as a recovery agent. The implications for NPLs are:
    a) As an agent PCRCL would not be able to take advantage of the scheme to revive distressed entities (above) as it would not be the owner of the NPLs.
    b) PCRCL believes that as agent it requires high levels of power and authority to be delegated to it by banks and DFIs to enable it to effectively negotiate and deal with defaulters. The banks or DFIs have two broad concerns: (a) the level of delegation to PCRCL needs to be monitored to prevent running afoul of banking and company laws; and (b) loss of power and authority to deal with NPLs that a bank or DFI owns.
    - Following passage of the CRC Amendment Act, the Federal Government will need to issue a notification to set-up the Corporate Restructuring Board. The Board will consist of not more than five members and will have experience and functions as stated in the CRC Act. It will be critical that the Board consists of well qualified members. To facilitate and regulate the asset management structure proposed through the CRC Amendments Act, the SECP will need to develop a framework according to the rules and regulations under the CRC Act.[65]
    - Once the CRC Amendment Act is enacted, the CRC Rules will be revised to cover liquidation of a trust by the CRC, governance of the Corporate Restructuring Board, contents of the scheme to be presented by CRC for review to the Corporate Restructuring Board, and information required by the CRC from concerned financial institutions.
    - Banks and DFIs are under an obligation not to divulge any information relating to the affairs of their customers (except in limited circumstances).[66] To enable corporate restructuring companies to perform due diligence of NPLs, prior to the NPL's transfer and assignment banks and DFI are permitted to exchange information relating to borrowers on a confidential basis.

8.6.3 Good bank/bad bank structure

Even upon the passage of the CRC Amendment Act it will not be possible for a bank or DFI to establish a CRC that it controls. A legal structure may be created under banking and NBFC laws where a bank or DFI establishes a subsidiary (including a wholly owned subsidiary) into which it may transfer its NPLs. This subsidiary for all practical purposes would operate for the bank or DFI. While this is feasible, no bank or DFI has implemented this structure.

Broadly, the structure would entail:

- An unlisted public company incorporated and licensed by SECP to provide investment finance services.
- The company above would be a subsidiary of the bank or DFI, and would require the SBP's approval.
- The NPLs would be transferred from the bank or DFI to the subsidiary by way of scheme of demerger sanctioned by the High Court or an assignment or asset sale or novation. The appropriate mechanism for the

[65] Recent changes in the trust laws, in Section 6A, make it advisable to replace relevant references to the "Trust Act, 1882" with "the applicable trust laws". However, the same is recommended only by way of clarity.
[66] For common law duty of confidentiality, see Tournier v. National Provincial & Union Bank ([*1924] 1 KB).*

transfer would be determined after examining issues of contractual restrictions, stamp duty implications, nature of security interest, and cooperation of the defaulter.

- The subsidiary would benefit from the provisions of the Recovery Ordinance, being a financial institution.

The transfer to a subsidiary in this way is significantly more complicated compared with the CRC Act. It is however the only viable option where a bank or DFI wishes to create a subsidiary to which NPLs can be transferred. Regulators may also be reluctant to permit a Subsidiary to be set up given that the CRC Act has been developed for the purpose of carrying out the business of a CRC.

8.7. NPL Servicing Infrastructure

The use and prevalence of debt collection or recovery agencies is limited in Pakistan. Whenever appointed, debt collection or recovery agencies are mainly engaged for recovery and repossession services for banks' retail portfolios such as auto financing, personal loans, or credit cards. Based on discussions with banks, it is understood that when engaged for corporate or commercial portfolios, third-party individuals or entities are generally used for asset tracing or coordinating with local law enforcement agencies and land revenue offices in a very limited role. A broader account-oriented servicing infrastructure does not exist.

There are no regulatory requirements, frameworks, or licensing requirements when it comes to setting up a debt collection company, however, there are some minimum compliance requirements for debt collection entities if they are to provide debt collection, recovery or repossession services to banks that are regulated by the SBP.

8.7.1 Licensing requirements and the role of collection, recovery and/or repossession agents

As a result of borrower complaints and grievances on fair treatment, the SBP issued "Fair Debt Collection Guidelines" in 2008. The guidelines apply to various types of consumer financing facilities including credit cards, housing loans, auto and personal loans. The guidelines require banks to adhere to minimum standards when it comes to debt collection or recoveries.

- All information relating to payments fallen due is to be provided to the borrower before proceeding for debt recovery.
- A minimum of 14 days' notice is to be served to the borrower via letter or SMS, advising them to make overdue payments, before a visit to the borrower's residence or business place.
- Borrowers are not to be contacted at an inconvenient time and the identity, name of the bank and purpose of the call is to be provided.
- Only lawful and acceptable business language and professional attitudes are to be used when contacting borrowers.
- Collection staff are not to harass a borrower's family members. However, necessary information can be obtained from family, friends or third-party contacts of the borrower, if they are not in contact for 30 days.
- At least 14 days' written notice to be provided before repossessing a leased vehicle. Recovery staff must allow the lessee to take their possessions out of the vehicle.
- the transfer or misuse of borrowers' personal data without their prior approval is prohibited and any information about borrowers that is provided to collecting staff is required to be properly documented.
- Banks must ensure that the collection/recovery agencies they employ are enrolled with and approved by the PBA. The SBP has advised the PBA to develop criteria for such agencies.

The PBA has recently published its *Guidelines for Collection, Recovery and/or Repossession Agencies*[67] stipulating the induction and performance monitoring of collection, recovery and/or repossession agencies.

In the PBA Guidelines, however, the Fair Debt Collection Guidelines relate to collecting, recovering and repossessing consumer financing. It is unclear whether the regulatory framework also applies to corporate financing and whether there is a regulated regime recovering corporate debts.

8.7.2 Enlistment with PBA

Applicants wishing to enlist with the PBA can apply any time throughout the year and they are enlisted every

[67] The PBA Guidelines have been accessed through an online search. As such, it remains to be confirmed whether PBA Guidelines (as provided in the noted link) are in effect. https://pakistanbanks.org.pk/wp-content/uploads/2021/03/guidelines.pdf

quarter if they meet the SBP's requirements under the PRs.[68] The details of eligibility criteria, appraisals, fee structure and renewals are in Annex U.

A list of Approved Agencies is not maintained by the PBA and the matter of PBA's role in enlistment of debt recovery and collection agencies is a subject of some discussion.

8.7.3 Operating model of servicers

Based on discussions with a debt collection company (based out of the United Arab Emirates but with experience of working in Pakistan), there are some notes about their operating model.

- Recovery agencies generally hire fresh graduates with a minimum of a bachelor's degree and no other specific requirements. Skills and expertise are acquired on the job. For mid senior or senior roles, prior experience of recovery, lending, or other credit related experience in a bank in a client facing role is preferred.
- Debt collection companies operate on a success-based recovery fee, (also known as "No Win No Fee" compensation structure). It means that financial institutions do not incur any fees related to an NPL once it is successfully resolved. Commission rates vary but are typically between 5 percent and 20 percent, depending upon the type and health of loan to be recovered. For instance, a loan with a DPD of more than seven years is more difficult and less likely to be recovered than a loan with a DPD of three years, so command a higher service charge.
- The remuneration model for banks' internal recovery units (in Special Asset Management Functions), varies between success-based and performance-based bonuses. The success-based bonus is like the agency compensation structure, where the bank's recovery department (usually SAM) earns about 3 percent of the total outstanding loans recovered in the year. This is then shared between the employees in the department depending upon the seniority. Performance-based bonuses are also common in banks, and is based on the standard KPI targets achieved in the year. This compensation structure is consistent with the remuneration of other bank departments.
- For corporate and commercial loan portfolios, debt collection agencies are not popular among banks in Pakistan as they have inhouse capability for debt recovery.

8.7.4 Servicing Challenges

The Special Asset Management functions of some banks and a debt collection company noted some challenges in debt recovery.

- Legal impediments are the main hurdle to resolving NPLs and include time consuming, expensive, and arduous court proceedings, the liberal use of stay orders, frivolous/ counter lawsuits by borrowers, faulty or defective asset titles (verbal conveyance of titles), falsification of documents and delay tactics. These are covered in detail in Section 8.1.1 of this report.
- Operationally, NPL resolution in Pakistan is mostly focused on liquidation and recovery. When it comes to restructuring, rehabilitating and reviving businesses, there is need for more focus, strategy and expertise in Special Asset Management functions in banks.
- For collection companies, a pure success fee-based model is thought to create financial and operational difficulties for their survival.

8.8. Recommendations

A summarized list of key impediments and related recommendations discussed in this chapter is in Table 20. The recommendations have been colored according to their priority.

High	
Medium	

[68] Ibid.

Low	

TABLE 20: RECOMMENDATIONS

S No.	Impediment	Recommendation
1.	Institutional capacity and administrative constraints causing delays and concerns in recovery proceedings	High Court: Dedicate a bench to deal with and dispose of banking matters. The benches dealing with banking matters in the Sindh, Lahore and Islamabad High Courts also preside over matters including commercial, civil, award, succession and intellectual property. A judge who has experience with banking matters should be allocated to the Banking Court roster. Develop procedural guidelines and manuals for applying for leave to defend and other interlocutory applications. Impose heavy costs on frivolous litigation. Banking Courts: Increase the number of Banking Courts, widen the pool of potential candidates, and fill all existing vacancies. Both Courts: In collaboration with a judicial academy, SBP should design a course to train judicial officers from the superior and subordinate judiciary and the Banking Courts for capacity building purposes. Sections 5(8) and 5(9) of the Recovery Ordinance (relating to amicus curiae) should be routinely fixed into service and a list of eminent professionals who will be qualified to act in this capacity should be prepared.
		High Court: Judicial clerks should be assigned to judges dealing with banking, commercial and tax matters to assist with carrying out legal research. When a suit is put up both parties should be required to submit skeleton arguments and a list of the citations they will rely on the first date of hearing.
2.	Section 2(a) of Recovery Ordinance (definition of financial institution). Doubt has been created by judicial pronouncements as to whether foreign FIs not having place of business in Pakistan are permitted to invoke the jurisdiction of the	Add clarity to Section 2(a) of the Recovery Ordinance so that a foreign financial institution (regardless of whether it has a place of business in Pakistan) falls

S No.	Impediment	Recommendation
	Banking Courts.	within the scope of the Recovery Ordinance.[69]
3.	Section 9(1) and 10(2) of the Recovery Ordinance (suit by borrowers). The Recovery Ordinance was promulgated to deal with the recovery process of NPLs in aid of the banks or DFIs. Allowing a borrower to file a suit under the Recovery Ordinance (rather than through civil suit under the CPC), is contrary to the intended purpose and causes delays in recovery proceedings and adds to the workload of the Banking Courts (which are faced with capacity issues).	Borrowers should not be allowed to file a suit under the Recovery Ordinance and may agitate available civil remedies. This should not preclude a borrower from filing a counter claim in respect of the suit if necessary. Another, but less desirable option would be to remove the requirement of leave to defend by the bank or DFI, or to alternatively prescribe a timeframe in which a defaulting borrower has to file a reply. The matter, if considered appropriate, may be incorporated as part of the judicial handbook.
4.	Sections 9(5), 10, 13(1), 19. 22, of Recovery Ordinance. Considerable delays in recovery proceedings are caused by borrowers challenging the decree on the basis of improper or lack of service, delays in decisions on leave to defend, the recording of evidence, procedural formalities at execution stage, and improper notice by borrowers when filing an appeal. Based on experience, borrowers do not serve notice on financial institutions and by placing incomplete facts before the Banking Court are able to procure interim orders.	Notice Service should be affected, both on the address given in the financing documents and on the address given in the CNIC of the directors or shareholders, through all the modes, on the first date of hearing. For corporate borrowers, consider using electronic communication when service through other means has been unsuccessful. The matter may be made part of judicial handbook designed as part of judicial capacity building program. Recording evidence: Prescribe a strict timeline for evidence to be recorded. Dedicate a panel of retired High Court Judges exclusively to recording evidence. Consider prescribing the recommendations through rules. Provide timeframes for decisions on leave to defend and disposing suits: Give Banking Courts 45 days to decide the success of leave to defend applications to expedite the recovery process. Confirm that the 90-day period prescribed for the disposal of a suit from grant of leave to defend is mandatory. These amendments would help reduce the time involved in deciding the application for leave to defend and should be included in the judicial handbook as part of the judicial training program.

[69] In view of recent case law (Syed Itrat Hussain Rizvi v. Tameer Micro Finance Bank Limited through Attorney and another (2018 CLD 116 [Sindh] and judgment of the Lahore High Court in Writ Petition No.5591 /2018 (Muhammad Tuseef and 4 others vs. The State Bank of Pakistan and 30 others), microfinance banks do not fall within the definition of 'financial institution' for the purposes of the Recovery Ordinance. Albeit outside the scope of this Report, an amendment to this effect may also be considered.

S No.	Impediment	Recommendation
		Execution modalities: The defaulting borrower and/or its directors, guarantors, shareholders should be required to submit a list of immoveable, moveable and benami assets with the application for leave to defend rather than at execution stage. If the matter cannot be addressed through rules, it should be included in the judicial handbook. Notice of filing of appeal: Borrowers should give notice of appeal through all modes and unless the banks or DFIs enter an appearance in the matter, the appeal should not be taken up for hearing until all facts have been provided. Even if no amendments are made in the statute, recommendations may be prescribed through rules or as guidelines in the judicial handbook.
5.	Section 10 (decision on leave to defend) There are significant delays in recovery proceedings pending the decision on leave to defend applied by the borrowers.	The Banking Court may (i) allow the leave to defend application; (ii) partially allow the leave to defend and pass an interim order in terms of section 11 of the Recovery Ordinance; or (iii) dismiss the leave to defend application. The leave to defend application should only be accepted by the Banking Court once the defaulter has provided the details of all family members/ legal heirs and/or a family registration certificate, and a complete list of assets and bank accounts of the directors/ guarantors. This would help expedite the execution proceedings for recovery cases and discourage borrowers, directors and/or shareholders from unnecessarily delaying proceedings. If the matter cannot be notified through rules of the Federal Government, include these guidelines in the judicial handbook designed as part of a judicial capacity building program.
6.	Sections 9, 12, 14, 16, 19, 22 and 24 of the Recovery Ordinance (references to CPC). There are significant delays in recovery proceedings (specifically execution stage) when Banking Courts follow CPC, procedural laws applicable to general civil cases	Remove all references to CPC except those necessary to the extent of powers of the Banking Court. The Recovery Ordinance should be a self-contained code to prevent defaulters from delaying the proceedings by taking advantage of the general jurisprudence relating to the execution of decrees.
7.	Section 19(1) of the Recovery Ordinance (automatic conversion to execution proceedings). In practice, in Sindh, automatic conversion to execution proceedings is not accepted, a bank or DFI is required to apply for execution proceedings and is subject to the time limitations noted in the Limitation Act,	For clarity, replace the words '*without the need to file a separate application and no fresh notice to be issued to the judgment-debtor in this regard*' in Section 19(1) with: '*without the need of any order of the Banking Court, filing of any application or issuance of fresh notice to the judgment-debtor in this regard*'. If a borrower fails to deposit the decretal amount within seven days, the attachment and sale of the

S No.	Impediment	Recommendation
	1908.	assets [the list of which is submitted with the application for leave to defend] should automatically follow.
8.	Section 22(3) of the Recovery Ordinance (admission of appeal) There are significant delays in concluding recovery proceedings (specifically execution stage).	Admitting an appeal under Section 22(3) should be subject to the borrower furnishing a security. The requirement to furnish a security should be made mandatory at the time of filing an appeal. The cost to file an appeal will help sift out frivolous litigation that adds to the workload of the courts. The purpose of proposed amendment is to make furnishing a security a mandatory requirement for admission of appeal. This will deter multiple proceedings specifically given that at this stage, a specialized forum has already determined a borrower's liability.
9.	Section 27 of the Recovery Ordinance (finality of order). Delays are caused by defaulting borrowers challenging consent decrees on the basis that consent decrees do not fall within the language noted under Section 27.	Extend the finality of order (as noted in Section 27) to consent decrees as well.
10.	Section 20 of the Recovery Ordinance (willful default). The Recovery Ordinance has overriding effect over the ORBO, the FIA Act and the PPC. However, it is possible to pursue criminal proceedings under various laws at the same time.	For the sake of clarity, make appropriate amendments to Section 20 of the Recovery Ordinance to codify the principle that criminal proceedings for willful default cannot be initiated concurrently under multiple legal regimes.
11.	Given the current state of NPLs, there is a need to consider reforms to discourage willful default.	Make amendments such that if 'willful default is made out in any case (i) CNIC, bank account(s) of the borrower and its directors/ sponsors remain blocked till the decree is satisfied; (ii) place the names of directors/ shareholders of the borrower on e-CIB; and/or (iii) place directors/ guarantors on the Exit Control List. The proposed amendments may deter 'willful default' by borrowers, their directors and/or shareholders.
12.	Section 15 of the Recovery Ordinance provides for sale of mortgaged property by a bank or DFI without court intervention. Section 15 (13), however, vests the Banking Court with the power to grant injunctive orders restraining the sale or proposed sale of mortgaged property. This means the objective of the Section is defeated when the Banking Courts grant injunctive orders in favor of the mortgagor, rendering the auction/sale process fruitless. This is more of a practical consideration as despite the	Include guidelines in connection with injunctive relief under Section 15(13) in the judicial handbook and the judicial training program.

S No.	Impediment	Recommendation
	restrictive grounds spelt out in the Recovery Ordinance, based on experience, injunctive orders are frequent.	
13.	While on a literal read of Section 16(3) of the Recovery Ordinance, permits out of court enforcement for all types of security interests, a specific process for this has not been prescribed; and for all practical purposes, enforcement is only availed following an order of the Banking Court.	Clarify that Section 16(3) of the Recovery Ordinance permits the recovery or sale of movable property at any stage and without the need for any order of the Banking Court. Procedure and modalities may be prescribed for out of court recovery and sale of movable property. If legislative amendments are not possible, the clarification or modalities may be added through rules.
14.	A consolidated framework for the insolvency of companies and non-corporate entities does not exist. Even for companies, the insolvency regime is spread across multiple laws.	All laws, procedures and modalities connected with corporate insolvency and the rights of secured and unsecured creditors may be captured under a consolidated regime where no creditor of a company would be entitled to invoke the winding up of the company. Invoke provisions for corporate insolvency recovery mechanisms where defaulting debtors will be assessed on whether it is capable of repaying its debt, failing which the debtor is either restructured, or else liquidated and finally dissolved. Ensure all kinds of Companies, partnership firms, proprietorship firms, or any other person incorporated with limited liability under any law, who have defaulted to pay their debt, are brought within the fold of the same insolvency framework.
15.	Specific duties owed by directors to creditors (in the context of insolvency) have not been statutorily prescribed.	Amend the Companies Act to encourage the directors to initiate or disclose bankruptcy proceedings as soon as possible and take all necessary measure to mitigate potential loss to the company and banks or DFIs. This would align with international jurisprudence.[70]
16.	The official liquidator is required to be appointed from the list of liquidators maintained by the SECP. However, liquidation proceedings are prone to delays, and there is a need for capacity building and training for liquidators.	Proper training programs handbooks concerning liquidation procedures and modalities may help build capacity.
17.	Uncertainty is created vis-à-vis the requirement of fresh disbursement and charging of mark-up in rescheduling as a result of inconsistent and confusing judicial pronouncements.	Fortify the bank or DFI's position through an SBP circular prescribing: (i) a fresh finance agreement executed between the financial institution and borrower, containing terms and conditions for rescheduling earlier finance facilities; (ii) that disbursement under the fresh finance agreement is not

[70] Certain directors' duties specifically in the zone of insolvency have been codified under the laws of England pursuant to the Companies Act, 2006 (as applicable in England) and the Insolvency Act, 1986 (as applicable in England). In terms of the said Act, any person including a director would be held liable for wrongful trading if it can be concluded that s/he failed to take "…*every step with a view to minimizing the potential loss to the company's creditors as (on the assumption that he had knowledge of the matter…) he ought to have taken*…"

S No.	Impediment	Recommendation
		required;[71] and (iii) banks may charge mark-up on the principal amount under the fresh finance agreement, which will constitute the outstanding debt (principal plus mark-up) under the original finance agreement.[72]
18.	The Corporate Rehabilitation Act was promulgated after circulation, debate, and several rounds of revisions based on comments from stakeholders and insolvency experts which took over a decade. Despite a heavy focus on creditor rights and the Corporate Rehabilitation Act being in the field for over three years, the framework has failed to find any traction.	A corporate rehabilitation plan is subject to approval by any class of persons holding any interests which is not impaired by the plan. The concept of 'impaired class' has not been defined. For sake of clarity, incorporate an appropriate definition of 'impaired class'. Unlike the Title 11 bankruptcy under the laws of the United States, the concept of a time bound "automatic stay" upon the commencement of rehabilitation process is not contemplated. The 'automatic stay' trigger may be incorporated, which with certain exceptions, will operate as an injunction against all actions affecting the debtor, its property, shareholders, directors or guarantors and will help facilitate the corporate rehabilitation process. If a borrower is unable to provide "adequate protection" (through cash collateral, or compensation for depreciation), then a secured bank or DFI will be entitled to obtain relief from the automatic stay and enforce its collateral rights. Prescribe a time frame of 180 days (extendable for another 90 days) to complete a corporate rehabilitation process. This will ensure a speedy process and may also help ensure that the banks and DFIs can explore alternate recourses should the corporate rehabilitation process fail. Consider a fast-track corporate rehabilitation process (to be completed within 90 days and extendable by another 45 days) for corporate or SME borrowers with assets and income below prescribed levels or a corporate borrower with a prescribed class of creditors.
19.	Some legal controversy has been created following judicial pronouncements as to whether stamp duty is payable on transfer of assets pursuant to Schemes sanctioned by High Court/SECP. The Companies Act has addressed this controversy by exempting stamp duty on transfers where notifications are issued by the respective provincial	Issue provincial notifications similar to the ICT notification exempting payment of stamp duties.

[71] The proposition has also been supported in: Bank of Punjab through Attorney v. Dewan Salman Fiber Limited 2017 CLD 451 [Sindh]; The Bank of Punjab vs. Arif Ali Shah Bukhari, 2016 CLD 1301 [Sindh]; Bank Al-Habib Limited vs. M/s. Khalid Javaid and Brothers and 8 Others, 2016 CLD 1493 [Sindh]; Bank Alfalah Limited vs. Syed Zulfiqar Ali Rizvi, 2016 CLD 618 [Sindh]; The Bank of Punjab vs. Flying Cement Company Limited, 2015 C L D 1567 [Lahore]; Syed Abbas Ali vs. Bank of Punjab, 2015 CLD 1409 [Lahore]; Ibrahim Oil Mills vs. Mcb Bank Limited, 2015 CLD 802 [Lahore] (Research conducted in July 2017).

[72] The proposition has also been supported in: Bank Al-Habib Limited vs. M/s. Khalid Javaid and Brothers and 8 others, 2016 CLD 1493 [Sindh] (relied on M/s. Dadabhoy Cement Industries Ltd. and 6 others v. National Development Finance Corporation Karachi [PLD 2002 SC 500]; The Bank of Punjab vs. Dewan Farooque Motors Limited, 2015 C L D 1756 [Sindh] (Research conducted in July 2017).

S No.	Impediment	Recommendation
	governments under the stamp laws. However, such notifications are yet to be issued (except in the case of Islamabad).	
20.	The framework for creditor schemes of arrangement has been in place for a long time, however, has not found traction for NPL resolution.	Set up separate tribunals for sanctioning Schemes for all types of enterprises. This will contribute towards making creditor schemes of arrangement an attractive option for NPL resolution by:(i) building capacity for matters involving complex financing and security arrangements and restructuring; (ii) reducing the workload of the SECP and the High Court; and (iii) expediting the overall process.
21.	There is ambiguity as to whether the process delineated under Section 292 of the Companies Act would necessarily have to be adopted in the case of rehabilitation of a sick public sector entity (as opposed to the rehabilitation regime under the Corporate Rehabilitation Act).	Seek clarity from the SECP/Federal Government as to whether the process delineated under Section 292 would have to be adopted in case of rehabilitation of a sick public sector entity.
22.	The 'true sale' standard under the SBP Circular, applicable where banks or DFIs are originators, are more stringent as compared with the applicable international accounting standards, as no recourse against the originator is permitted.	Include some limited recourse where the originator breaches a warranty that was relied upon by the SPV to purchase the NPLs. For example, if the originator warrants as to the accuracy of past defaults and this turns out to be materially incorrect, some recourse against the originator should be permitted. The extent of such recourse should fall within the domain of the relevant accounting standards to determine whether a particular sale could be accorded an off-balance sheet treatment in the hands of the originator.
23.	To the extent of residential and commercial mortgage-backed securities, the Amended SBP Circular now permits banks and DFIs (having capital adequacy ratio of at least 1.3 times of existing regulatory requirements) to set up a 100 percent owned SPV. SECP Securitization Rules however provide that the "Originator shall not be a connected person to the Special Purpose Vehicle".	The SECP Securitization Rules need to be amended as appropriate.
24.	The banks participating in a securitization transaction (pursuant to BPRD Circular No. 31 of 2002) cannot hold any share capital in the SPV (except in certain cases involving residential and commercial mortgage-based securities). There is general reluctance by independent third parties to act as shareholders of the SPV. One major reason for this is the exposure to negative e-CIB reporting at a group level on account of any default on the part of the SPV.	Make appropriate revisions to e-CIB reporting to alleviate the problem.
25.	Under the SBP Circular, the ABS needs to have a minimum credit rating of 'A' and be	Consider relaxing these requirements in relation to a securitization involving NPLs. Further, on account of

S No.	Impediment	Recommendation
	listed. Regulatory compliances have been prescribed in the regulations issued by the Pakistan Stock Exchange Limited in relation to listed or OTC listed ABS issued by an SPV.	an ambiguity under the SECP Securitization Rules, amendments providing clarity are advisable to confirm that listing in not a mandatory requirement under the said Rules.
26.	High stamp duty and registration costs may be an impediment in securitization of NPLs.	This issue can be addressed if all Provinces also issue notifications exempting stamp duty like the ICT notification.
27.	Even after enactment of the CRC Amendment Act, subordinated legislation/regulatory measures will be required to make the CRC Act an effective NPL restructuring regime.	Even after the CRC Amendment Act is enacted, the following additional measures/recommendations may be noted: If from a policy angle a financial institution should be permitted to control a CRC, a further amendment to the CRC Act will be required. Following passage of the amendment the Federal Government will need to issue a notification to set up the Corporate Restructuring Board. The Board should have a maximum of five members and have relevant experience. To facilitate and regulate the asset management structure proposed through insertion of Section 6A in the CRC Act, the SECP will need to develop a framework in harmony with the rules and regulations under the CRC Act.[73]
28.	There is ambiguity as to whether banks and DFIs may only engage with Approved Agencies in in accordance with the PBA Guidelines for collecting, recovering and repossessing NPLs.	Revise the PBA Guidelines to remove ambiguity in relation to corporate financing. Alternatively, a separate set of guidelines may be considered for collection, recovery and/or repossession agents servicing corporate NPLs.

[73] As a result of the recent changes in the trust laws, in Section 6A, replacement of relevant references to the “Trust Act, 1882” with “the applicable trust laws” is also advisable. However, the same is recommended only by way of clarity.

9. NPL INVESTORS AND NPL INVESTMENT STRUCTURES FOR PAKISTAN

9.1. Key Investors in NPLs Markets Globally

Potential NPL investors for the Pakistan market are listed according to their presence in the region (including China, India, Middle East, and Southeast Asia), their assets under management, recent involvement in NPL deals, and investments in emerging markets. IFC has also partnered with some of these investors.

i. Cerberus Capital Management

Cerberus is one of the world's largest and most experienced investors in NPL portfolios. Since 1998, its global NPL platform has invested approximately $21.3 billion in equity through almost 250 NPL transactions with total transaction values of approximately $72 billion.

ii. Apollo Global Management

Apollo Global Management, Inc., is a global alternative investment manager firm. Apollo is headquartered in New York City, with offices across North America, Europe, and Asia.

Apollo's largest business segment by assets under management is credit, with more than $320 billion under management for global investors as of December 31, 2020. Within this segment of the business, Apollo also invests in NPLs.

Apollo has set up a business in India, in Mumbai and New Delhi which should provide a reasonable understanding of the regional NPL dynamics and thus a good potential entity which may be approached.

iii. Blackstone

The Blackstone Group Inc. is an American alternative investment management company based in New York. As of 2020, the company's total assets under management were approximately $619 billion.

Blackstone's private equity business has been one of the largest investors in leveraged buyouts in the last three decades. and it is one of the world's largest credit-oriented asset managers. The Assets under management for Blackstone's Credit business were $149 billion in March 2021.

In 2017, Blackstone bought NPLs worth $200 million from Huarong Asset Management, one of the four asset management companies in China. Similarly, Blackstone has acquired NPLs from the European markets.

Given Blackstone's size and its involvement in the global NPL market, it may be a potential investor to work with IFC and other stakeholders in Pakistan.

iv. BlackRock

BlackRock is one of the world's largest asset management firms with $8.68 trillion assets under management in December 2020.

Blackrock has proven investment experience in NPLs. In 2014, Blackrock purchased a stake in the Chinese NPL market and there is a speculation that with a couple of other asset management companies, it may tap into the Indian NPL market.

v. KKR & Co

KKR & Co. Inc. is a New York-based global investment company that manages multiple alternative asset classes. In December 2020, KKR's assets under management were worth ~$78 billion across seven countries including UAE, India, and Singapore.

KKR has invested in NPLs globally, developing strong relationships with banks and advisors across Europe and growing its presence in Asia. This has allowed KKR to access acquisition opportunities bilaterally with the sellers or through auction processes. They have ownership in debt servicing platforms across Europe and Asia and leverage to source and then service these investments post-acquisition.

Since 2016, KKR has purchased four Spanish and one Portuguese NPL portfolios, totaling over €2.4 billion in

aggregate outstanding balance that is being managed by its captive servicer.

As KKR already operates in Asian NPL markets including Hong Kong, Singapore, Tokyo, and Beijing, it would suit the Pakistan market.

vi. Brookfield Asset Management

Brookfield Asset Management is a global alternative asset manager with over $600 billion in assets under management across real estate, infrastructure, private equity and credit (including through affiliate Oaktree Capital Management).

Brookfield owns and operate long-life assets and businesses, offering investment products and services to public and private pension plans, endowments and foundations, financial institutions, insurance companies and private wealth.

Brookfield has global reach with assets under management in North America of $378 billion, in Europe and Middle East of $106 billion, $43 billion in South America and $75 billion Asia Pacific.

Brookfield also invests in NPL markets to fight distressed debt. In 2016, Brookfield put $1 billion in India to recapitalize and provide financial support to distressed corporate clients. Brookfield's global network and operational capacity make it a suitable potential investor for the Pakistan NPL market.

vii. Shoreline Capital Management

Shoreline Capital is a private fund manager established to find and create value in distressed assets and special situation investments in China. Shoreline manages portfolios of NPLs, restructured single credits, special situation financings, distressed private equity and real estate. Shoreline has over $500 million of capital under management, of which several billion dollars is invested in distressed debt assets and equity. Shoreline's investor base consists of internationally renowned endowments, funds-of-funds, pensions and philanthropic foundations.

Shoreline Capital's Shoreline Capital CNY Fund is one of the largest in Asia, seeking $1.5 billion in capital. The fund invests in opportunities in China, with around 70 percent of capital invested in non-performing assets of banks, loans to local government platforms and state-owned enterprise loans.

In 2015, Shoreline Capital Management and Oaktree Capital Group purchased a portfolio of NPLs in China for a total of $168 million. The portfolio consists of loans issued to Chinese companies typically secured by the companies' hard assets. Sellers include Chinese banks and one of the country's asset management companies that buy bad loans at a discount from banks and other financial institutions.

viii. Oaktree Capital Group

Oaktree Capital Management is a global alternative investment management firm with expertise in credit strategies.

Oaktree focuses on rated and non-rated debt of sub-investment grade issuers, and its investments include high yield bonds, convertible securities, leveraged loans, structured credit instruments, distressed debt, and private debt.

In 2020, Oaktree had $148 billion of assets under management out of which around $32.5 billion investment had been made for acquiring distressed debt. The regional mix shows around 15 percent assets in Asia Pacific, 19 percent in Europe, Middle East & Africa (EMEA) region and the rest in Americas.

In 2018, Oaktree Capital Group LLC bought a portfolio of distressed loans in China with a face value of $476.70 million. This NPL portfolio, consisted of 178 loans in China´s Pearl River Delta, that were mostly property backed.

ix. Bain Capital

Bain Capital is a private multi-asset alternative investment firm with approximately $140 billion in assets under management. It invests in global private and public equity, fixed income, credit, venture capital, and real estate across multiple sectors, and industries.

Bain Capital bought a portfolio of non-performing loans worth $200 million from a Huarong asset management company in China as part of its special situations strategy in Asia. The portfolio of NPLs was of real estate-related loans, including loans linked to commercial retail assets, hotels, and industrial assets.

Bain Capital raised $1 billion through the India Resurgent Fund – a joint venture with Piramal Enterprises and its first Asia-focused credit fund. IFC also contributed $100 million to the fund and was an anchor investor.

The India Resurgent Fund is expected to revitalize several distressed companies, and provide capital relief to banks, helping to resolve NPLs in India. It will support a new regulatory framework and contribute to a more robust

distressed asset market, allowing banks to increase lending.

x. Sancta Capital Group

Sancta Capital is the only investment manager focused on distressed and deep value investing in the Middle East and Africa.

It invests in publicly listed debt and equity securities, loans and claims of stressed and distressed borrowers, and alternative financing solutions to companies outside the traditional bank market. It specializes in acquiring and restructuring distressed and NPLs, bonds and trade claims.

Sancta Capital has $130 million of assets under management in mainly the United Arab Emirates, Kuwait, Egypt, and Saudi Arabia.

xi. Aiqon Capital Group

Aiqon Capital Group Sdn Bhd is the largest NPL-acquiring firm in Malaysia, specializing in acquiring and managing NPL assets from banks and FIs.

Since starting operations in 2010, Aiqon has acquired retail NPLs with a total face value of over $12 billion in Malaysia. The last notable transaction was Aiqon’s purchase of retail banking NPLs from AMMB Holdings Bhd in early 2019 for about $132.5 million.

Aiqon currently manages acquired NPL portfolios with a face value of $7 billion in Malaysia, Singapore, Thailand, Philippines, Australia, Luxembourg, and Spain. The NPLs are from individuals and corporations who had made industrial hire purchases and had taken out small-and medium-industry loans, auto financing, mortgage, personal loans or financing under cooperatives, and credit cards.

xii. Collectius Group

Collectius Group is a credit management service and asset management company with operations in Indonesia, Philippines, Singapore, Malaysia and Thailand. It is one of the largest NPL-acquiring companies in Southeast Asia, having purchased 65 portfolios from banks and finance companies with a total face value of $3.5 billion. In Malaysia, it has $173.6 million in retail NPLs. Collectius has partnered with IFC to launch a $60 million regional investment platform dedicated to acquiring and resolving unsecured debt in Indonesia, the Philippines, Malaysia, Thailand and Vietnam.

In 2018, Collectius acquired an NPL portfolio in Thailand from Thai Military Bank, the NPL portfolio consisted of almost 7,000 credit cards and personal loans with a total principal value of $23 million. In the same year, Collectius acquired its second NPL portfolio from a FI in the Philippines for $100 million and pioneered debt purchase in Indonesia, signing its first NPL portfolio deal for $300 million.

9.2. Common NPL Resolution Models and Potential NPL Transaction Structures

9.2.1 Background and available options

In Pakistan, NPL resolution is an internal bank-led model. All commercial banks have in-house special asset management or remedial asset management units which are mandated to resolve NPLs transferred to them using restructuring, litigation, debt-asset swaps, out of court settlements, or other similar tools. To resolve these NPLs some banks contracted individuals or third parties for asset identification services and coordination with local land revenue offices, and asset repossession services for consumer finance debt collection (Annex O). Loan servicing companies like those operating in European NPL markets do not exist (see Table 20 for examples). The NPL problem in Pakistan is largely considered a legal one and until the impediments in the law and the court system are resolved, banks’ preference for an in-house model over any options of sale or securitization will remain. However, it is possible that the banks hold this view because an attractive alternative model for NPL resolution has not been available to them.

As well as internal bank-led model, a few other models are common in Europe, Southeast Asia and India. These models are essentially based on the transfer of NPLs from a bank to an NPL buyer through sale or a securitization-like structure. Among these models of NPL buyers, public, and private and hybrid entities exist. Some examples of these models include:

i. Integrated Bank Credit Trading Platform (Portugal) or Project Solar (Greece). In these models NPLs from multiple banks are pooled into an SPV allowing banks to derecognize their NPLs. The SPV is privately

owned.

ii. ARCs (India). In this model an asset reconstruction company set up as a non-bank finance company under SRFAESI Act, 2002 of India buys NPLs from banks. The purchase is funded by security receipts issued by a trust (under an ARC) to qualified buyers. NPL purchases are through tender and auction.

iii. GACS (Italy) and Greece (HAPS) Securitization Models. In these models, NPLs are transferred to an SPV for a cash payment by the SPV to the selling bank. The SPV issues asset-backed securities to investors. With a layered funding structure, the senior securities issued are backed by a government guarantee against a fixed fee. A servicer is appointed for NPL servicing against a management fee. The transferring banks can also act as servicers.

iv. NAMA (Ireland), SAREB (Spain), KAMCO (Korea) and Danaharta (Malaysia). In these models distressed assets are pooled into government sponsored or established (but not necessarily majority owned) SPVs allowing participating banks to derecognize their NPLs receiving government-risk securities as payment.

The skills, specialization and robustness of the servicing entity can contribute to the success of an investment structure depends. Common NPL servicing models (based on examples from European markets) are shown in Table 21.[74]

TABLE 21: SERVICE ENTITIES OPERATING IN EUROPE

S no.	Category	Examples
1	**Captive servicers** with exclusive relationships with private equity NPL investors	Hudson with Lone Star Lapithus with Apollo
2	**Loan servicing platforms** owned or controlled by NPL private equity investors but open to third parties	CHL (UK and Ireland) and Haya (Spain) with Cerberus. Pepper, HipoGes, and Pillarstone with KKR
3	**Debt purchasing and collection agencies** with growing secured servicing capabilities	Lowell, Arrow, Hoist, Cabot
4	**Bank platforms or Asset Management Companies** (AMC)	FMS Wert management, Euro bank Financial Planning Services (FPS)
5	**Global Commercial Real Estate** (CRE) loan servicers	Situs, Mount Street, CBRE
6	**Country-focused players**	LOANCOS (Germany)
7	**Business Process Outsourcing** (BPO) integrated servicers	Link Asset Servicing, Computershare, Tech Mahindra (Target)

Conventionally, the servicing industry is comprised of debt collection agencies which purchase NPLs for their own account, and third-party servicing companies that administer portfolios and collect loans, but crossover models such as captive servicers or loan servicing platforms are becoming popular as many loan servicers in Europe have either have been bought by investors, have grown to become investors themselves, or have been created via joint ventures between banks and loan servicers or investment funds (Metz, 2020).

In Pakistan, other than the Pakistan Corporate Restructuring Company (PCRCL), which is loosely comparable with

[74] Deloitte (2019), Deleveraging Europe https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/corporate-finance/deloitte-uk-deleveraging-europe-2019.pdf

the ARC model in India, no structure or entity similar to the servicing entities operating in Europe exists. A review of the legal impediments relating to PCRCL is in Section 8 of this report, however, there are three crucial points to note following discussions with PCRCL.

i. Under the CRC Act, PCRCL cannot buy NPLs from banks involved in its establishment, ownership or control. This ambiguity in the law regarding the use of words ownership and establishment has resulted in some uncertainty as to whether the banks that own PCRCL can sell or transfer their NPLs to PCRCL.

ii. PCRCL has limited capital, preventing it from becoming a notable player in the secondary NPL market. PCRCL was established with an equity of PKR 500 million and does not have sufficient capital to purchase large corporate or commercial NPLs and keep a sufficient base of investment portfolio for regular cash flows.

iii. PCRCL has entered some success fee-based agency contracts and NPL sale agreements with banks. This agency model is neither expressly allowed in PCRCL's mandate nor was it the reason it was established, but this model has been adopted by the company as a temporary measure to stay in business until the legislative amendments necessary to shore up its viability occur. The agency agreements that PCRCL has agreed so far, will be effective upon the relevant legal amendments.

In this context, there are a few possible models for the sale or securitization of NPLs. In presenting these models, IFC's investment preferences[75] such as having risk-reward based propositions, requirement of a servicing or distressed asset partner, avoiding asset comingling risk, having a clear exit strategy, separating ownership and servicing of portfolios, and having some reserved powers such as the right to veto portfolio/asset purchases have been discussed. It is important to understand that the success of any of these models will depend on the extent to which the shortcomings in provisioning and tax regulations, enforcement laws, recovery laws and the court system in Pakistan are addressed, as they can improve recovery times, reduce transactional costs of recovery and improve per rupee NPL recovery. Whether or not these legislative changes occur will have a direct impact on whether any of the model options discussed below present themselves as attractive investment options for a private investor.

[75] Any investment by the IFC will be subject to necessary improvements in the legal, regulatory and taxation regimes and be subject to IFC management and board approvals.

9.3. Summary of Possible NPL Models and Transaction Structures

Table 22 contains a summary of the characteristics of each of the possible NPL models and the transaction structures contained in Section 9.4.

TABLE 22: SUMMARY OF POSSIBLE NPL MODELS & TRANSACTION STRUCTURES

S. No	Characteristic	Option 1: PCRCL (enhanced & expanded)	Option 1A: New company under CRC law	Option 2: PCRCL (Funds/ Trusts) as asset management company	Option 3: Securitization by originating bank	Option 4: Alternative Funds set up by Private Fund Management Companies
1	Legal changes required to enable the structure	None	None	Amendments in the CRC law required to allow CRC to operate as asset management company.	None	None
2	Legal basis for transfer of assets	CRC Law	CRC Law	CRC Law	By specific contractual terms	By specific contractual terms
3	Ability to remit the upside on the portfolio (recoveries beyond the initial purchase price)?	Yes, as dividend payments in case of equity investment (subject to 9 below).	Yes, as dividend payments in case of equity investment (subject to 9 below).	Yes, by redemption of units (where set up as open-end fund) and as dividends when invested in units of the trust (subject to 9 below) [also refer to Annex V].	Yes, only if a profit participating investment instrument is used for example, participating term finance certificates (subject to 9 below).	Yes, as dividends when invested in units of the trust/shares of the fund (where it is set up as a company) or through redemption of units, where applicable (subject to 9 below) [also refer to Annex V].
4	Transfer of collateral along with NPL	Automatic by operation of CRC law	Automatic by operation of CRC law	Automatic by operation of CRC law	Movable collateral will transfer along with NPL unless contractually agreed otherwise. Transfer of immovable collateral will require registration under registration laws. The registration duty applicable on transfer of immovable property	Movable collateral will transfer along with NPL unless contractually agreed otherwise. Transfer of immovable collateral will require registration under registration law. The registration duty applicable on transfer of

S. No	Characteristic	Option 1: PCRCL (enhanced & expanded)	Option 1A: New company under CRC law	Option 2: PCRCL (Funds/ Trusts) as asset management company	Option 3: Securitization by originating bank	Option 4: Alternative Funds set up by Private Fund Management Companies
					varies from Province to Province. By way of example, in the Province of Punjab, the registration duty may be up to one per cent of the value of the immovable property whereas in the Province of Sindh, registration duty of PKR 1000 is payable.	immovable property varies from Province to Province. By way of example, in the Province of Punjab, the registration duty may be up to one per cent of the value of the immovable property whereas in the Province of Sindh, registration duty of PKR 1000 is payable.
5	Borrower approval required?	Yes, in case of anti-assignment clause.	Yes, in case of anti-assignment clause.	Yes, in case of anti-assignment clause.	Yes, in case of anti-assignment clause.	Yes, in case of anti-assignment clause.
6	Primary funding option[76]	Equity	Equity	Equity or Units of fund	Asset-backed securities	Units of alternate fund (equity)
7	Regulatory approvals for investment	Procedural requirements of SECP on issuance of capital will apply. Pre-merger clearance from Competition Commission may also be required. No SBP approval required for investment in FX. Investment must be	Incorporation and licensing requirements to set up public limited company under Companies Act and CRC law will apply including requirement for managerial capacity of sponsors/ board. Minimum capital, PKR	No requirements at this stage. Additional requirements may be prescribed along with in-process regulatory amendments.	Securitization of assets other than lease and mortgage finance require SBP approval. Investment in and transfer of ABS also requires SBP approval.	Incorporation and licensing requirements to set up public limited company (non-bank finance company) under Companies Act will apply. NBFCs operate under a regulated framework and are subject to various regulatory requirements including reporting to the SECP. Minimum capital, PKR 10

[76] As an alternative IFC may lend to a CRC against a pledge of its portfolio. This option will be possible provided there are no restrictions in the regulatory framework to be prescribed for investment in trusts set up by CRC. As noted in the table above, presently only an enabling provision in the CRC Act is proposed which would permit CRCs to acquire NPLs from financial institutions through one or more trusts constituted and managed by it and the regulatory framework in connection there is yet to be prescribed. In the case of other funds of a similar nature operating in Pakistan (such as private funds or REIT funds) certain secured/unsecured borrowing thresholds/fund investor disclosure requirements have been prescribed vis-à-vis borrowing by the trust funds. Further, prior approval of the SBP will be required for trusts to seek borrowing from abroad in view of Chapter 19 of the FE Manual.

S. No	Characteristic	Option 1: PCRCL (enhanced & expanded)	Option 1A: New company under CRC law	Option 2: PCRCL (Funds/ Trusts) as asset management company	Option 3: Securitization by originating bank	Option 4: Alternative Funds set up by Private Fund Management Companies
		registered with Authorized Dealer on repatriable basis.	500 million. No SBP approval required for investment in FX. Investment must be registered with Authorized Dealer on repatriable basis.			million. No SBP approval required for investment in FX. Investment must be registered with Authorized Dealer on repatriable basis.
8	Regulatory approvals for profit repatriation	No SBP approval required for investment in FX. Investment must be registered with Authorized Dealer on repatriable basis.	No SBP approval required for investment in FX. Investment must be registered with Authorized Dealer on repatriable basis.	No SBP approval required for investment in FX. Investment must be registered with Authorized Dealer on repatriable basis.	No prior approval of the SBP will be required for IFC to invest in ABS or transfer the same to any resident/non-resident.	No SBP approval required for investment in FX. Investment must be registered with Authorized Dealer on repatriable basis.
9	Regulatory approvals for divestment (exit options)	Feasible subject to requirements of CRC Act and relevant rules. *Sale to Pakistan resident*: Repatriation subject to basic due diligence by Authorized Dealer. If proceeds exceed $50 million in six months, additional requirements by Authorized Dealer. *Sale to non-resident*: No restrictions, if sale price paid outside Pakistan. Stamp duty on share	Feasible subject to requirements of CRC Act and relevant rules. *Sale to Pakistan resident*: Repatriation subject to basic due diligence by Authorized Dealer. If proceeds exceed $50 million in six months, additional requirements by Authorized Dealer. *Sale to non-resident*: No restrictions, if sale price paid outside Pakistan. Stamp duty on share	(Presumed for equity investment) feasible subject to requirements of CRC Act and relevant rules. *Sale to Pakistan resident*: Repatriation subject to basic due diligence by Authorized Dealer. If proceeds exceed $50 million in six months, additional requirements by Authorized Dealer. *Sale to non-resident*: No restrictions, if sale price paid outside Pakistan. Stamp duty on share transfer applies.	No prior approval of the SBP will be required for IFC to transfer the same to any resident/non-resident.	*Sale to Pakistan resident*: Repatriation subject to basic due diligence by Authorized Dealer. If proceeds exceed $50 million in six months, additional requirements by Authorized Dealer. *Sale to non-resident*: No restrictions, if sale price paid outside Pakistan. Stamp duty on share transfer applies.

S. No	Characteristic	Option 1: PCRCL (enhanced & expanded)	Option 1A: New company under CRC law	Option 2: PCRCL (Funds/ Trusts) as asset management company	Option 3: Securitization by originating bank	Option 4: Alternative Funds set up by Private Fund Management Companies
		transfer applies.	transfer applies.			
10	Taxes on income	Income taxable at 29 percent as income from business. Gain/loss on disposal of assets (collateral acquired) taxable as capital/ gain loss. Varying rates for capital gain/loss based on holding period and asset type.	Income taxable at 29 percent as income from business. Gain/loss on disposal of assets (collateral acquired) taxable as capital/ gain loss. Varying rates for capital gain/loss based on holding period and asset type.	Under the current tax law, the profit/surplus earned by the trust will be taxed as business income at 29 percent and any gain/loss on disposal of assets (collateral acquired) will be taxable as capital/ gain or loss for the trust. Varying rates for capital gain/loss based on holding period and asset type. Dividends paid by the trust will generally be taxed at 15 percent for unitholders. On redemption of units, the difference between the initial investment value of units and the redemption value of units will be taxed as capital gain for the investors (on FIFO basis).	Income taxable at 29 percent as income from business. Gain/loss on disposal of assets (collateral acquired) taxable as capital/ gain loss. Varying rates for capital gain/loss based on holding period and asset type.	Under the current tax law, the profit/surplus earned by the fund will be taxed as business income at 29 percent and any gain/loss on disposal of assets (collateral acquired) will be taxable as capital/ gain or loss for the fund. Varying rates for capital gain/loss based on holding period and asset type. Dividends paid by the fund will generally be taxed at 15 percent for unitholders. On redemption of units, the difference between the initial investment value of units and the redemption value of units will be taxed as capital gain for the investors (on FIFO basis).

S. No	Characteristic	Option 1: PCRCL (enhanced & expanded)	Option 1A: New company under CRC law	Option 2: PCRCL (Funds/ Trusts) as asset management company	Option 3: Securitization by originating bank	Option 4: Alternative Funds set up by Private Fund Management Companies
11	Transaction specific taxes or duties on NPL sale/purchase/transfer	No stamp duty/registration costs	No stamp duty/registration costs	No stamp duty/registration costs	Stamp duty varies from province to province. In Islamabad, stamp duty is capped at PKR 100,000/- as per the legal exemptions. In Punjab, stamp duty is 3 percent of the value of property. In Sindh, there is some doubt as to applicability of stamp duty on sale of movable property as, whilst the enabling stamping provision is wide enough to capture sale of movable property, the mechanism for computation of stamp duty does not cater for movable properties. On a narrow read, stamp duty of 1 percent of the transaction value will be attracted.	Stamp duty varies from province to province. In Islamabad, stamp duty is capped at PKR 100,000/- as per the legal exemptions. In Punjab, stamp duty is 3 percent of value of property. In Sindh, there is some doubt as to applicability of stamp duty on sale of movable property as, whilst the enabling stamping provision is wide enough to capture sale of movable property, the mechanism for computation of stamp duty does not cater for movable assets. On a narrow read, stamp duty of 1 percent of the transaction value will be attracted.
12	Minimum statutory establishment costs[77]	None. PCRCL is already established.	Statutory licensing fee - PKR 50,000/-. Fees for incorporating a public limited company vary depending upon share capital of the company and may be calculated at https://www.secp.gov.pk /company-formation/fee-	None	Fees for incorporating a public limited company vary depending upon share capital of the company and may be calculated at. An SPV may only apply for OTC listing of debt securities offered and issued through private placement if it's paid up, capital is at least Rs. 25,000,000/-, otherwise minimum	Statutory application fee for registration of Alternative Fund as a notified entity - PKR 1,000,000/-.

[77] https://www.secp.gov.pk/company-formation/fee-calculator/company-incorporation-fee-calculator/

S. No	Characteristic	Option 1: PCRCL (enhanced & expanded)	Option 1A: New company under CRC law	Option 2: PCRCL (Funds/ Trusts) as asset management company	Option 3: Securitization by originating bank	Option 4: Alternative Funds set up by Private Fund Management Companies
			calculator/company-incorporation-fee-calculator/). A CRC under CRC Law is required to have a minimum share capital of PKR 500 million.		paid up capital requirement is PKR 100,000.	
13	Servicing capacity and infrastructure, outsourcing of operations	PCRCL to be the default servicing option. Third-party servicing options are limited. Setting up a captive servicing company may be explored.	The new CRC to be the default servicing option. Third-party servicing options are limited. Setting up a captive servicing company may be explored.	PCRCL to be the default servicing option. Third-party servicing options are limited. Setting up a captive servicing company may be explored.	Private third-party servicers (limited options) or setting up a new servicing company/ platform.	PCRCL, private third-party servicers (limited options) or setting up a new servicing company/ platform.
14	Governance and control by IFC	Proportionate control, shared with 10 existing shareholders (commercial banks)	Full control possible	Control in NPL portfolio and underlying assets based on investment proportion.	Control in NPL portfolio and underlying assets based on investment proportion.	Control in NPL portfolio and underlying assets based on investment proportion.
15	Control of cash flows	Proportionate share through dividend distributions approved by the Board (specific exceptions can be made through shareholder agreement).	Full control on profit distributions/ dividends possible.	Control in NPL portfolio and underlying assets based on investment proportion.	Control in NPL portfolio and underlying assets based on investment proportion.	Control in NPL portfolio and underlying assets based on investment proportion.
16	Asset ownership	Assets owned by PCRCL	Assets owned by the new CRC	Assets owned by the fund(s)/ trust(s)	Assets owned by the SPV	Assets owned by the alternate investment fund

S. No	Characteristic	Option 1: PCRCL (enhanced & expanded)	Option 1A: New company under CRC law	Option 2: PCRCL (Funds/ Trusts) as asset management company	Option 3: Securitization by originating bank	Option 4: Alternative Funds set up by Private Fund Management Companies
17	Collateral	No restrictions on the type of collateral.	No restrictions on the type of collateral.	No restrictions on the type of collateral.	No restrictions on the type of collateral.	No restrictions on the type of collateral.
18	Debt Enforcement	No restricted options under CRC law. Soft collection, litigation, asset swap, out-of-court settlement, restructuring and rehabilitation may be used.	No restricted options under CRC law. Soft collection, litigation, asset swap, out-of-court settlement, restructuring and rehabilitation may be used.	No restricted options under CRC law. Soft collection, litigation, asset swap, out-of-court settlement, restructuring and rehabilitation may be used.	All remedies as are typically available for debt enforcement including litigation, rescheduling, restructuring and rehabilitation.	All remedies as are typically available for debt enforcement including litigation, rescheduling, restructuring and rehabilitation.

9.4. Possible NPL Transaction Structures to Start an NPL Market in Pakistan

FIGURE 23: OPTION 1 DIAGRAM

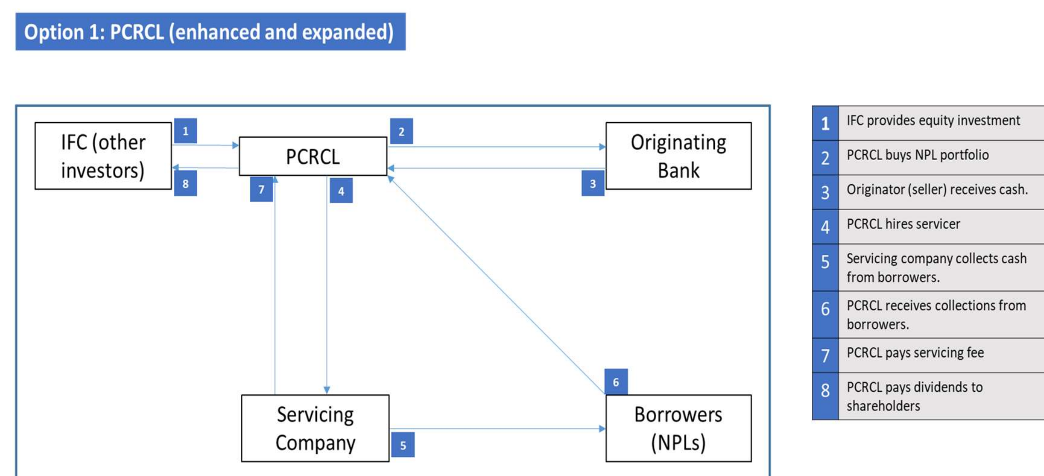


TABLE 23: OPTION 1 DESCRIPTION

Option 1	
Model Description	
PCRCL (enhanced and expanded)	1. The scope and depth of PCRCL is increased by addition of new private investors (for example, IFC) providing additional capital to fund NPL purchases. 2. With enhanced capital, PCRCL can purchase NPLs from banks against cash or issuance of debt securities or a combination of the two. The transfer of NPLs by a Bank/DFI to PCRCL, shall take effect "notwithstanding anything to the contrary contained in any law, decree, judgment, order, contract, instrument or document". As such, the transfer is affected by operation of law and not by way of any contract. 3. All legal proceedings shall automatically stand transferred from the transferor to PCRCL upon the vesting of the transfer in terms of the CRC Act. A variety of modes may be availed for recovery of NPLs, such as debt rescheduling, debtor rehabilitation/restructuring, recovery proceedings (with or without Court intervention), as detailed in chapter 8 of the report. Additionally, as detailed in Section 8.5, recovery of NPLs may also be undertaken (where PCRCL holds two-thirds in value of the principal amount payable to secured financial institutions of the distressed entity) through sanction of a scheme of revival (without Court involvement) through proposed amendments to the CRC Act, that is binding on all creditors (Scheme of Revival). 4. The acquired NPLs are kept on the balance sheet of PCRCL which can either service the portfolio itself or can outsource servicing to an appropriate third-party servicing company. Based on available

Option 1	
	information, third-party servicing companies in Pakistan (recovery or debt collection companies) only operate in consumer financing portfolios and the existence of a servicing company for corporate loans is not known. Where PCRCL both owns and services the NPL portfolio itself, this model will be comparable to a crossover servicing structure where an NPL purchaser also undertakes portfolio servicing. For PCRCL, this is the current and default servicing model and may be easier to implement or continue with. However, his structure combines asset ownership and asset servicing which goes against IFC's investment preferences. To resolve this, there are some alternatives. • Achieving internal segregation in portfolio servicing and ownership through the governance structure, board and management committees and internal portfolio specific service-level agreements. • A captive servicing company (a separate legal entity) which services PCRCL's portfolio against a servicing fee. Its shareholders can include IFC and other private investors. • A (non-exclusive) servicing platform owned by IFC and other private investors which services portfolios for a variety of NPL investors with no exclusivity. 5. In this model, private co-investors will be equity holders and be paid through dividends (profit distributions) by PCRCL. Practically speaking, if private investors become shareholders alongside commercial banks, a conflict of interest about the transfer price of NPLs may exist. The shareholder commercial banks might not be fully motivated to negotiate for the lowest purchase price given the loss on sale of NPLs accruing to their primary business. In addition, non-shareholder commercial banks might have concerns about sharing information with a bank owned PCRCL as its shareholders could be competitors. It will be useful to have strong, transparent, and effective shareholder agreements and a clear segregation between policy-making and everyday management of the company to overcome these obstacles. This may be achieved by: • Clearly articulating the mandate of NPL servicing and management based on maximizing returns and recoveries for PCRCL. • A clear statement of NPL valuation methods to be employed and other minimum information and deal criteria. • A clear matrix of authorities with proper governance committees like those for Investment and Risk Management with equitable representation of bank and non-bank private investors. • Providing certain reserved powers to non-bank private investors by virtue of shareholder agreement where they approve each asset purchase. • Providing clear guidance in the Board charter for disclosure and decision making where there is a perceived conflict of interest, for example when evaluating investment proposals for shareholder bank.
Investment Options	

<table>
<tr><th colspan="2">Option 1</th></tr>
<tr><td>Direct equity investment in PCRCL</td><td>IFC or other similar private investors can take a direct equity stake in the company, enhancing its capital base and helping to resolve its capital constraints. IFC's experience and expertise will facilitate investment from the equity investors from other NPL markets. The investment can also be made by creating an offshore holding company or SPV which invests in PCRCL. After operating for several years with greater capital, the company could access capital markets to raise more capital and further widen the investor base.</td></tr>
<tr><td colspan="2">Legal/Regulatory Considerations</td></tr>
<tr><td>Legal and Taxation Requirements/Considerations</td><td><u>Licensing/Regulatory Requirements</u>

This option does not require a new entity to be set up, licensed, and operationalized. It capitalizes on the existing specialist legal framework aimed at NPL resolution (with required changes assumed). There is a clear need for PCRCL to gain additional capital to get its operations underway.

<u>Foreign Exchange Law Requirements</u>

Equity investment

No prior SBP approval is required for private foreign co-investors (such as IFC) to make an equity investment in PCRCL provided the issue price is paid by foreign investor in foreign exchange, through normal banking channel by remittance from abroad, or out of a foreign currency account maintained by the investor in Pakistan. The investment must be registered with the SBP through an Authorized Dealer. Once registered, the foreign investment will be held on a repatriable basis (all dividends and divestment proceeds will be repatriable from Pakistan).

To divest from PCRCL, foreign co-investors will be able to transfer its shares in PCRCL to any resident or non-resident purchaser that meets the eligibility criteria under the CRC Act and the rules issued thereunder (as applicable). Following recent reforms in the foreign exchange laws, the restrictions on repatriation of divestment proceeds exceeding the break-up value or listed price, as applicable, of shares have been relaxed.

• Where a foreign investor sells its registered investment to a Pakistani resident, divestment proceeds may be repatriated without the need for prior approval of the SBP provided the necessary documentation is provided to the Authorized Dealer. For disinvestment proceeds not exceeding the market value (in case of listed securities)/ break-up value (in case of unlisted securities), the Authorized Dealers can allow the divestment proceeds to be remitted after conducting basic due diligence involving a review of share purchase agreement, broker/auditor report regarding market/break-up value of shares, buyer verification. Where divestment proceeds exceed the market or break-up value (depending on whether the securities are listed) , the Authorized Dealer can allow the proceeds to be remitted only after it is satisfied that the transaction is genuine by reviewing additional documents such as detailed justifications/ rationale/ basis of setting the transaction price per share, from the buyer, in original, attested copy of transaction due diligence, independent third party valuation report of the buyer (where proceeds exceed $50 million in a span of</td></tr>
</table>

Option 1	
	six months). • Where a foreign investor sells its registered investment to a non-resident, there will be no restrictions or requirements regarding the sale price so long as payment is made outside Pakistan. Stamp duty on the transfer of shares will be repatriated to Pakistan, and the PCRCL will be required to register the share transfer with the Authorized Dealer. <u>Other requirements</u> Depending on the quantum of investment and turnover of all parties, pre-merger clearance of the Competition Commission of Pakistan may be required. <u>Legal Reforms</u> Amendments to the CRC law should be made to remove certain lacunas and deficiencies. <u>Tax Considerations</u> Income earned by a company (person) from profit on debt is taxable under the head "Income from Business". 'Profit on debt' (received or paid) means any profit, yield, interest, discount, premium or other amount owing under a debt, other than a return of capital. It also includes any service fees relating to a debt, including any fees incurred through a credit facility which has not been utilized. Based on these definitions, it is understood that only surplus cash flows (those above the purchase price) received on an NPL portfolio whether they be periodic payments or received after a result of sale or transfer, will be taxable. However, where portfolios are acquired by PCRCL (NPL Buyer) other than in cash and the purchase price is based on valuation of securities issued, then it may become a subject of debate with tax authorities given a lack of clear framework on generally accepted ways of portfolio sale/purchase transactions in the ITO (refer to Section 7). Regardless of a company's structure (a non-bank), the company's income during the year shall be taxed as income from business at the standard corporate tax rate of 29 percent. Where collaterals are acquired in satisfaction of debt, for tax purposes, the assets acquired are likely to be classified as non-business assets (much like non-banking assets) and therefore the gain or loss on disposal of these assets may be treated as a capital gain or loss. In the income tax ordinance, there are varying rates of taxation for capital assets depending on the type of asset and their holding period. (Please note, this interpretation is based on general understanding of the tax provisions and is not tax advice). For dividends or profit repatriations back to the holding company, a standard rate of 15 percent will apply. Pakistan has tax treaties with some other countries through which lower rates on dividends may be achieved. If a foreign investor sets up a holding company in a country that has a treaty with Pakistan, it may be possible to get the dividends taxed at a lower rate than 15 percent. For example, in Switzerland where the investor company holds not less than 20 percent in an investee company in Pakistan, dividend is taxable at 10 percent. Further considerations Where movable or immovable property acquired to satisfy a debt is disposed of by the NPL acquiring entity, the gain can be (by

Option 1	
	interpretation) classified as either income from business or a capital gain. Where it is classified as capital gain, it may attract a lower rate of taxation (between 12.5 percent and 15 percent instead of the standard corporate tax rate of 29 percent). In general, NPL acquisitions below book value or with unusual fair valuations will be questionable and the use of trusts, SPVs or other specialist corporate structures will run the risk of being re-characterized. These potential problems are described in Section 9.4.

Tax Impacts on Different Transaction Stages in Option 1

Table 24 summarizes and explains the impact, application, and incidence of various taxes at different stages of transaction(s) between the participants in Figure 23. The reference numbers in Table 24 correspond to the steps shown in Figure 23.

TABLE 24: TAX IMPLICATIONS IN OPTION 1

Ref. No	Steps	Tax Impact
1	Investor provides equity investment	There is no tax impact.
2	PCRCL buys NPL portfolio	There is no tax impact.
3	Originator (seller) receives cash	The gain or loss on sale of NPL portfolio will be treated as business income or business loss of the bank (NPL Seller) and taxed at income tax rate of 35 percent.
4	PCRCL hires servicer	There is no tax impact.
5	Servicing company collects cash from borrowers.	1. Servicing company will charge service fee inclusive of (Sindh) sales tax on services at 13 percent to PCRCL. This is a provincial tax and rates will vary depending on the concerned province. 2. The management or service fee income of the servicing company will be taxed as business income at 29 percent.
6	PCRCL receives collections from borrowers	1. Business income of PCRCL (the surplus recovered) will be taxed at higher of the following: a. 29 percent of taxable income b. 1.25 percent of annual turnover (revenue) c. 17 percent of accounting income 2. In addition to regular business income, if PCRCL acquires an asset to satisfy a debt which is later sold at market value, then the gain or loss on the asset's sale will be taxed at the capital gain rate of 29 percent (standard corporate tax rates apply for assets other than immovable property). If the holding period of such asset(s) is greater than one-year then the amount of taxable capital gain will be reduced by 25 percent. For immovable property, various rates of capital gain tax of up to 15 percent apply. For this tax treatment, it is understood that all receipts from the borrower are treated as principal repayments since PCRCL would have purchased the NPLs at a discount. In this case there is no at-source withholding by the borrower (being a company).

		Alternatively, if the repayments from the borrower (being a company) are structured and split between principal payments and interest payments then the borrower will be obligated to deduct 15 percent of the interest portion of the payment at the time of payment. This will be an at-source withholding of the income tax on business income of PCRCL adjustable against the total income tax liability of PCRCL.
7	PCRCL pays servicing fee	While making payments to the servicing company, PCRCL would withhold income tax at 8 percent of gross amount of payment and 20 percent of the amount of sales tax charged by the servicing company. These are not new or additional taxes but are an at-source deduction of a portion of existing income taxes.
8	PCRCL pays dividends to shareholders	Dividends paid to investors will be taxable at 15 percent (by withholding) or a lower rate if there is an applicable tax treaty.

TABLE 25: OPTION 1A DESCRIPTION

Option 1A (Variation of Option 1)	
Model Description	
A new company under the CRC law	This option is a variation and a direct solution to address a conflict of interest which may arise in a bank-private investor co-owned entity. In this option a new corporate restructuring company exclusively owned by private investors may be set up under the CRC law (CRC). It will resolve the conflict of interest, and enable efficient management, in comparison with PCRCL which has ten banks and DFIs (as its shareholders and management). The downside of this option is the time and cost of setting up and operationalizing a company. In this model, the CRC will also purchase NPLs from banks against cash or issuance of debt securities. The acquired NPLs are kept on a CRC's balance sheet which can either service the portfolio itself or can outsource servicing to a third-party servicing company. Third-party servicing companies in Pakistan (recovery or debt collection companies) only operate in consumer financing portfolios, not corporate loan portfolios. Where the new CRC both owns and services the NPL portfolio itself, this model will be comparable to a crossover servicing structure (discussed above) where an NPL purchaser also undertakes portfolio servicing. For PCRCL, this is the current and default servicing model and may be easier to implement or continue with. However, his structure combines asset ownership and asset servicing which goes against IFC's investment preferences. To resolve this, there are some alternatives. • Achieving internal segregation in portfolio servicing and ownership through the governance structure, board and management committees and internal portfolio specific service-level agreements. • A captive servicing company (a separate legal entity) which services the CRC's portfolio against a servicing fee. Its shareholders can include IFC and other private investors. • A (non-exclusive) servicing platform owned by IFC and other private investors which services portfolios for a variety of NPL

Option 1A (Variation of Option 1)	
	investors with no exclusivity.
Investment Options	
Establishment of CRC by IFC	Private investors can aim to establish a CRC and take on direct equity stake in the company and provide it with capital and liquidity to invest in NPLs. IFC's expertise and experience will facilitate investment from equity investors from other NPL markets. The investment can also be made by creating an offshore holding company or SPV which invests in the CRC. After operating for several years with greater capital, the company could access capital markets to raise more capital and further widen the investor base. *Variation:* A literature review shows that when the government is added as an investor in these structures, it increases the credit worthiness of the entity and provides a positive signal, helping to increase the appetite of private investors. One of the models could add the government as a co-investor along with IFC. It is important to understand that direct equity investment through budgetary allocation may not be a preferred option for the government, so options involving a guarantee capital or contingent capital (subject to Constitutional borrowing/guarantee limits) may be considered.
Legal/Regulatory Considerations	
Legal and Taxation Requirements/Considerations	Licensing/Regulatory Requirements A corporate restructuring company will have to be set up as a public limited company and licensed by the SECP. Minimum paid up capital prescribed for the incorporation of a CRC is PKR 500 million. For licensing of the CRC, subscribers and board members are required to meet certain criteria including special knowledge and experience of matters regarding the restructuring of companies in distress, financial engineering techniques, and the skills and capacity to deal with out of court work outs. The remaining legal and taxation considerations for this variation are the same as Option 1.

FIGURE 24: OPTION 2 DIAGRAM

Option 2: PCRCL (asset management company)

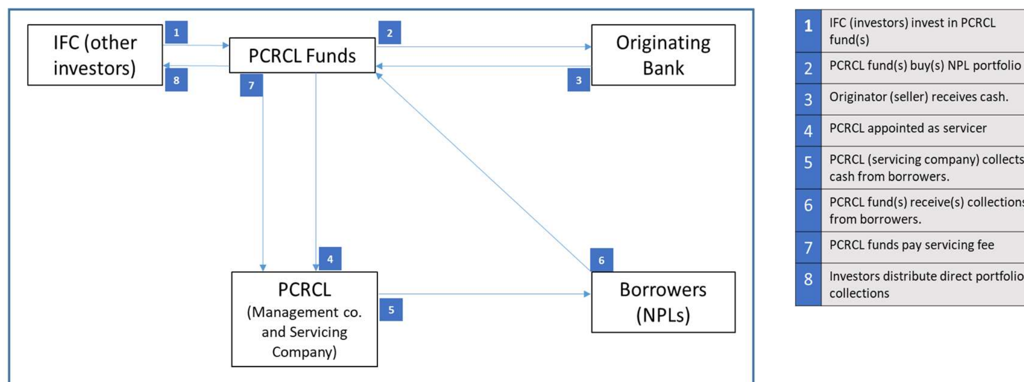


TABLE 26: OPTION 2 DESCRIPTION

Option 2	
Model Description	
PCRCL (Funds/ Trusts) as asset management company	In this option, PCRCL operates as an asset management company where various fund(s) (as separate legal entities) are created with non-consolidating investment from PCRCL. Private investors such as IFC can directly invest in NPL portfolios by investing in the securities issued by the fund(s) while PCRCL acts as a servicer for NPL portfolios in these fund(s). 1. PCRCL creates fund(s) in the form of trusts. 2. The trusts operate as unit trusts (like open ended funds). IFC or other investors can invest in these trusts by buying the units or securities issued by the trust which will represent the carrying value of its NPLs. Where there is any surplus above the original carrying value of the net assets it will result in an increased net asset value (NAV) of the units. The NAV structure will allow investors to collect variable cash flows (initial investment and surplus) through regular redemptions (a model can be agreed in the offering documents of the trust such as systematic redemption option of units). Annex V contains more details about the periodic cashflow collection. It is important to note that amendments to the CRC law to enable CRCs to create trusts only propose that CRCs can create trusts, the enabling rules or modalities in which these trusts will operate or raise finances are to be determined. 3. All legal proceedings shall automatically stand transferred from the transferor to PCRCL upon vesting of transfer. 4. The acquired NPLs are kept on the balance sheet of fund(s) or trust(s). 5. PCRCL offers servicing on fee basis or uses third party servicers. 6. Security holders of fund(s) or trust(s) are paid out of cash flows arising from portfolio recoveries.

Option 2	
	7. A variety of modes may be availed for recovery of NPLs, such as debt rescheduling, debtor restructuring, recovery proceedings (with or without Court intervention) as well as Schemes of Revival, as described in Section 8.
Investment Options	
Investing in securities issued by funds/ trust	Private investors can directly (or through an offshore alternative investment fund) invest in the securities or units issued by the fund(s) or trust(s) created by PCRCL. For a better credit rating, the underlying assets for these securities can include non-performing, under-performing, and performing assets, or they could be backed by government guarantee on a case-by-case basis. As per the legislative amendments, the trust(s) or fund(s) can be matured over the long term into a collective investment vehicle where their securities or units are subscribed by a wider set of investors such as insurance companies, mutual funds or even retail investors.
Legal/Regulatory Considerations	
Legal and Taxation Requirements/Considerations	Legal Reforms (CRC Law) Amendments to the CRC law should be made to remove certain lacunas and deficiencies. One of the proposed amendments is to permit CRC to acquire NPLs from banks or DFIs through one or more trusts constituted and managed by it. This will enable the CRC to act as an asset management company and acquire NPLs through the trusts it would manage. This would allow for separate funds for different types of portfolios segregated by asset class or resolution strategy, or for separate funds for portfolios funded by the same investors. To facilitate and regulate this asset management structure, SECP will need to develop a framework under the CRC Act. The current framework of SECP for asset management companies that fall within the umbrella of non-banking finance companies cannot apply to CRCs. This means that even if a trust or fund structure is created under PCRCL in the CRC law, it will not have the features of a more holistic fund structure as has been prescribed by the SECP for collective investment schemes. Trust laws Despite this legal limitation, by virtue of some recent amendments in the trust laws in Sindh and KPK, a simplified process has been introduced to register certain ‘specialized trusts’ that are subject to regulatory oversight of the SECP. The process for ‘specialized trusts’ is simplified and is one-off unlike for registering other types of trusts. While they arguably already fall within the ambit of ‘specialized trusts’, to exercise abundant caution, unit trusts to be set up by PCRCL or any other CRC, should also be notifiable as ‘specialized trusts’ under relevant trust laws to expedite registration. Foreign exchange laws The SBP can permit non-residents to invest in units of any funds quoted on the stock exchange, units of mutual funds registered as open-end schemes under the management of asset management

Option 2	
	companies, and units of private funds managed by Private Fund Management Companies, licensed by the SECP. The units may be transferred to any non-resident or resident and divestment proceeds may be remitted outside of Pakistan under the same conditions as detailed in the context of units of Alternative Funds under Option 4. There is currently no general permission of the SBP that would be available for non-residents to invest in units of trusts set up by CRCs for NPLs. Any non-resident investors need special permission from the SBP. Alternatively, a general permission may be introduced in the foreign exchange laws to allow non-residents to invest in units of any trusts established by a CRC (like that available for units of mutual and private funds). This could enable divestment of units in the same way as for Private Funds or listed funds. Tax Considerations Income earned by a company from profit on debt is taxable under the head "Income from Business". 'Profit on debt' (received or paid) means any profit, yield, interest, discount, premium or other amount owing under a debt, other than a return of capital. It also includes any service fees relating to a debt, including any fees incurred through a credit facility which has not been utilized. Based on these definitions, it is understood that only surplus cash flows (those over the purchase price) received on an NPL portfolio whether they be periodic payments or received after a result of sale or transfer, will be taxable. However, where portfolios are acquired by PCRCL (NPL Buyer) other than in cash and the purchase price is based on valuation of securities issued, then it may become a subject of debate with tax authorities given a lack of clear framework on generally accepted ways of portfolio sale/purchase transactions in the ITO (refer to Section 7). Regardless of a company's structure (a non-bank), the company's income during the year shall be taxed as income from business at the standard corporate tax rate of 29 percent. Where collaterals are acquired in satisfaction of debt, for tax purposes, the assets acquired are likely to be classified as non-business assets (much like non-banking assets) and therefore the gain or loss on disposal of these assets may be treated as a capital gain or loss. In the income tax ordinance, there are varying rates of taxation for capital assets depending on the type of asset and their holding period. (Please note, this interpretation is based on general understanding of the tax provisions and is not tax advice). Where the PCRCL Trust declares a dividend for its unitholders, a standard rate of 15 percent will apply. Pakistan has tax treaties with some other countries through which lower rates on dividends may be achieved. If an investor sets up a holding company in a country that has a treaty with Pakistan, it may be possible to get the dividends taxed at a lower rate than 15 percent. For example, in Switzerland where the investor company holds not less than 20 percent in an investee company in Pakistan, dividend is taxable at 10 percent. Further considerations Exemptions in the ITO mean the income of a collective investment

Option 2	
	scheme (for instance, a mutual fund) as defined in the NBFC Rules 2003, does not pay tax where 90 percent of its profit is distributed to its unit holders. If the NPL purchasing entity (such as a trust, SPV, or alternate investment fund) can be classified through special provisions or relaxations, or is structured as a collective investment scheme, then it may also possibly benefit from this tax exemption. Where movable or immovable property acquired to satisfy a debt is disposed of by the NPL acquiring entity, the gain can be (by interpretation) classified as either income from business or a capital gain. Where it is classified as capital gain, it may attract a lower rate of taxation (between 12.5 percent and 15 percent instead of the standard corporate tax rate of 29 percent). In general, NPL acquisitions below book value or with unusual fair valuations will be questionable and the use of trusts, SPVs or other specialist corporate structures will run the risk of being re-characterized. These potential problems are described in Section 9.4.

Tax Impacts on Different Transaction Stages in Option 2

Table 27 summarizes and explains the impact, application, and incidence of various taxes at different stages of transaction(s) between the participants shown in Figure 24. The reference numbers in Table 27 correspond to the steps in Figure 24.

TABLE 27: TAX IMPLICATIONS IN OPTION 2

Ref. No	Steps	Tax Impact
1	IFC (investors) invest in PCRCL fund(s)	There is no tax impact.
2	PCRCL fund(s) buy(s) NPL portfolio	There is no tax impact.
3	Originator (seller) receives cash.	The gain or loss on sale of NPL portfolio will be treated as business income or loss of the bank (NPL Seller) and taxed at income tax rate of 35 percent.
4	PCRCL appointed as servicer	There is no tax impact.
5	PCRCL (servicing company) collects cash from borrowers.	1. PCRCL will charge a service fee inclusive of (Sindh) sales tax on services at 13 percent to PCRCL Fund(s). This is a provincial tax and rates will vary depending on the province. 2. The management or service fee income of PCRCL will be taxed as business income at 29 percent.
6	PCRCL fund(s) receive(s) collections from borrowers.	1. Business income of PCRCL Funds (the surplus recovered) will be taxed at higher of the following: a. 29 percent of taxable income b. 1.25 percent of annual turnover (revenue) c. 17 percent of accounting income In addition to regular business income, if PCRCL acquires an asset to satisfy a debt which is later sold at market value, then the gain or loss on the asset's sale will be taxed at the capital gain rate of 29 percent (standard corporate tax rates apply for assets other than immovable property). If the holding period of these asset(s) is greater than one

		year, then the amount of taxable capital gain will be reduced by 25 percent. For immovable property, various rates of capital gain tax of up to 15 percent apply. For this tax treatment, it is understood that all receipts from the borrower are treated as principal repayments since the PCRCL Fund(s) would have purchased the NPLs at a discount. In this case there is no at-source withholding by the borrower (being a company). Alternatively, if the repayments from the borrower are structured and split between principal payments and interest payments then the borrower will be obligated to deduct 15 percent of the interest portion of the payment at the time of payment. This will be an at-source withholding of the income tax on business income of PCRCL Fund(s) adjustable against the total income tax liability of PCRCL Fund(s).
7	PCRCL Fund(s) pay servicing fee	While making payments to the management or servicing company (PCRCL) PCRCL Fund(s) would withhold income tax at 8 percent of gross amount of payment and 20 percent of the amount of sales tax charged by the management or servicing company. These are not new or additional taxes but are an at-source deduction of a portion of existing income taxes.
8	Investors distribute direct portfolio collections	Investors can derive two types of incomes from PCRCL Funds. 1) Dividends taxable at 15 percent (by withholding) or a lower rate if there is an applicable tax treaty. 2) Capital gain or loss on disposal or redemption of PCRCL Fund(s) units at standard corporate income tax rate of 29 percent (for listed securities or units this tax rate is 15 percent taxed as separate block of income). This treatment assumes that the capital gain from redeeming units is taxable in Pakistan. If the investment company is registered in a country with a double tax treaty with Pakistan, then it can apply for an exemption on this tax in Pakistan and must obtain an exemption certificate otherwise a 20 percent withholding tax on the gross amount remitted by PCRCL fund(s) will apply. This withheld amount will, be adjustable as a tax credit in the investor's home country.

FIGURE 25: OPTION 3 DIAGRAM

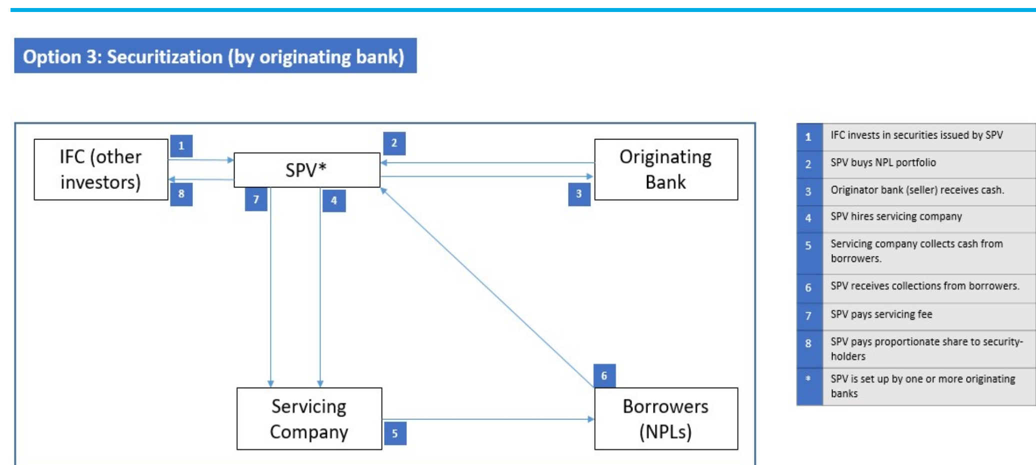


TABLE 28: OPTION 3 DESCRIPTION

Option 3	
Model Description	
Securitization through SPV by originating banks/ a combination of originating banks.	This is a decentralized model where private investors can invest in NPL portfolios by subscribing to the debt securities of a SPV set up by one or more originating banks. There are several options for securitization structures involving NPLs. (i) An SPV incorporated as a public unlisted company will issue asset-backed securities (ABS) in the form of redeemable capital (such as term finance certificates). (ii) The SPV will acquire the NPLs from the originator (a bank or DFI) using the funds generated from issuing ABS. Without a contractual restriction in the NPL documentation, borrowers may not consent to such an acquisition. (iii) The SPV may, for a fee, engage PCRCL as a servicer or any other third-party servicer. (iv) Where the originator is a bank or DFI there will need to be a 'true sale' of the NPLs, typically, an absolute assignment of receivables. (v) Banks or DFIs may securitize their assets relating to lease financing (with the acknowledged assignment of lease rental proceeds), mortgage financing and to toll financing (for infrastructure developmental projects). Other assets, may be securitized by banks and DFIs with the approval of the SBP, on a case-by-case basis. ***Variations*** (i) Securities could be backed by the government under a scheme, such as in GACS. This is to ensure asset-based securities have favorable capital treatment on originating banks or investor balance sheets. The bid-ask differences are at their minimum and can increase investor confidence. (ii) Alternatively, the securities may also be tranched as senior, mezzanine and junior to suit the risk appetite and investment objectives of a wider set of investors. To propose a tranche-based structure, more information regarding the portfolios, certainty of the cash flows, and other legal and enforcement related challenges will be required. As Pakistan is a nascent NPL market, more time will be required before complex transaction structures can be introduced. While this private securitization model or decentralized bank-led securitization model is theoretically possible in Pakistan, Option 3 may not be the best one to choose now. • Without sophisticated structuring, a bank-led securitization might not qualify for the non-consolidation and true sale criteria under the applicable accounting framework in Pakistan. Under IFRS 9, an entity (such as a bank or DFI) can de-recognize an asset when it has transferred all the risks and rewards associated with it. The transfer of risks and rewards is evaluated by comparing the entity's exposure before and after the transfer, with the variability in the

Option 3	
	amounts and timing of the net cash flows of the transferred asset. An entity has retained substantially all the risks and rewards of ownership of a financial asset if its exposure to the variability in the present value of the future net cash flows from the financial asset does not change significantly after the transfer. An entity has transferred substantially all the risks and rewards of ownership of a financial asset if its exposure to such variability is no longer significant in relation to the total variability in the present value of the future net cash flows associated with the financial asset. • The general regulatory and reputational risks which affect the banking sector may still affect this SPV, its investors and its servicers. The structure may not be considered an 'outside the banking sector' structure. • It may be difficult to achieve economies in this model as it will largely be bank-specific compared with an AMC with multiple funds and the ability to pool assets from more than one bank. • If created outside the CRC law, this SPV will not have the special powers and privileges available to CRCs. • The depth and participation in the private debt securities market in Pakistan is limited.
Investment Options	
Investing in asset backed securities	IFC and other private investors can invest in ABS issued by the SPV.
Legal/Regulatory Considerations	
Legal and Taxation Requirements/Considerations	Foreign Exchange Law Requirements Pakistan's Foreign Exchange Manual enables private investors to invest in ABS (such as term certificates) on a repatriable basis, and to transfer the ABS if procedural requirements are met. Legal Reforms To facilitate Option 3, recommendations relating to true sale requirements, limitations on establishing a wholly owned SPV, minimum capital requirements, ABS credit rating requirements, and stamp laws are described in Sections 8.3 and 8.5. Tax Considerations The remaining taxation considerations for this option are the same as Option 1.

FIGURE 26: OPTION 4 DIAGRAM

Option 4: Alternative Investment Fund (AIF)

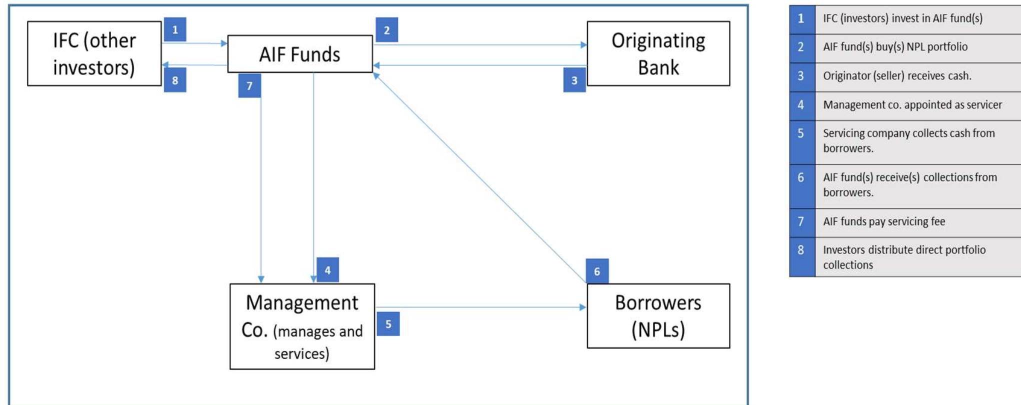


TABLE 29: OPTION 4 DESCRIPTION

Option 4	
Model Description	
Alternative funds set up by Private Fund Management Companies (FMC)	Alternative funds in Pakistan can be structured as conventional trust funds, where an author of a trust creates the trust in the name of beneficiaries, while appointing a trustee and a trust manager. In the alternative funds model, a non-banking finance company acts as the trust manager to oversee a fund of investments that may comprise NPLs (alternative fund). Only sophisticated investors (having net assets of PKR 15 million (excluding the value of their personal residence) are permitted to invest in Alternative Funds. Unlike Options 1 and 2: (i) Alternative funds can acquire NPLs contractually rather than by operation of law; and (ii) FMCs will not be able to enforce any Scheme of Revival under the CRC Act and so will need to rely on other avenues, such as out of Court settlement, recovery, and schemes under the Companies Act and Corporate Rehabilitation Act. All of these may be more time consuming and cumbersome or have their own limitations as described in 10.3. However, an Alternative Fund model will allow greater risk diversification, as up to 30 percent of its net assets may be invested in assets other than NPLs.
Investment Options	
Direct equity investment in Fund Management Company	IFC or other similar private investors can aim to set up an FMC to establish alternative funds. IFC's experience and expertise will facilitate investment from equity investors from other NPL markets. The investment can also be made by creating an offshore holding company or SPV which invests in an FMC.

Option 4	
	After operating for several years with greater capital, the company could access capital markets to raise more capital and further widen the investor base.
Investing in units issued by the alternative fund	IFC and other private investors can directly (or through an offshore alternative investment fund) invest in the securities or units issued by an alternative fund. For gain a better credit rating, the underlying assets for these securities can include non-performing, under-performing, and performing assets, or they can be backed by government guarantee (on a case-by-case basis or under an overarching scheme of guarantee and subject to constitutional borrowing/guarantee limits). The trust can be matured into a collective investment vehicle where its securities are subscribed by insurance companies, mutual funds or retail investors. This second investment option, is not possible in Pakistan today, as there are no alternative funds for investments in NPLs.
Legal/Regulatory Considerations	
Legal and Taxation Requirements/Considerations	Licensing/Regulatory Requirements A non-banking finance company will have to be set up which will then obtain a license from the SECP to act as an FMC. All promotors, directors, the chief executive officer, and the chairperson must meet the criteria prescribed by the SECP, and the FMC must have minimum capital of PKR 10 million. Alternative funds established by the FMC must be approved by and registered with the SECP. Foreign Exchange Law Requirements Equity investment in FMC No prior SBP approval is required for private investors to make an equity investment into a FMC provided the issue price is paid in foreign exchange, through normal banking channel by remittance from abroad, or out of a foreign currency account maintained by the investor in Pakistan. The investment must be registered with the SBP through an Authorized Dealer. Once registered, the investment will be held on a repatriable basis (all dividends and divestment proceeds will be repatriable from Pakistan). To divest from FMC, investors will be able to transfer their shares to any purchaser that meets the criteria of the. Following recent reforms in the foreign exchange laws, the restrictions on repatriation of divestment proceeds exceeding the break-up value or listed price, as applicable, of shares have been relaxed. (a) Where an investor sells its registered investment to a Pakistani resident, divestment proceeds may be repatriated without the need for prior approval of the SBP provided the necessary documentation is provided to the Authorized Dealer. For disinvestment proceeds not exceeding the market value (in case of listed securities)/ break-up value (in case of unlisted securities), the Authorized Dealers can allow the divestment proceeds to be remitted after conducting basic due diligence involving a review of the share purchase

Option 4	
	agreement, a broker or auditor report on the market or break-up value of shares, buyer verification. Where, divestment proceeds exceed the market or break-up value (depending on whether the securities are listed), the Authorized Dealer can allow the proceeds to be remitted only after it is satisfied that the transaction is genuine by reviewing additional documents such as detailed justifications/ rationale/ basis of setting the transaction price per share, from the buyer, in original, attested copy of transaction due diligence, independent third party valuation report of the buyer (where proceeds exceed $50 million in a span of six months). (b) Where an investor sells its registered investment to a non-resident, there will be no restrictions or requirements regarding the sale price so long as payment is made outside Pakistan. Stamp duty on the transfer of shares will be repatriated to Pakistan, and the FMC will be required to register the share transfer with the Authorized Dealer. Units of Alternative Funds No prior SBP approval is required for private investors to make an equity investment in units of alternative funds provided the issue price is paid in foreign exchange, through normal banking channel by remittance from abroad, or out of a foreign currency account maintained by the investor in Pakistan. The investment must be registered with the SBP through an Authorized Dealer. Once registered, the investment will be held on a repatriable basis (all dividends and divestment proceeds will be repatriable from Pakistan).To divest from the Alternative Fund, investors will be able to transfer their units to any resident or non-resident purchaser. Following recent reforms in the foreign exchange laws, the restrictions on repatriation of divestment proceeds exceeding the net asset value of units have been relaxed. (c) Where an investor sells its registered investment to a Pakistani resident, divestment proceeds may be repatriated without the need for prior approval of the SBP provided the necessary documentation is provided to the Authorized Dealer. For disinvestment proceeds not exceeding the market value (in case of listed securities)/ break-up value (in case of unlisted securities), the Authorized Dealers can allow the divestment proceeds to be remitted after conducting basic due diligence involving a review of the share purchase agreement, a broker or auditor report on the market or break-up value of shares, buyer verification. Where, divestment proceeds exceed the market or break-up value (depending on whether the securities are listed), the Authorized Dealer can allow the proceeds to be remitted only after it is satisfied that the transaction is genuine by reviewing additional documents such as detailed justifications/ rationale/ basis of setting the transaction price per share, from the buyer, in original, attested copy of transaction due diligence, independent third party valuation report of the buyer (where proceeds exceed $50 million in a span of six months). (d) Where an investor sells its registered investment to a non-resident, there will be no restrictions or requirements regarding the sale price so long as payment is made outside Pakistan. Stamp duty on the transfer of shares will be

Option 4	
	repatriated to Pakistan, and the FMC will be required to register the share transfer with the Authorized Dealer. (e) For disinvestment proceeds from matured units of the alternative fund, the Authorized Dealer will review the winding-up report verified by external auditor and trustee of fund, unitholders investment statement and distributions statement (including principal repayment) before allowing a remittance. Other requirements Depending on the quantum of investment and turnover of all parties, pre-merger clearance of the Competition Commission of Pakistan may also be required. Tax Considerations The remaining legal and taxation considerations for this option are the same as Option 1.

9.5. Options for preferred NPL investment model

Of the four potential NPL transaction structures and their variations, Option 2 – PCRCL as an asset management company – is the preferred for IFC.I It generally meets IFC's investment preferences, particularly by avoiding the risk of asset co-mingling, separating ownership and servicing structures, allowing for direct investment in portfolios, building on an existing PCRCL company structure, and benefiting from the specialized CRC law. However, in practical terms, it requires changes in the legal framework to allow PCRCL to set up fund(s) and trust(s).

The next best alternative is Option 1 – direct equity investment in PCRCL. This option may not meet all conditions of the preferred investment model for a foreign investor but would retain the key benefit of operating under the CRC law, with an operationalized company structure and would require no legal amendments.

Options 3 and 4 are the least preferred. Pakistan's underdeveloped securitization and secondary markets makes Option 3 – a decentralized bank-led securitization difficult to implement, and the large scale of the legal amendments required for Option 4 – an alternate investment fund – make it unfeasible.

10. ANNEXES

10.1. Annex A - List of laws, regulations and circulars reviewed

- Sindh Trust Act, 2020
- Financial Institutions (Secured Transactions) Act, 2016
- Companies Act, 2017
- Sale of Goods Act, 1930
- Contract Act, 1872
- Financial Institutions (Recovery of Finances) Ordinance, 2001
- UNCITRAL Model Law on Secured Transactions
- Financial Institutions (Secured Transactions) (Amendment) Ordinance, 2020
- Collateral Management Companies Regulations, 2019
- Price Control and Prevention of Profiteering and Hoarding Act, 1977
- Transfer Property Act, 1882
- Punjab Tenancy Act, 1887
- Government Tenants Act, 1893
- Land Acquisition Act, 1894
- Colonization of Government Lands Act, 1912
- Sindh Tenancy Act, 1950
- Khyber Pakhtunkhwa Tenancy Act, 1950
- Provincial Land Revenue Act, 1967
- Balochistan Tenancy Ordinance, 1978
- Land Record Manual
- Land Administration Manual and Settlement Manual
- Land Registration Act, 1925 (UK)
- Indian Transfer of Property Act, 1882
- Sindh Trusts (Amendment) Act, 2021
- Credit Bureaus Act, 2015
- Credit Bureau Rules, 2016
- Credit Bureau Regulations, 2016
- Prudential Regulations for Corporate/ Commercial Banking
- Defamation Ordinance, 2002
- Pakistan Penal Code, 1860
- The Prevention of Electronic Crimes Act, 2016
- State Bank of Pakistan's Framework for Risk Management in Outsourcing Arrangements
- Pakistan Banks Association's Guidelines for Collection, Recovery and Repossession Agencies
- Civil Procedure Code, 1908
- Limitation Act, 1908
- National Accountability Bureau Ordinance, 1999
- FIA Act, 1974
- Offence in Respect of Banks (Special Courts) Ordinance, 1984
- Constitution of Pakistan, 1973
- Financial Institution (Recovery of Finances) (Amendment) Act, 2016
- The Financial Institutions (Recovery of Finances) Rules, 2018
- Provincial Insolvency Act, 1920
- Insolvency (Karachi Division) Act 1909
- Companies Act, 2006 (England)
- Insolvency Act, 1986 (England)
- Corporate Rehabilitation Act, 2018
- Stamp Act, 1899
- The Companies (Asset Backed Securitization) Rules, 1999
- Structuring of Debt Securities Regulations, 2020
- Registration Act, 1908
- Corporate Restructuring Act, 2016

- Corporate Industrial Restructuring Corporation Ordinance, 2000
- Financial Assets and Enforcement of Securities Interest Act, 2002
- Pakistan Stock Exchange Rule Book
- Trust Act, 1882
- Banking Companies Ordinance, 1962
- Non-Banking Finance Companies (Establishment and Regulation) Rules 2003
- Non-Banking Finance Companies and Notified Entities Regulations, 2008
- Fair Debt Collection Guidelines, 2008 issued through BPRD Circular No.13 of 2008
- BCD Circular No. 13 of 1984 dated 20.6.1984
- BCD Circular No. 32 of 1984 dated 26.11.1984
- BCD Circular No. 27 dated 12.11.1984
- BCD Circular No. 37 dated 10.12.1984
- BCD Circular No. 23 dated 25.5.1985
- BCD Circular No. 4 dated 30.6.1988
- Circular Letter No. BID (Gen) 2470/601-Q4-90 of 1990 dated 17.6.1990
- BPRD Circular No. 06 of 2007 dated 5.6.2007
- BPD Circular No. 24 dated 04.07.2003
- BPD Circular No. 37 dated 03.11.2003
- BPD Circular No. 29 of 2002 dated 15.10.2002
- BPRD Circular No. 08 of 2013
- BPRD Circular No. 12 of 2014
- BPRD Circular Letter No. 34 of 2014
- BPRD Circular Letter No. 28 of 2011 dated 30.12. 2011
- BPRD Circular No. 31 of 2002 dated 14.11.2002
- BPRD Circular No. 3 of 2021 dated 25.2. 2021
- BPD Circular No. 8 of 2003 dated 12.3,2003
- BPRD Circular Letter No. 40 of 2020 dated 27.8.2020
- BPD Circular No. 1 of 2005 dated 28.1.2005
- BPD Circular No. 13 of 2005 dated 4.4.2005
- Notification no. S.R.O. 362(I)/2008 dated April 4, 2008
- SECP letter No. CLD/CCD/602/24/2016-1614 dated December 2, 2019
- BPRD Circular Letter No. 01 of 2010
- BID Circular No. 3, dated 20.2.1989
- BPRD Circular Letter No. 27 of 22.6.1999
- SD Circular No. SD 2/99 of 16.7.1999
- BPRD Circular Letter No. 02 of 29.1.2000
- BPRD Circular Letter No. 4 of 17.2.2000
- BPRD Circular No. 9 of 27.4.2000
- BPRD Circular Letter No. 16 of 5.6.2000
- BPRD Circular Letter 34 of 13.12.2000,
- BPRD Circular No. 06 of 5.6.2007
- BSD Circular No. 16 of 2004
- S.R.O No. 1(KE)/2018 dated July 6, 2018 issued by the Ministry of Finance
- S.R.0. 840(i)/2017 dated 17.8.2017 issued by the Finance Division Government of Pakistan
- BPRD Circular No. 6 of 2019 dated 22.4.2019
- Guide to the Companies Act (17th Edition 2010)

10.2. Annex B - List of Banks in Pakistan

The table below provides a list of banks operating in Pakistan.

TABLE 30: LIST OF BANKS IN PAKISTAN

Sr. No.	Category of Bank	Name of Bank	Nature of Bank
1	Public Sector Commercial Banks (majority of ownership with the government)	First Women Bank Ltd.	Conventional Bank
2		National Bank of Pakistan	Conventional Bank with Islamic Banking Branches
3		Sindh Bank Ltd.	Conventional Bank with Islamic Banking Branches
4		The Bank of Khyber	Conventional Bank with Islamic Banking Branches
5		The Bank of Punjab	Conventional Bank with Islamic Banking Branches
6	Private Sector Commercial Banks	AlBaraka Bank (Pakistan) Ltd.	Islamic Bank
7		Allied Bank Ltd.	Conventional Bank with Islamic Banking Branches
8		Askari Bank Ltd.	Conventional Bank with Islamic Banking Branches
9		Bank AL Habib Ltd.	Conventional Bank with Islamic Banking Branches
10		Bank Alfalah Ltd.	Conventional Bank with Islamic Banking Branches
11		BankIslami Pakistan Ltd.	Islamic Bank
12		Dubai Islamic Bank Pakistan Ltd.	Islamic Bank
13		Faysal Bank Ltd.	Conventional Bank with Islamic Banking Branches
14		Habib Bank Ltd.	Conventional Bank with Islamic Banking Branches
15		Habib Metropolitan Bank Ltd.	Conventional Bank with Islamic Banking Branches
16		JS Bank Ltd.	Conventional Bank
17		MCB Bank Ltd.	Conventional Bank

Sr. No.	Category of Bank	Name of Bank	Nature of Bank
18		MCB Islamic Bank Ltd.	Islamic Bank
19		Meezan Bank Ltd.	Islamic Bank
20		SAMBA Bank Ltd.	Conventional Bank
21		Silk Bank Ltd	Conventional Bank with Islamic Banking Branches
22		Soneri Bank Ltd.	Conventional Bank with Islamic Banking Branches
23		Standard Chartered Bank (Pakistan) Ltd.	Conventional Bank with Islamic Banking Branches
24		Summit Bank Ltd	Conventional Bank with Islamic Banking Branches
25		United Bank Ltd.	Conventional Bank with Islamic Banking Branches
26	Foreign Banks	Citibank N.A.	Conventional Bank
27		Deutsche Bank AG	Conventional Bank
28		Industrial and Commercial Bank of China Ltd.	Conventional Bank
29		Bank of China Limited	Conventional Bank
30	Specialized Banks	Punjab Provincial Co-operative Bank Ltd.	Conventional Bank
31		SME Bank Ltd.	Conventional Bank
32		Zarai Taraqiati Bank Ltd.	Conventional Bank with Islamic Banking Branches

10.3. Annex C - Conditions for Rescheduling/Restructuring in PRs

Rescheduling/Restructuring of Non-Performing Housing Finance

a) Banks/DFIs shall have policy for rescheduling/restructuring of non-performing housing finance, which should be approved by the Board of Directors or by the Country Head/Executive/Management Committee in case of branches of foreign banks.

b) Rescheduling/restructuring should not be done just to avoid classification of financing and provisioning requirements. In this connection, banks/DFIs shall ensure that house financing facilities of any borrower should not be rescheduled/restructured more than once within two years.

c) For the purpose of rescheduling/restructuring, banks/DFIs may change the tenure of the financing by maximum two years beyond the original tenure agreed with the customer subject to maximum financing tenure of 25 years.

d) While considering rescheduling/restructuring, banks/DFIs should, inter alia, take into account the repayment capacity of the borrower. The condition of 50% of Debt Burden Requirement (DBR) shall not be applicable to financing rescheduled/restructured. However, any new house financing facility extended to a borrower who is availing any rescheduled/restructured facility shall be subject to observance of minimum DBR.

e) The status of classification of the non-performing assets shall not be changed because of rescheduling/restructuring unless borrower has paid at least 10% of the rescheduled/restructured amount (including principal and mark-up both) or six instalments as per terms & conditions of the rescheduling/restructuring whichever is high. However, for internal monitoring purpose, banks/DFIs may re-set the dpd (days past due) counter of the newly created finance to "0" dpd.

f) Provisions already held against non-performing financing, to be rescheduled/restructured, will only be reversed if condition of 10% recovery or six instalments is met.

g) If the borrower defaults (i.e. reaches 180 dpd) again within two years after declassification, the financing shall be classified under the same category in which it was prior to rescheduling/restructuring. Banks/DFIs, however, at their discretion may further downgrade the classification based on their own internal policies.

Rescheduling/Restructuring of Performing / Non-performing Consumer Financing Facilities

1. Banks/DFIs should frame policy for rescheduling/ restructuring of consumer financing facilities including non-performing financing facilities. The Policy should inter-alia include definition and types of rescheduling/restructuring, criteria to assess the financial distress or income impairment warranting the rescheduling / restructuring, the reduced mark-up/profit rates applicable on restructured accounts and specify the limits on the amount of rescheduled / restructured performing financing facilities as percentage of total outstanding consumer financing. The policy should be approved by the Board of Directors or by the Country Head/Executive/Management Committee in case of branches of foreign banks.

2. For the purpose of rescheduling/ restructuring, banks/DFIs may:

   a) Club or consolidate outstanding amounts on account of personal loans/financing and credit cards and create one financing facility. The new facility so created shall be placed in the lowest category of classification amongst the classifications of the financing facilities clubbed.

   b) Convert revolving facility into an instalment-based financing facility with maximum repayment tenor of 5 years.

   c) Change the tenure of the financing by maximum two years beyond any regulatory cap on maximum tenure.

3. Rescheduling/ restructuring, or transfer of any financing facility from one category of consumer finance to another, should not be done just to avoid classification of financing facilities and provisioning requirements. In this regard, banks /DFIs shall ensure:

   a) Consumer financing facilities of any borrower should not be rescheduled/ restructured more than once within 12 months and three times during five-year period,

   b) The loan account has existed for at least 9 months before rescheduling/restructuring as a performing

loan account,

c) Islamic banking institutions shall ensure shariah compliance in rescheduling/restructuring of consumer finance facilities

4. While considering rescheduling/restructuring, banks/DFIs should, inter alia, take into account the repayment capacity of the borrower. The condition of 50% of Debt Burden Requirement (DBR) mentioned at Regulation R-3 of Prudential Regulations for Consumer Financing will not be applicable to loan rescheduled/ restructured. However, new consumer financing facility extended to a borrower who is availing any rescheduled/ restructured facility shall be subject to observance of minimum DBR prescribed in the Regulation R-3 of Prudential Regulations for Consumer Financing.

5. The status of classification of the non-performing financing facility shall not be changed because of rescheduling/restructuring unless borrower has paid at least 10% of the total rescheduled/restructured amount (i.e. principal and mark-up) or six instalments (comprising principal and mark-up) as per terms & conditions of the rescheduling/restructuring. However, for internal monitoring purpose, banks/DFIs may re-set the DPDs counter of the newly created loan to "0" DPD.

6. Provisions already held against a non-performing financing facility, to be rescheduled /restructured, will only be reversed if above mentioned condition of 10% recovery or six instalments is met. 7. If the borrower defaults (i.e. reaches 90 DPD) again within one year after declassification, the financing facility shall be classified as under.

TABLE 31: TYPE OF CONSUMER FINANCING & CLASSIFICATION

Type of Consumer Financing	Classification
Unsecured	Loss
Secured	Same category in which it was prior to rescheduling or restructuring. At their discretion, banks and DFIs may further downgrade the classification based on their own internal policies.

10.4. Annex D - Detailed documents required under multiple loan scenarios

Detailed documents required under multiple loan scenarios:

If Secured against Government Securities

- Demand Promissory Note (IB-12)
- Letter of guarantee (IB-29)
- Letter of Pledge, Lien and Authority for Shares, Stocks & Securities (IB-26A)
- Letter of lien, Set Off & First Charge (IB-28)
- Agreement for sale and buy back of marketable securities. (IB-31)
- Letter of Authority to mark lien and encashment
- Power of Attorney – attested and notarized
- Authority to appropriate profit on securities to recover mark-up
- Original Certificates duly discharged by owner, signature verified and marked lien on the face of securities
- Letter by the Issuing Authorities confirming marking of bank's lien on securities
- Registration of charge under STR arrangements

If secured against fixed deposits/cash collateral

- Original Deposit receipt /TDR endorsed /discharged by the holders, signatures verified and marked lien on face
- Letter of Pledge, Lien and Authority for Shares, Stocks & Securities (IB-26A)
- Letter of lien, Set Off & First Charge (IB-28)
- Letter of Authority to mark lien and encashment
- Registration of charge under STR arrangements

If secured against Inventory / movable property/Fixed Assets (Plant Machinery & Equipment)

- Letter of Hypothecation of stocks / movable assets (IB-25-A)
- Letter of Hypothecation of Fixed assets (IB-25-B)
- Letter of Pledge of goods (moveable assets) (IB-26)
- Board Resolution (limited Companies)
- CTC of Form-10 (for creation of charge over book debts / current assets/stocks/fixed assets) Limited Companies
- Certificate of registration of charge issued by Registrar of Companies/SECP (Limited Companies)
- Post charge Search Report from SECP
- Registration of charge under STR arrangements
- Insurance policy assigned to the Bank
- Valuation certificate for fixed assets such as Plant, machinery & equipment
- Collateral Inspection

If secured against equitable mortgage of property

- Declaration of Properties (Form-188)
- Borrower's Board Resolution for mortgage (limited Companies)
- Obtain title deeds, Chain Title documents and property plan - legally vetted
- Genuineness of Tile of property
- Memorandum of deposit of title deeds (IB-24)
- Letter of Hypothecation for Fixed Plant & Machinery (IB-25-B)
- CTC of Form-10 filed with Registrar / Receipt evidencing filing of charge with SECP (Limited Companies)
- Certificate of registration of charges issued by SECP (Limited Companies)
- Post charge Search report from SECP
- Valuation Report
- Consent of third party, if the property not owned by the borrower himself
- Third Party Memorandum of deposit of title deeds (IB-24-A)
- NOC from relevant property authorities for creation of mortgage
- Notification of bank’s mortgage charge with Revenue Authorities/land owning authorities
- Agreement to mortgage
- Personal Guarantee from owner of property (IB- 29)
- Power of Attorney:
- Pre & Post mortgage Search Certificate
- Schedule of fixed assets
- Municipal Tax / Ground Rent / Lease Rent paid Receipts
- Mortgage deed, in case of legal mortgage (registered with Registrar of Assurances)
- Clearance from Bank's legal advisors

If secured against shares

- Transfer deed signed by borrower; stamps / signature verified (in case of Physical Share Certificates)
- List of shares (in case of Physical Share Certificates)
- CDC Statement evidencing Lien/ pledge of Shares with Bank (in case of electronic shares)
- Letter of Pledge, Lien and Authority for Shares, Stocks & Securities (IB-26A)
- Board Resolution (Limited Companies)
- Copy of Form-10 filed with Registrar / Receipt evidencing filing of charge with SECP (Limited Companies)
- Certificate of registration of charges issued by SECP (Limited Companies)
- Post charge Search report from SECP
- Registration of charge under STR arrangements
- Power of Attorney - Attested and notarized

If secured by Personal Guarantee

- Personal Guarantee (IB- 29)
- List of Assets of Guarantors

If secured against Book Debts

- Letter of Hypothecation of book debts (IB-25-F)
- Form-L, for creation of charge
- Board Resolution (Limited Companies)
- Copy of Form-10 filed with Registrar / Receipt evidencing filing of charge with SECP (Limited Companies)
- Certificate of registration of charges issued by SECP (Limited Companies)
- Post charge Search report from SECP
- Registration of charge under STR arrangements
- Power of Attorney - attested and notarized

10.5. Annex E – NPL Market – A case study of Spain

NPL Market Players & Companies

The Banco de España (BdE) is Spain's primary monetary authority, and it also acts as the country's national bank supervisor under the Single Supervisory Mechanism (SSM) of the Eurozone. There are twelve banking groups in Spain which include 52 commercial banks, two savings banks, and 61 cooperative banks. In addition, in 2012, the Spanish government formed SAREB, a bad bank (Bank of Spain, 2020). The European Union imposed Sareb as a condition in exchange for up to €100 billion in aid to the Spanish banking sector. In 2012, Sareb acquired real estate and other toxic assets worth more than €50 billion from nine Spanish savings banks.

SAREB works as an Asset Management Company (AMC), which permits the isolation of problematic assets from credit institutions that require government assistance to remove them from their balance sheets. In return for the NPLs acquired from banks, the AMC offers bonds with a government guarantee. The assets must be transferred to SAREB without the agreement of any third parties. The value of the assets will be determined by the Bank of Spain based on assessment reports prior to the transfer.

SAREB is a group of Spanish and international private and public investors. Aside from rebuilding the Spanish financial system in a maximum of 15 years (scheduled to be completed in 2027), the goal is to extract as much profit as possible from the toxic assets. Nationalized financial institutions and bodies have remitted about €55,000 million to SAREB. Two-thirds of this sum is made up of property-related loans and credits, the remainder is property assets. SAREB is deemed the owner of the assets that were transferred (Bankia, 2021).

NPL Market in Spain

The rate of NPL reduction has slowed dramatically since the outbreak of the pandemic. In both the business and residential categories, the total stock of nonperforming loans (NPLs) recorded by the Bank of Spain (BdE) dropped by €5.2 billion (8.2 percent) to €57.8 billion by July 2020, compared with the previous year. Most of this decrease occurred in the second half of 2019, although loan sales and other restructuring activities slowed in March due to the COVID-19 pandemic, this market, however, has recently become more active.

Due to the government and banking industry's support measures (payment moratoria and public guarantees) , the percentage of NPLs in total loans (NPL ratio) remained at 4.7 percent as of end-July 2020, just marginally lower than the end-2019 figure of 4.8 percent. In the first half of 2020, state guarantees covered a large part of new company loans, successfully ensuring that firms could meet their liquidity demands. While these interim measures were highly effective in the near term, they will need to be supplemented with more structural measures, such as effective debt resolution and corporate restructuring frameworks. The support programs can only partially reduce credit risks, and the banking sector's asset quality is expected to deteriorate in as the pandemic progresses, especially if more restraint measures are required.

In the first half of 2020, the stock of home NPLs grew, accounting for over half of the entire stock, with a net inflow of €1.6 billion of NPLs. The NPL ratio for Spanish banks fell from 3.5 percent at the end of June 2019 to 3.0 percent at the end of June 2020, according to statistics from the European Banking Authority (EBA), which is similar to the EU average of 2.9 percent. The EBA data also reveals that provisioning levels have remained relatively steady, with total NPL impairments accounting for 43.3 percent of all NPLs at the end of June 2020, up from 42.9 percent a year earlier and below the EU average of 45.3 percent (European Commission, 2020).

SAREB – Recent Development & Outlook

SAREB has liquidated 36 percent of its assets and repaid 31 percent of its senior debt at the halfway point of its projected life cycle. By 30 June 2020, SAREB's senior debt, which is backed by the government and held by banks that received government assistance, would have been decreased from €50.8 billion to €35.1 billion.

Since 2019, SAREB has been executing a new strategy and has gradually converted its RED (real estate development loans) into assets. In view of the significant discounts required on that market, the new approach is to depend less on non-performing loan sales. As a result, SAREB plans to step up its efforts to convert loans into underlying collateral that may subsequently be offered and sold in the retail real estate market. As a result, 2019 was the first year in which real estate surpassed financial assets as the primary source of revenue.

SAREB also introduced several cost-cutting measures in an effort to better oversee and monitor its assets and reduce needless maintenance costs. As of June 2020, loans and advances made up 56 percent of SAREB's overall balance sheet, with NPLs accounting for nearly all of them. The rest of SAREB's balance sheet was made up of about €14 billion in real estate owned (REO). Nearly a quarter of these assets have been published for retail sales, with the remainder either unpublished or destined for specialist sales (European Commission,

2020).

Structure of AMCs / Bad Banks

SAREB began as a majority-owned private corporation (55 percent private, 45 percent public). There were 14 domestic banks, two international banks, and ten insurance firms among the private equity investors. The Fund for Orderly Bank Restructuring was used to inject public capital. Property development loans and properties held as security are the two major types of assets transferred to SAREB. It was originally financed with €50.8 billion in government-backed senior debt, €3.6 billion in subordinated debt (15-year callable bonds convertible into equity), and €1.2 billion in stock owned by 26 banks and insurance firms.

Sareb is set up as a centralized AMC from an operational standpoint. A centralized AMC consists of a single workout company that is partially owned by the public. This centralized, "systemic" strategy entails pooling a bigger part of the financial system's troubled assets under a single group that may benefit from economies of scale in terms of resources and experience, as well as standardization of workout methods. Section 11.2 - Common NPL Resolution Models contains further information on how to set up AMC.

SAREB has hired specialized trained personnel with prior private sector expertise, and it mostly outsources asset servicing. SAREB utilized contributing banks as servicers when it was first established, but in 2015 it shifted loan administration and management to four private firms.

Evaluating the Effectiveness of SAREB

SAREB has liquidated 36 percent of its assets and repaid 31 percent of its senior debt at the mid-point of its anticipated lifespan, as previously stated. Its delayed recovery is partly because all its assets are in Spain, where the property market is still recovering. As it received numerous small-value residential property loans and collateral, SAREB has a considerably larger number of individual assets. Access to collateral and foreclosure processes have not hampered Sareb's performance in Spain; in fact, they are widely viewed as benefiting lenders. The retail channel provides the majority of SAREB's revenue.

SAREB has suffered significant and consistent losses in terms of financial performance. SAREB's capital base has been eroding because of these ongoing losses. On the regulatory front, some relief has been implemented. SAREB lost €947 million in 2019 and €396 million in the first half of 2020. Unrealized losses are also included in the RED and REO portfolios. Several steps to alleviate the situation have been implemented. SAREB was able to account for asset impairments against value adjustments because to Real Decreto-Ley 4/2006, which enabled it to do so without reporting them in its profit and loss statements.

The revised guidelines for SAREB asset valuation were published by the Bank of Spain in October 2015. By the end of 2016, the new standards demand an individual assessment of all assets to reflect market price changes. This resulted in additional impairment provisions of €2.04 billion. The new valuation criteria also had an impact on SAREB's asset disposal business, since they required the company to focus on activities where the asset's sale price is higher than the valuation price to make profits and forcing a temporary halt in asset disposal.

This surge in NPL sales has resulted in portfolio reductions of up to 70 percent, which SAREB could not agree to. Instead of selling NPLs, the current goal is to prioritize and expedite the conversion of loans into “real estate-owned” assets through foreclosures. As Spanish real estate values rise, this is projected to give liquidity to the bank's holdings and facilitate property transactions.

The year 2012 when Sareb was created had an NPL ratio of 7.5 percent and in year ending 2020 the NPL ratio is only 4.5 percent. Although Spain's NPL is now low, economists believe that it will climb soon. As a result, banks and the Spanish Central Bank must ensure that NPL management is addressed seriously. Sareb is a prominent player in NPL management, having purchased nearly 200,000 properties worth €50.8 billion. Only 36 percent of these assets had been sold as of 30 June 2020, and SAREB's portfolio has suffered significant losses since its inception. Nonetheless, supporters of SAREB point out that, despite its difficulties, SAREB's final performance is unknown. Furthermore, even if it never becomes profitable, SAREB's overall purpose of assisting the financial sector may be accomplished. There was limited evidence about the effectiveness of SAREB at the time of this research, not least because SAREB is an ongoing programme.

10.6. Annex F – NPL Market – A case study of Italy

NPL Market in Italy

The NPL market in Italy has been declining since 2015, peaking at €341 billion in 2015. It is expected to reach €130 billion by 2020. The NPL ratio was 5.2 percent in December 2020 (6.7 percent in 2019), which is higher above the EU average of 2.9 percent and the gross NPL ratio objective of 5 percent set by the European Banking Authorities (EBA).

The lockdown measures imposed in response to the COVID-19 pandemic caused a slowing in the declining trend compared to the same time in 2019. Looking at the composition of gross bad loans (the most serious category), the "Corporate & SME" sector accounted for the largest percentage (74.4 percent) of gross bad loans in Italy in July 2020, followed by Consumer loans (17.5 percent). In comparison with YE-2019, the proportion of Secured Bad Loans (45 percent) stayed very steady (44 percent). Corporate and SME constituted 68 percent of secured bad loans, while Retail represented 23 percent (PwC, 2020).

NPL Market Players & Companies

In Italy, there are roughly 500 banks, including 136 public limited banks, 22 cooperative banks, 268 mutual banks, and 79 foreign bank branches. The banking industry employs 280,000 people and has around 25,400 branches. The four largest Italian banks by assets are Unicredit, Intesa Sanpaolo, CDP, and Banco BPM. The Banca d'Italia (or Bank of Italy) was founded in 1893 and is the country's central bank.

In 2016, the Italian government opted to implement Garanzia Cartolarizzazione Sofferenze, or GACS, which allows NPLs to be transferred from a bank to an NPL investor via securitization rather than direct sale or purchase. GACS refers to the Ministry of Economy and Finance's (MEF) unconditional, irrevocable, and payable on first demand guarantee given on senior tranches issued in an NPL's credits securitization deal. The senior notes' subscribers will receive payment of the due amount from the MEF within 120 days of the occurrence of a trigger event (such as non-payment of interest or repayment of principle by the SPV).

To execute and finalize the NPL transactions, various parties must work together (structure of GACS and how these stakeholders interact is mentioned in the section below). The following are the parties engaged in this process:

- Originator: These are the banks that are presently dealing with NPLs and are looking to remove excess NPLs from their balance sheet to make room for new loans.
- Arrangers: The arranger oversees the transaction's preparation and marketing. It is also known as the placement agent in this last position. Most arrangers will additionally underwrite the transaction's possibly unsold notes. International investment banks that can operate in several countries dominate the arrangers industry. JPMorgan Chase & Co. is the primary arranger of NPL securitizations. In its reference market, Italy, Banca IMI and Mediobanca are major local businesses.
- Rating agencies: The rating agency assigns a credit default rating to the securitization's tranches. Running a statistical model based on the data provided by the source is their core job. The algorithm assigns a grade to each tranche based on a base case scenario, but it also analyses alternate situations. Some of the world's largest rating agencies dominate the industry. The rating agencies Moody's, Scope Ratings, and DBRS are all active.
- Servicers: Servicers play an important role in the transaction's preparation. The bank must hire an independent servicer to handle the portfolio for primary GACS transactions. The servicer for secondary transactions is usually the same person who is currently managing the portfolio. Prelios is the leading servicer in terms of transactions due to its strong position in the Italian GACS. DoValue, Credito Fondiario, and Cerved are the companies that come after it.
- Advisers: In the planning and promotion of deals, financial advisors are monitored. Advisors can help with overall project management, data preparation, and serving as a sounding board for servicers' business ideas. Financial advisers' markets are also characterized by the presence of foreign players. With their experience preparing sell-side portfolio deals, Big Four advisers are typically involved in transactions.
- Lawyers: Lawyers are involved in the operation's structure and the production of legal paperwork, such as the prospectus and SLAs between the SPV and the servicers. They are a mix of multinational firms like as Orrick and A&O, as well as local firms such as Chiomenti in Italy (Deloitte, 2020).

Transaction structure under GACS

Portfolios of nonperforming loans are transferred to a special purpose vehicle (SPV) that supports the acquisition by issuing Asset Backed Securities (ABS) or notes, which can have a fixed or floating rate coupon and are generally organized in various seniority tranches. The NPLs are the underlying collateral that backs the ABS under this system. Securitizations help banks by providing capital relief and a smaller immediate P&L effect than a direct sale.

In the form of a CDS contract between the State and the SPV, the government offers a guarantee to the senior tranche. In the event of assurances offered by an EU member state, this must be authorized by the European Commission. Government-backed schemes, in contrast to market transactions, usually provide better pricing and therefore limit possible losses for originator institutions.

The stages for primary securitization deals under GACS are as follows:

i. SPV buys a portfolio of nonperforming loans and issues notes to pay for it;

ii. Senior, mezzanine, and junior tranches are the most common; 03. The senior tranche has the first claim, followed by mezzanine, and finally junior;

iii. An independent servicer must be appointed by the originator;

iv. Interest payments are based on the notional value of outstanding notes and can be payable annually, semiannually, or quarterly;

v. Liquidity lines are typically given to deal with discrepancies between possible collections deficits and note interest payments.

vi. All collections are combined into a single pool and subjected to a single payout cascade;

vii. To comply with risk retention rules, the Bank must maintain a minimum of 5 percent of mezzanine and 5 percent of junior notes (Deloitte, 2016).

Guarantee Pricing Mechanism under GACS

Guarantee price is based on a basket of single name CDS on Italian issuers (regardless of issuer type) pulled from the Bloomberg database, with an underlying debt instrument rated by S&P, Fitch, or Moody's. The basket composition is determined when the assurance is approved. It remains constant over time and is based on the actual rating of the NPL securitization's eligible senior tranche (Deloitte, 2016).

Structure of Atlante Fund

Atlante functions similarly to a private equity firm. The fund has received funding from several banking foundations and insurance firms. A total of €4.25 billion has been raised for the fund. According to shareholders, at least 30 percent of the fund's assets would be used to purchase junior tranches of securitized nonperforming loans. On the purchase side, Atlante is giving a greater price for bundles of NPLs, creating market rivalry and encouraging other companies to bid higher. Senior tranches are protected by the Italian government under GACS, making them more desirable to other NPL investors. The remaining 70 percent of the money is allocated to bank investments to back recapitalizations. The fund has a five-year horizon, with the option to extend it to up to eight years on an annual basis, and pays a 6 percent annual return.

The Atlante effect, which creates value not only by buying the junior tranches but also by stimulating competition, boosts NPL values by the securitization process itself (the benefits of splitting the risks (Bocconi Students Investment Club, 2016).

Evaluating the Effectiveness

During the previous few years, GACS has played a key role in the disposal of NPLs. Without considering the most recent ongoing securitizations, 27 GACS transactions were completed between 2016 and 2020, amounting for a total GBV of about €74 billion, of which 58 percent was secured. The nominal value of issued notes is about €18 billion, with senior notes accounting for 81 percent, mezzanine notes for 12 percent, and junior notes accounting for 7 percent. In terms of GBV, 20 of the 27 agreements had a deal size more than €1 billion, with five of them exceeding €5 billion.

Except for Intesa Sanpaolo and Cariparma, almost all Italian major banks employed GACS to accomplish their deleveraging strategy. Deals in the Italian NPL market peaked in 2018, when the public guarantee benefited €45.8 billion out of a total of €84 billion in NPE disposals. GACS completed a €24 billion jumbo sale (Siena

NPL 2018), the largest GBV deal in the Italian market to date.

Given the success in allowing the development of a market for banks' non-performing loans (and, as a result, their deleveraging), the Decree Law of 25 March 2019 renewed the GACS for another 24 months (until the end of May 2021), with the option to extend it for another 12 months (which has yet to be exercised).

On the other hand, tougher rules relating to meeting performance objectives that safeguard the note holder, as well as higher fees to acquire the guarantee, lowered the attraction of GACS transactions for sellers. In comparison to 2018, the number of GACS transactions has more than half in 2019, while volume (in terms of GBV) has fallen by a third. Only three transactions have been submitted for the GACS guarantee in 2020. The Coronavirus outbreak in Italy resulted in a halt to judicial procedures and a less liquid property market, slowing collection operations (PwC, 2020).

The European Commission recently awarded Italy approval for a one-year extension, to the middle of 2022, of a state guarantee plan that has been critical in clearing bad debts from the country's banks. The GACS guarantee system Rome adopted in 2016 has helped convert Italy into Europe's largest market for distressed bank loans by reducing the losses that banks must bear in order to shed bad debts. Over the last five years, Italian lenders have reduced problem assets by more than €200 billion ($242 billion). The overall value of GACS-backed disposals was €87 billion. When GACS was created in 2016 it had an NPL ratio of 17.1 percent and in year ending 2020 the NPL ratio is only 5.2 percent.

In terms of experimentation, Italy's experience with NPLs is arguably the most extensive of any European country. To embrace a broader range of solutions and learn from them, it's better to talk about asset-management schemes (AMS) rather than AMCs in the strictest sense. Multiple players were involved in the establishment of GACS for managing NPLs, particularly the involvement of Atlantis and a few other private equity funds (generating lower-than-expected returns) in injecting cash and allowing NPL investors to purchase the various tranches of notes issued by SPVs. Despite the GACS proved to be a beneficial tool for the Italian economy, the global impact of COVID-19 slowed progress, resulting in a lower amount of NPL securitizations in 2020 (€2.4 billion) than in previous years (€17.4 billion in 2019 and €45.8 billion in 2018).

10.7. Annex G – NPL Market – A case study of India

NPL Market in India

The decline in the Gross Non-Performing Assets (GNPA) ratio, which began after the March 2018 high, has so far lasted through 2019-20 and 2020-21, with the GNPA ratio reaching 7.5 percent by the end of September 2020. Lower slippages (new accretion of NPAs during the year/total standard assets at the start of the year) drove the improvement, which fell to 0.74 percent in September 2020. Public Sector Banks continued to have the largest number of new slippages.

Write offs accounted for most of the decrease in NPAs throughout the year. Banks may choose to write off NPAs older than three years since they need 100 percent provisioning. Furthermore, banks deliberately write off non-performing assets (NPAs) to clean up their balance sheets, obtain tax benefits, and maximize capital use. Borrowers of written-off debts, on the other hand, remained liable for payments. During 2019-20, the proportion of performing loans to total advances grew across all commercial banks, except for private sector banks and small financing banks.

At the end of September 2020, large borrower accounts (with an exposure of INR 50 million or more) accounted for 79.8 percent of NPAs and 53.7percent of total loans. The GNPA ratio of public sector banks, which was 10.3percnet in 2019-20, and the ratio of restructured standard assets to total financed amounts from bigger borrower accounts, both trended lower. Asset quality improved substantially in September 2020 compared to March 2020 in industry, agriculture, and services, with a decrease in GNPA and stressed advances ratios. However, in the case of retail advances, the GNPA ratio fell only little, and stressed advances remained unchanged. The GNPA ratio was declining across the board in all main industry sub-sectors.

Without the asset quality halt given as a COVID-19 relief mechanism, the accretion to NPAs would have been substantially greater. Given the uncertainties created by COVID-19, the financial system's asset quality may worsen dramatically in the future. In its baseline stress scenario, the Reserve Bank of India (RBI) forecasts the GNPA ratio to climb 600 basis points (bps) to 13.5 percent by September 2021, or nearly double to 14.8 percent in a severe stress scenario, bringing it to a 25-year high. (Reserve Bank of India , 2020)

NPL Market Players & Companies

The Reserve Bank of India (RBI) oversees India's financial sector. In addition to cooperative credit institutions, the Indian banking system includes 12 public sector banks, 22 private sector banks, 46 foreign banks, 56 regional rural banks, 1485 urban cooperative banks, and 96,000 rural cooperative banks. (India Brand Equity Foundation , 2021)

There are 27 Asset Reconstruction Companies (ARCs) which recover NPAs from secured lenders' books and unlock their value. The Reserve Bank of India (RBI) has registered ARCs, which are governed under the Securitization and Reconstruction of Financial Assets and Enforcement of Securities Interest Act of 2002. (SARFAESI Act, 2002).

Qualified Institutional Buyers (QIBs) are the only people or investors who can help the ARCs generate cash in India. Financial Institutions, Insurance Companies, Banks, State Financial Corporations, State Industrial Development Corporations, trustees or ARCs registered under SARFAESI, and Asset Management Companies registered under Securities and Exchange Board of India (SEBI) that invest on behalf of mutual funds, pension funds, Foreign Institutional Investors, and other entities are included among the QIBs.

The Indian ARC Association (IAA) is a non-profit and non-governmental organization that represents all ARCs. IAA has been in operation for over eight years and works with a variety of ministries, regulatory agencies, and government entities to ensure smooth business operations. It also serves as a debate forum and exchange of ideas. (Indian ARC Association, 2021)

Structure of ARCs in India

Asset Reconstruction Companies (Securitization Companies / Reconstruction Companies), often known as ARCs, are companies that are registered under Section 3 of the SRFAESI Act, 2002. As a Non-Banking Financial Company, it is governed by the RBI. Within RBI's rules, ARC works similarly to an AMC. Unlike in many other countries, where debt aggregation arose because of government backing, ARCs in India were established as private entities, mostly with the help of banks.

Only after obtaining a registration certificate under Section 3 of the SARFAESI Act, 2002, may an asset reconstruction or securitization company be started. The primary criterion in this respect is that the 'net owned funds,' as defined by the RBI Act, must be worth at least INR 1 billion. Only secured debts that have been

categorized as non-performing assets can be taken over by the ARC (NPA). If debentures or bonds are not paid, the beneficiary of the securities must issue a 90-day warning before the securities can be taken over. (India Filings, 2021)

NPA Recovery Mechanism by ARCs

Starting with the loan amount accepted by a borrower (by supplying mortgaged asset), if the borrower fails to repay it and it is due for 90 days or longer, it will be turned into NPA. In this situation, the bank must choose between recovering the debt on its own or selling the NPA to an ARC. The money will be raised by ARC using a subscription mechanism offered by the trust. The Security Receipt (SR) is an instrument that is issued to Qualified Institutional Buyers (QIBs). Banks or FIs wanting to sell their poor assets to ARCs ask interested ARCs to declare their interest, indicating their readiness to buy the financial assets. The seller banks or FIs provide their terms and conditions for the sale of financial assets, to which prospective ARCs must agree. Due diligence is performed before the intended ARCs submit their offer. The ARCs make a preliminary offer to the seller's bank or FI.

They execute assignment of debt with seller bank/FI upon receipt of seller acceptance so that ARCs can take additional actions to resolve acquired NPAs. After imposing a discount, the assets will be taken over either on a sale or agency basis (typically 30 to 40 percent). The discount will be determined in cooperation with banks and FIs and will be based on a variety of variables like security value, promoter profile, asset state (operating or idle), age, and product market.

The entire procedure must be carried out in a transparent way and on mutually acceptable conditions. If 75 percent of the lenders by value agree in a consortium or multiple banking situation, the remaining banks and FIs are obligated to accept the ARC's offer. If the board of directors of the individual banks and FI has consented to the transfer of assets to ARCs, the borrower has no right to object. Almost all state governments have reduced stamp duty and registration fees for debt assignment and registration to make the purchase of financial assets by ARCs easier.

Evaluating the Effectiveness of ARCs

ARCs have been effectively used as part of a global NPA management strategy. Korea, Taiwan, Mexico, and Thailand have all successfully used various ARC methods to address the issue of NPAs. Several governments have also promoted asset transfers to ARCs by establishing a favorable regulatory environment.

The ARC's business strategy is like an asset management company (AMC), with assets being transferred to one or more trusts (at the price at which the financial assets were acquired from the originator). The trusts then issue security receipts (SRs) to qualified institutional buyers (QIBs) and pay the ARCs management fees. Any difference between the acquired and realized prices is split between the trust beneficiaries (banks or FIs) and the ARCs. Having stated that, the performance of ARCs and their efficacy may be evaluated using the following measure:

i. Growth of the Industry - After being relatively stable in the early years of their existence (2002-2005), the number of ARCs increased in 2008, and then again in 2016. Despite the rise in the number of ARCs, the growth in their assets under management (AUM) has been essentially flat, except for a significant spike in 2013-14. Except for the time of significant increase in the AUM during 2013-14, the AUM of ARCs has been on a falling trend when compared to the volume of NPAs of banks and NBFCs.

ii. Funding Sources - Borrowings are a key source of money for ARCs, nearly equivalent to the businesses' net owned funds. Any difficulties in generating money will almost certainly result in a greater reliance on borrowings by these businesses. Furthermore, ARCs' funding sources have generally been dominated by banks. Domestic sources, notably banks and financial institutions, account up most of the ARCs' capital, with international sources being limited. A breakdown of ARC borrowings indicates their reliance on banks as well. The percentage of bank borrowings has declined in recent years, with bonds and debentures emerging as a key source of capital for these businesses.

iii. Profitability - Management/trusteeship fees, upside revenue from the difference between debt recovery and purchase cost, and additional performance incentives provided by banks for an early recovery are the main sources of income for ARCs. To motivate ARCs to focus on recovery, management fees are tied to the net asset value (NAV) of SRs (rather than the volume of outstanding SRs, as was previously the case). As a result, any reduction in ARCs' recovery ratings has a direct impact on their management costs. The overall profitability patterns of ARCs point to a relatively steady return on assets (RoA) of around 3 percent. While the return on equity (RoE) had a considerable fall after 2014, it has now recovered to be close to 7 percent from 2016 onwards. The RoA of ARCs is significantly greater than that of NBFCs.

iv. Acquisition of Assets - ARCs often purchase assets from banks and financial institutions through bilateral agreements or auctions. Until recently, auctions (85 percent of total sales) have dominated the ARC transactions. For ARCs in the acquisition process, determining the value of acquired assets is a crucial business problem. Given that ARCs and banks are on opposite ends of the transaction, banks benefit from a greater acquisition ratio (measured as acquisition cost to book value of assets). It has long been claimed that banks have been hampered in their efforts to offload troubled assets due to a low acquisition ratio and, as a result, a greater haircut. Although the average acquisition ratio has significantly increased over time, it remains in the low 30 to 40 percent range. Further, the acquisition ratio continues to vary widely between ARCs, with the variance growing with time.

v. Asset Resolution - ARCs' asset resolution techniques are split into five categories (Table 32), with ARCs favoring the approach of postponing payment obligations. The percentage of assets resolved by way of enforcing the security interest has steadily decreased over time. Changes in management or seizing control of assets have also been used sparingly as a means of resolving disputes.

TABLE 32: RESOLUTION MODELS

Resolution Methods	Mar-16	Mar-17	Mar-18	Mar-19	Mar-20
1. Rescheduling of payment of debt	37.0	36.5	36.8	35.7	32.0
2. Enforcement of security interest	32.0	35.1	31.5	28.6	26.6
3. Settlement of dues of borrower	30.0	24.8	25.2	28.4	26.0
4. Taking possession of assets	2.0	3.9	6.2	7.2	1.5
5. By sale of business	0.0	0.4	0.3	0.1	13.9

vi. Recovery and Redemption of SRs - SR recovery is a key metric for assessing the effectiveness of ARCs. ARCs are required by regulatory standards to report the NAV of the SRs they issue, which is utilized by investors to value the SRs. ARCs must acquire a recovery rating from a recognized credit rating agency to establish the NAV (CRA). In most cases, the CRA bases its recovery rate on an evaluation of the resolution technique used. In the books of ARCs, the age profile of exceptional SRs indicates a concentration of older SRs. Given that the ARCs have a five-year (extendable to eight-year) horizon to redeem the SRs, the age of the SRs issued is likely to drive their redemption performance. In other words, the younger SRs would outnumber the older SRs in the outstanding stock of SRs. However, as of March 2020, around 42 percent of outstanding SRs were over five years old and would have to be redeemed during the following four years to prevent write offs. (Reserve Bank of India , 2021)

ARCs have been demonstrated to be the most effective recovery channel for NPAs, according to numerous economists. For banks, ARCs are still a significant source of loan recovery. Most of the auctions failed due to the difficulties experienced by ARCs, particularly the limited finances available and the mismatch in pricing expectations (30 percent to 40 percent haircuts on purchasing NPAs) between FIs and ARCs. As a result, India has underused the option of exiting through the sale of stressed loans to ARCs. With the SARFAESI Act's application extended to co-operative banks, recovery via the ARCs channel is projected to gain traction in the coming years.

10.8. Annex H – NPL Market – A case study of Malaysia

Historical NPL Market of Malaysia

Malaysia was struck by the Asian financial crisis in mid-1997, which remains the country's worst financial crisis since independence. As a result, the country was on the verge of recession, with the economy experiencing a negative growth rate of 7.5 percent in 1998. Many businesses are having significant financial issues, which has resulted in a high level of nonperforming loans (NPLs) of 14.6 percent in the Malaysian economy.

In January 1998, the Malaysian government formed the National Economic Action Council (NEAC) to combat the economic downturn brought on by the Asian financial crisis. The National Economic Recovery Plan (NERP) was created by the NEAC to steer the country back to economic stability. The NERP recommended that the Ministry of Finance establish an AMC to buy NPLs from financial institutions to address the growing NPLs in the banking industry. As a result, Danaharta was founded in June 1998 as a wholly owned subsidiary of the Ministry of Finance. (Bank Negara Malaysia , 2005)

NPL Market Players

In addition to Danaharta, the NERP specified a Special Purpose Vehicle (SPV) Called Danamodal as part of its proposals to be deployed alongside Danaharta. Danamodal was formed soon after as a bank and FI recapitalization SPV. FIs were forced to transfer their NPL portfolios to Danaharta to be eligible for recapitalization.

The first-loss concept was implemented by Danamodal, which meant that the FIs' shareholders were forced to suffer the initial losses on the sale of NPLs to Danaharta. Danamodal would only recapitalize viable FIs on commercially reasonable conditions and in accordance with market principles. Due diligence assessments were conducted by international investment bankers to evaluate if banking institutions were eligible for capital injection and their recapitalization requirements.

The Corporate Debt Restructuring Company (CDRC) was also established to aid corporate debt restructuring, with the goal of providing a forum for creditors and debtors to identify appropriate and realistic debt restructuring plans without resorting to legal action (Yale Program on Financial Stability, 2020).

Funding Structure of Danaharta

The government provided Danaharta with an initial capital injection of RM 3 billion, allowing Danaharta to acquire NPLs from banks. Danaharta chose to offer government-guaranteed zero-coupon domestic bonds to banks with a five-year maturity to facilitate additional NPL purchases. Danaharta was given government assistance to ensure that they would not default on bond repayments to the banks in return for the NPLs.

Commercial banks, financing businesses, development banks, merchant banks, Islamic banks, and locally incorporated foreign banks were all eligible to sell NPLs to Danaharta, if the NPL had a value of RM5 million or more. Danaharta's activities were constrained by the NPL size criterion, which allowed for a stronger emphasis on higher-value NPLs, which represented for around 70 percent of the overall NPL value in the Malaysian banking industry. Bank Negara Malaysia (BNM), Malaysia's central bank, ordered banks and financial institutions with NPL ratios of 10 percent or above to sell their NPLs to Danaharta (Yale Program on Financial Stability, 2020).

Danaharta Operating Model

Danaharta, which functioned as an Asset Management Company (AMC), had a two-pronged strategy: it bought NPLs outright from banks and other FIs, and it managed NPL portfolios on behalf of the banks (agency model). It methodically handled the NPLs in its portfolio, account by account, with the goal of maximizing recovery values for managed and acquired NPLs.

An AMC approach was more suitable for Danaharta because maximum NPL recovery was paramount — as other agency models such as a warehouse agency model, take a long-term approach when recovering NPLs, as it waits for the market to pick up before beginning NPL recovery. This was not a suitable approach for Danaharta as Malaysia had suffered through the Asian financial crisis (Bank Negara Malaysia , 2005).

Evaluating the Performance of Danaharta

The ratio of NPLs to total loans was 8.5 percent at the end of May 1998 (the year Danaharta was founded). The economy's decline and the collapse of the property and stock markets were direct causes of NPLs. However, state-directed credit policies, a lack of competition, and a lack of prudential rules are more fundamental reasons for the large NPLs.

Danaharta's activities ended in September 2005, with a total loan rights acquired (LRA) portfolio of RM47.68 billion, including RM19.71 billion in acquired NPLs and RM27.97 billion in managed NPLs. Danaharta acquired NPLs at a 54.6 percent discount on average, allowing the company to keep its expenditures down. In 2005 the NPL ratio was around 9 percent which could indicate that Danharta may have prevented the NPL ratio to grow even further.

Danaharta was able to collect RM30.35 billion from its NPL portfolio, with a 58 percent average recovery rate, which was a significant achievement given the country's economic difficulties during the Asian financial crisis of 1997. On purchased NPLs, the average recovery rate was 49 percent, while on managed NPLs, it was 65 percent. Danaharta's total recovery rate and recovery strategies are depicted and broken down in Table 33.

TABLE 33: RECOVERY METHODS USED BY DANAHARTA

Recovery Method	Adjusted LRA RM Billion (a)		Recovery RM Billion (b)		Recovery Rate (%) C=(b)/(a)	
	Acquired NPLs	Managed NPLs	Acquired NPLs	Managed NPLs	Acquired NPLs	Managed NPLs
Plain Loan Restructuring	1.07	3.77	0.86	3.58	80%	95%
Settlement	3.55	8.55	3.11	6.41	88%	75%
Schemes of Arrangement	3.14	6.82	1.84	4.32	59%	63%
Appointment of Special Administrators	1.66	2.59	0.84	0.58	51%	22%
Foreclosure	9.12	3.69	2.62	1.65	29%	45%
Others	3.81	3.29	1.74	2.60	46%	79%
Legal Action	0.28	1.08	0.06	0.14	20%	13%
Total	22.63	29.79	11.07	19.28	49%	65%
Overall	52.42		30.35		58%	

Danaharta's overall performance was judged a success since it prevented future rises in NPLs, repaid bonds on schedule, completed operations in seven years, and cost the government a modest amount of money. Danaharta's plan was deemed "well-conceived" by the IMF, since it had a manageable portfolio of loans to resolve and an appropriate focus on resolution rather than warehousing or fast disposal (Yale Program on Financial Stability, 2020).

Reasons for Danaharta's Success

Danaharta was deemed a "fairly effective" policy instrument by the Bank for International Settlements (BIS) for recovering NPLs for Malaysian banks and financial institutions because it had legal authority, a coordinated strategy, government financial support, and political backing that allowed it to operate efficiently and effectively.

The Danaharta Act is said to have been a key factor in Danaharta's success. Danaharta was given unique powers under the Act when it was tasked with maximizing NPL recovery. Danaharta was given the following unique powers under the Act:

1. The capacity to purchase assets as a result of statutory vesting

2. The power to appoint Special Administrators to oversee the operations of insolvent businesses.

3. The opportunity to swiftly market foreclosed assets (through amendments in National Land Code)

4. The court was not allowed to issue an injunction against Danaharta.

5. The Act ensured that third-party rights were protected; for example, when Danaharta bought a secured loan from a bank, the ownership of the collateral was not transferred to Danaharta; instead, Danaharta assumed the selling bank's or financial institution's rights as a chargee of the asset, such as land (Bank Negara Malaysia , 2005).

10.9. Annex I – EBA NPL Templates

The EBA NPL Templates comprise two sets of templates:

- "EBA NPL transaction templates", aimed to serve for the financial due diligence and valuation of portfolios.
- "EBA NPL portfolio screening template", designed for the initial screening of portfolios.

  i. The EBA NPL transaction templates are asset class specific and provide data loan by loan, at the most granular level, including information on counterparties related to the loan and the collateral provided. The EBA NPL transaction templates aim at enabling potential bidders to perform a detailed analysis of the assets, commonly performed during the financial due diligence and valuation phase, regarding the NPL portfolio which forms the subject matter of the transaction.

     a. The EBA NPL transaction templates provide data at the most granular level, which includes the following data categories: Portfolio, Counterparty Group, Counterparty, Loan, Historical Collection and Repayment Schedule, External Collection, Forbearance, Property Collateral, Non-Property Collateral, Forbearance, Enforcement and Swap.

     b. In the NPL transactions template, each data field is classified with a level of criticality for the FDD and valuation of the portfolio: "critical", "important" or "moderate" to assist the user with navigating through the high number of data fields and to help ensuring that essential information is provided clearly. "Critical" are the fields which are essential for investors to adequately run their pricing models and to allow a transaction to reach the binding offer stage. "Important" are the fields which are expected to have a material impact on the transaction price of the Portfolio. "Moderate" are the fields which add value to the Portfolio but are not expected to have significant pricing impact in general.

  ii. The EBA NPL portfolio screening template provides information, which is commonly required to perform a market sounding exercise. In this template, stratified data provides a high level view of an NPL portfolio to investors and other third parties potentially involved in transactions. The EBA NPL screening template aims at enabling potential bidders to perform an initial screening, commonly performed during the first phase of an intended NPL transaction. The EBA NPL portfolio screening template includes information on an aggregated level, which is covered by the EBA NPL transaction templates, for example on a loan by loan or collateral by collateral level.

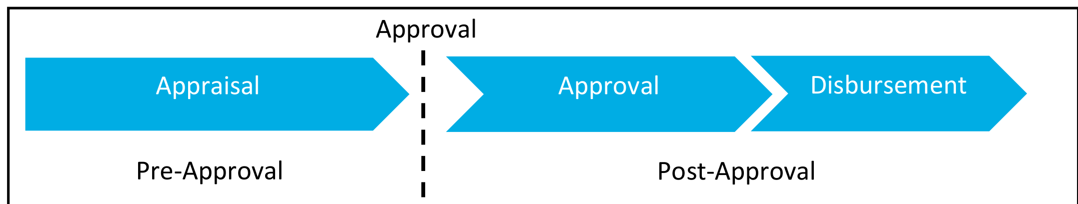
The NPL Transaction Templates & NPL Screening Template are publicly available and can be accessed via the following link:

https://www.eba.europa.eu/risk-analysis-and-data/npls

10.10. Annex J – Credit Approval Cycle Phases

Figure 27 illustrates the three phases of credit approval cycle and further defines each of the three phases in detail below.

FIGURE 27: CREDIT APPROVAL CYCLE



Phase 1: Pre-Approval Appraisal and Assessment

The appraisal stage is generally initiated upon the Relation Management (RM) team (front office) receiving a request for loan from a client. The RMs have the primary responsibility for gathering enough information, corroborating that information, and making objective evaluations about clients to determine if the clients are reputable and involved in lawful business activities, with income and wealth from legal sources. The RM team prepares the credit proposal after completing the preliminary credit assessment and usually sends it to the independent credit risk management team for review.

The credit risk team conducts an independent and impartial evaluation of the loan proposals. A thorough due diligence of the proposals is carried out and the analysis includes a detailed review of borrower's financial position, and considers the external influences like the economy and industry in which the borrower operates in. Credit Officers ensure the limits being sanctioned to the borrower are in line with the need and financial strength of the borrower. The credit analysts also generally ensure that all the terms/conditions and necessary requirements are being met by the borrower. In case of any non-conformity, the same shall be highlighted in the due diligence report and conveyed explicitly to the approving authorities. Once the due diligence and KYC activities are completed by the credit team, the case is forwarded to the credit approving authorities to take the final decision.

Phase 2 - Approval

The credit approving authorities consisting of all the signatories to credit applications ensure that the loan proposals fit with business strategy and credit and risk policies as well as the applicable laws and regulations. The credit approval powers generally rest with the management level credit or risk management committees, except for certain higher risk / large cases which are approved by the board level risk management committee.

Phase 3 - Post Approval (Disbursement)

After the loan is approved by the credit approving authorities and before the amount is disbursed to the borrower, the Credit Administration Department (CAD) plays an important role in ensuring that all documentations are complete and in line with the credit policy of the bank and applicable laws and regulations. CAD may also require for additional information or documents, based on the bank's policies and credit risk of the borrower.

The loan documentation that the CAD ensures can be broken down to different categories depending on the nature of collaterals: such as if the loan is secured against government securities then bank would require power of attorney, latter of guarantee, and letter of encashment, where if the loan is secured against immovable property then valuation certificate, insurance policy, and collateral inspection would be required. Annex D contains detailed documents required under multiple scenarios. Once all the documents are completed and arranged, CAD provides its approval on the disbursement authorization, upon which the branch or business team proceeds with the loan disbursement. CAD also plays a key part in credit risk management by ensuring the loan monitoring reports are prepared on timely basis. Some of the common reports include loan ageing report and classified accounts reports, which are both usually reported monthly to the business team and the management level risk committee.

10.11. Annex K - Salient Features of the Recovery Ordinance

Salient features of the Recovery Ordinance are:

- Summary Procedure: Where a borrower (corporate or non-corporate) or a bank or DFI[78] commits a default in fulfilling any obligation with regard to any finance, the bank or DFI or the borrower , as the case may be, can institute a suit in the special banking Court (the "Banking Court"), or where the claim exceeds one hundred million rupees, in the High Court.[79] A defendant who has been duly served is not entitled to defend the suit unless he files an application for leave to defend within 30 days of the date of first service.[80] The Banking Courts may grant a leave to defend if it is viewed that substantial questions of law or fact have been raised in respect of which evidence needs to be recorded.[81] Where (i) a defendant defaults in filing an application for leave to defend; (ii) the application is rejected; or (iii) a defendant fails to fulfill the conditions attached to the grant of leave to defend, the Banking Court can decree the suit[82] provided that in the case of (i) above, a decree may be set aside by the Banking Court on an application filed by the defendant within 21 days of the date of decree.[83]

  Where leave to defend has been granted in a suit, the suit has to be disposed of within 90 days from the day on which leave was granted, failing which the defendant may be required to furnish security in such amount as the Banking Court may deem fit.[84] If the defendant fails to furnish security when required to do so, the Banking Court is required to pass an interim or final decree in such amount as it deems appropriate.

- Banking Courts:_A Judge of a Banking Court is appointed by the Federal Government after consultation with the Chief Justice of the High Court of the Province in which the Banking Court. The qualification criteria for appointment as a Judge of the Banking court prescribed under the law is prior appointment as a Judge of a High Court or a District Judge.[85]

  The Banking Courts may, at their discretion, seek assistance on technical aspects of banking transactions by an amicus curiae who has at least ten years' experience of banking at a senior management level in a financial institution of repute or the SBP and has a degree in commerce and account, economics, business administration or has completed a course in banking with the Institute of Bankers, Pakistan.[86]

- Availability of Recovery Proceedings under the Recovery Ordinance to Financial Institutions: "financial institution", for the purposes of the Recovery Ordinance, means and includes any company whether incorporated within or outside Pakistan which transacts the business of banking, financing, leasing, investment, unit, mutual or modaraba funds.[87]

  The Banking Court jurisdiction extends to a suit filed by a 'financial institution' for fulfillment of 'obligations' of a 'customer' with regard to any 'finance' provided by the 'financial institution'. On a plain reading of the Recovery Ordinance, a foreign financial institution (such as the IFC) falls within the meaning of 'financial institution';[88] interest based facilities[89] that may be provided will come within the ambit of 'finance';[90] and any of its borrowers in Pakistan will fall within the

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[78] Whilst the right to initiate recovery proceedings under the Recovery Ordinance is available to a variety of financial institutions (including non-banking finance companies, leasing companies etc.), the same falls outside of our scope of work.
[79] Section 9 read with Section 2(b) of the Recovery Ordinance as amended vide the Financial Institutions (Recovery of Finances) Act, 2016.
[80] Section 10 of the Recovery Ordinance.
[81] Section 10(8) of the Recovery Ordinance.
[82] In terms of Sections 10(1) and 10(11) of the Recovery Ordinance, where the borrower defaults in filing an application for leave to defend or the application is rejected or a defendant fails to fulfill the conditions attached to the grant of leave to defend, the allegations of fact in the plaint are to be deemed to be admitted and the Banking Court can, in such a case, decree the suit on the basis thereof. Where the application for leave to defend is rejected or where a defendant fails to fulfill the conditions attached to the grant of leave to defend, the Banking Court is to forthwith proceed to pass judgment and decree in favor of the plaintiff.
[83] Section 12 of the Recovery Ordinance.
[84] Section 13 of the Recovery Ordinance.
[85] Section 5 of the Recovery Ordinance.
[86] Section 5(8) of the Recovery Ordinance.
[87] Section 2 (a) of the Recovery Ordinance.
[88] As defined in section 2(a) of the Recovery Ordinance.
[89] An argument, if any, based on a cursory reading of section 29(2) of the Recovery Ordinance, may be made that interest bearing loans are not included within the meaning of 'finance'. This argument is fallacious for several reasons.
[90] As defined in section 2 (d) of the 2001 Ordinance.

definition of 'customer';[91] and agreements, undertakings, representations, warranties, or covenants that may be made by such borrower, will be covered by the definition of 'obligation'.[92]This means such foreign financial institutions can avail the protections and benefits stated in the Recovery Ordinance. This principle has been upheld in various reported judgements as well.[93]

- Restrictions on dealing with secured property: After the publication of summons pursuant to the institution of a suit for recovery under the Recovery Ordinance, no borrower can, without the prior permission of the Banking Court, transfer or encumber any property on which a security interest has been created in favor of a financial institution and any such transaction shall be void. However, this restriction does not bar the borrower from selling any property which has been retained by him for the purposes of dealing with the same in the ordinary course of business subject to the terms of the security documentation.[94] Further, the Banking Court may, on an application by a bank or DFI, pass an order to prevent such property from being transferred or dealt with in a manner which is likely to prejudice the security in favor of the bank or DFI, attach such property, transfer possession of such property to the bank or DFI or appoint one or more receivers of such property.[95]
- Attachment before judgment and appointment of receiver: In a suit for recovery filed before the Banking Court, banks and DFIs, with a view to prevent secured property from being transferred, alienated, encumbered, wasted or otherwise, may apply to the Banking Court to restrain the borrower from dealing with the property in any manner, attach such property, transfer possession of such property to the bank or DFI, or appoint receivers for such property.[96]
- Interim and Final Decree: A Banking Court may pass an interim decree in respect of that part of the claim which relates to the principal amount and which appears to be payable by the defendant to the plaintiff.[97] The final decree passed by a Banking Court shall provide for payment from the date of default of the amounts found to be payable and for costs including, in the case of a suit filed by a bank or DFI, cost of funds of the bank or DFI as certified by the SBP, for the period from the date of default till realization of the cost of funds.[98] Cost of funds, as the name suggests, is meant only to compensate the bank or DFI for the cost that they had to bear for their stuck up finances.[99] To calculate the cost of funds, SBP issues a certificate of costs of funds specific to each bank or DFI for a specific period after taking into account all the relevant considerations. In practice, cost of funds is generally awarded in the final decree awarded to a bank or DFI. [Subject to confirmation and revision - For all practical purposes, notwithstanding the liquidation damages/indemnity clauses in the security documentation, apart from cost of funds, no other amount is recoverable in Pakistan.
- Execution of Decree: Upon pronouncement of judgment and decree by a Banking Court, the suit automatically stands converted into execution proceedings without the need to file a separate application or fresh notice to be issued to the judgment debtor.[100] We understand, in Sindh the practice is that an application is filed for initiating execution proceedings, albeit not required under the law. As part of the execution stage, sale of movable and immovable property is administered through a Court appointed administrator through public auction under the provisions of the CPC. Separate procedure and modalities have been prescribed with respect to sale of movable and immovable property.

i. Appeal: Any person aggrieved by a judgment, decree, sentence, or final order of a Banking Court may, within thirty days thereof, refer an appeal to the High Court. The appeal is required to be heard by at least two judges. The admission of the appeal is not per se to operate as a stay and no stay is to be granted therein unless the decree holder has been given an opportunity of being heard and unless the appellant deposits in cash with the High Court an amount equivalent to the decretal amount inclusive of costs, or in the case of an appeal other than an appeal against an interim decree, at the discretion of the High Court furnishes security equal in value to such amount.[101]

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[91] As defined in section 2 (c) of the 2001 Ordinance.
[92] As defined in section 2 (e) of the 2001 Ordinance.
[93] International Finance Corporation v. Sarah Textiles Ltd., (2009 CLD 761 (Lahore)).
[94] Section 23 of the Recovery Ordinance.
[95] Section 16(1) of the Recovery Ordinance.
[96] Section 16(1) of the Recovery Ordinance.
[97] Section 11 of the Recovery Ordinance.
[98] Sections 3 and 17 of the Recovery Ordinance.
[99] Habib Bank Limited vs. Karachi Pipe Mills Limited (2006 CLD 842 at 849).
[100] Section 19(1) of the Recovery Ordinance.
[101] Section 21 of the Recovery Ordinance.

10.12. Annex L – Foreclosure Process

Briefly, a foreclosure procedure entails:

- Upon default, bank or DFI shall get the outstanding mortgage money determined by a chartered account firm that neither is nor has been a statutory auditor of the bank or DFI or the mortgagor in the last three years.[102]
- After seven days of due notice to the parties, the chartered accountant firm shall examine the accounts and determine the mortgagor's total liability including cost of funds and within thirty business days of appointment submit its report to the bank or DFI.[103]
- The bank or DFI thereafter shall serve a notice to the defaulter to satisfy the outstanding payment not exceeding the amount determined by the chartered accountant firm as above within fourteen days.[104]
- Upon failure to the aforementioned, a second notice to be sent on similar terms.[105]
- Upon failure to satisfy the second notice, a final notice demanding payment within thirty days shall be sent to the mortgagor.[106]
- If the mortgagor fails to complete the payments in the time stipulated above, the bank or DFI shall initiate sale of mortgaged property through public auction, through the following procedure:[107]
  a) the bank or DFI shall have the property evaluated by three reputable valuation company listed on the panel of PBA within seven business days after the expiry of thirty days period of final notice issued to the mortgagor;[108]
  b) issue a public notice in daily newspapers, which include:(a) particulars of the property; (b)details of the borrower; (c) outstanding amount; (d) any encumbrances; (e) reserve price (this will be determined by the valuation company and the property cannot be sold for less than this amount); and (f) time and place of the auction;
  c) within 15 days of the aforementioned publication, the public auction shall be held;[109]
  d) in case there is more than one bidder with competitive offers, the highest bidder shall be successful;[110]
  e) if on the bidding date only one bidder with offer equal to or more than the reserve price comes forward, the property may be sold to such bidder;[111]
  f) on acceptance of bid by the bank or DFI, the successful bidder shall submit 25 percent of the bid amount within two business days of auction whereas the rest of the amount shall be deposited within 15 days from the date of the initial deposit;[112]
  g) in case no bid is received, the auction shall be cancelled and the entire exercise shall be repeated provided that where no bid is received in three auctions, the financial institution may purchase the mortgage property at a price 10 percent higher than the reserve price.[113]
- The bank or DFI can participate in the auction, however, it may only be able to buy the property for an amount 10 percent higher than the highest bid. If within three business days, the mortgagor can match the bank's or DFI's bid, the borrower shall be allowed to purchase the property.[114]

[102] Rule 3(a) of the Recovery Rules.
[103] Rule 3(b) of the Recovery Rules.
[104] Section 15(1) of the Recovery Ordinance.
[105] Section 15(1) of the Recovery Ordinance.
[106] Section 15(1) of the Recovery Ordinance.
[107] Section 15(4) of the Recovery Ordinance.
[108] Rule 3(b) of the Recovery Rules.
[109] Rule 3(c) of the Recovery Rules.
[110] Rule 3(c) of the Recovery Rules.
[111] Rule 3(c) of the Recovery Rules.
[112] Rule 3(c) of the Financial Institutions (Recovery of Finances) Rules, 2018.
[113] Rule 3(b) of the Financial Institutions (Recovery of Finances) Rules, 2018.
[114] Section 15(6) of the Recovery Ordinance.

- If the mortgagor does not give voluntary possession of the property, the Banking Court shall put the Bank/DFI (or the purchaser), in possession of the same. However, in case of bona fide lease, the Banking Court shall not order eviction until expiry of such lease.[115]
- For purposes of executing and registration of sale deed, bank or DFI shall be deemed to be the duly authorized attorney.[116] Upon consummation of the sale of mortgaged property, any surplus left, after paying in full all the dues of the mortgagees, shall be paid to the mortgagor.[117] Thereafter, proper accounts of the sale proceeds shall be filed by the mortgagee in the Banking Court within 14 days of the sale.**[118]**
- Disbursement

Judicial pronouncements on disbursement are at variance. On one hand the judgments in *Habib Bank Ltd vs. Taj Textile Mills Ltd*[119] and in *Muhammad Arshad and another vs. Citibank N.A.*[120] ("Citibank Case") respect the sanctity of the commercial bargain between the borrower and the conventional bank under the restructuring arrangement and seem to support the proposition that disbursement under the fresh mark-up agreement is not necessary.

On the other hand, there is case law[121] pursuant to which conventional banks will be denied recovery for lack of actual disbursement of funds under the fresh mark-up agreement. Without actual disbursement, the fresh mark-up agreement has been held "to be without consideration and void".[122] Even where conventional banks make actual disbursements under the fresh mark-up agreement subsequently used to settle earlier loans, recovery under the fresh mark-up agreement may not be permitted according to a body of judicial opinion.[123]

- Mark-up on mark-up

Mark-up on mark-up was first made unlawful vide Mark-up Circulars and reaffirmed by subsequent notifications and circulars[124] issued by SBP from time to time as well various judgments of the Pakistan courts[125] that establish that charging additional mark-up is illegal and un-Islamic. Following these judgments conventional banks can only restructure loans if they do not charge additional mark-up under the fresh mark-up agreement.

Having said so, the courts have in several instances adopted a lenient and flexible approach in enforcing the principle prohibiting mark-up on mark-up. There have been cases where: (a) mark-up on mark-up was literally interpreted to allow additional mark-up as long as it was charged only on the outstanding principal amount of the original finance facility and not on the mark-up element;[126] and (b) additional mark-up was allowed on the sale price or principal amount (principal plus mark-up under the original loan) under the fresh mark-up

[115] Section 15(7) of the Recovery Ordinance.
[116] Section 15(8) of the Recovery Ordinance.
[117] Section 15(9) of the Recovery Ordinance.
[118] Section 15(11) of the Recovery Ordinance.
[119] 2009 CLD 1143 [Lahore].
[120] 2006 CLD 1011 [Supreme Court].
[121] See Mushtaq Ahmed Vohra vs. Crescent Investment Bank Limited, 2005 CLD 444 [Karachi]; UBL vs. Ch. Ghulam Hussain 1998 CLC 816 [Lahore]; Habib Bank vs. M/s. Qayyum Spinning Ltd., 2001 MLD 1351 [Karachi]; United Bank Limited vs. M/s. Gravure Packaging (Pvt.) Limited, 2001 YLR 1549.
[122] Mushtaq Ahmed Vohra vs. Crescent Investment Bank Limited, 2005 CLD 444 [Karachi] decided on 15th June, 2004at page 451.
[123] Qamaruzaaman Khan vs. Industrial Development Bank of Pakistan and others, 2009 CLD 460 [Karachi]; Habib Bank vs. Qayyum Spinning Ltd. MLD 2001 Kar. 1351.
[124] Circulars subsequent to Circular 13 and 32, namely BCD Circular No. 27 dated 12.11.1984, BCD Circular No. 37 dated 10.12.1984, BCD Circular No. 23 dated 25.5.1985 and BCD Circular No.4 dated 30.6.1988 further provide that mark- up cannot be charged on 'marked-up price' and that Banks/DFIs should ensure 'that instructions governing elimination of "Riba" from banking are strictly observed both in letter and spirit'. Additionally, SBP by way of BPD Circular No. 24 and BPD Circular No. 37 also set up a committee for resolution of disputes between borrowers and the banks where mark-up on mark-up was allegedly charged by the banks 'in violation of guidelines issued by SBP for elimination of "riba" from banking system'.
[125] Habib Bank vs. M/s. Qayyum Spinning Ltd and United Bank Limited vs. M/s. Gravure Packaging (Pvt.) Limited 2001 YLR 1549 which have placed reliance on Federal Shariat Court (FSC) and Shariat Appellate Bench of Supreme Court judgments in Dr. Mehmoodur Rehman Faisal and others v. The Secretary Ministry of Law, Justice & Parliamentary Affairs, Government of Pakistan PLD 1992 FSC 1 and Dr. M. Aslam Khaki v Syed Muhammad HashimPLD 2000 SC 225.
[126] Habib Bank Ltd. vs. Taj Textile Mills Ltd 2009 CLD 1143 [Lahore]: It is doubtful whether the approach adopted by the Court in Habib Bank Ltd (2009) is consistent with SBP Circulars. SBP Circulars issued subsequent to Circulars 13 and 32 prohibited charging mark –up on "marked-up price", which suggests that a literal interpretation of charging mark-up on mark-up, as adopted by the Court in Habib Bank case is contrary to law. Mark-up, as per SBP Circulars, cannot be charged on marked up price, i.e. total outstanding balance (principal plus mark-up) under the original finance facility.

agreement.[127] It is emphasized that in the Citibank Case, the Supreme Court did not directly discuss the issue of mark-up on mark-up; however, it did permit recovery of additional mark-up under the fresh mark-up agreement.[128]

There is, as such, uncertainty created on aspects of debt rescheduling (as discussed above) resulting from inconsistent and confusing judicial pronouncements. Notwithstanding these, based on market practice, loans are being rescheduled on the basis of fresh mark-up agreements.

[127] Saudi Pak Commercial Bank Ltd. vs. Qazi Ehtishamul Haq and another, 2008 CLD 566 [Karachi]; Investment Corporation of Pakistan vs. Sheikhupura Textile Mills Ltd. 2004 CLD 1396 [Karachi]; and Yousuf Hardware Industries and others vs. UBL, Spl. HCAs No. 186 & 187 of 1998 [Karachi] (Unreported Judgment).

[128] Observations of the Banking Court, Lahore Appellate Bench of the High Court and the Supreme Court read together suggest that the outstanding liability (principal plus mark-up) under the original finance agreement, amounting to Rs, 1,297,000/-, formed the principal amount under the restructuring/renewal agreement dated 26-06-1999. Additional mark-up was then charged under the restructuring/renewal agreement resulting in the marked up price of Rs. 2,105,280/- as mentioned therein. It is therefore, arguable that the Supreme Court by allowing recovery by the Bank of Rs. 1,795,176/-, by necessary implication, allowed charging mark-up on marked- up price. Having said so, the discussion on the merits of this argument is beyond the scope of this article.

10.13. Annex M – Examples of Creditors' Schemes of Arrangement

A few case examples where a Scheme may successfully be affected (along with questions of law raised and principles developed by the High Court) are:

- (Gulshan Weaving Mills Limited & others v. Al Baraka Bank (Pakistan) Limited and 8 others (2018 CLD 389)):

  The company and its secured creditors had filed a Scheme before the Court for the repayment of the existing liabilities of the company by sale of all its fixed assets by and under the supervision of an asset sale committee consisting of four members amongst the secured creditors.

  In this case the issue of whether the consent of the shareholders was required even though the Scheme did not target the shareholders was considered. The High Court held that it is not always necessary to call meeting of such class of person to which Scheme is not targeted. However, where Scheme proposed between one set of stakeholders also affects or varies rights and interest of any other set of stakeholder, then it is necessary to call meetings of affected class of person and seek approval of proposed Scheme from such class of stakeholders as well. If such course is not adopted and the affected class is neglected, then also the sponsors of the Scheme of arrangement may fail to secure the approval of the High Court.

- Paramount Spinning Mills Limited v. Bank of Punjab (2019 SHC 420):

  The company and certain secured creditors had filed a Scheme for repayment by the company through sale of its assets to the secured creditors of the outstanding amounts due to the secured creditors, or a portion thereof.

  The secured creditors had already filed suits of recovery for finance under the Recovery Ordinance against the company and the company had also filed various cases against its creditors, both of which were pending. The company and the secured creditors had then reached an agreement and a Scheme was accordingly filed. More than 75 percent in value of the secured creditors had consented to the Scheme and although consent had not been obtained from two secured creditors (one was absent and the other had opposed the Scheme), the Court held that since the statutory threshold had been complied with, the Scheme was sanctioned.

- Saudi Pak Industrial & Agricultural Investment Company Limited v. Chenab Limited (2019 LHC 3938):

  The Lahore High Court considered the application of the secured creditors of the company (who had earlier filed for the winding-up of the company). The secured creditors sought the permission of the High Court to allow the company to take steps for rehabilitation of certain units of the company, which was allowed subject to certain directions such as submitting monthly financial statements of the company.

- Messrs Consolidated Exports Ltd. v. Messrs Dyer Textile and Printing Mills Limited (PLD 1984 Karachi 541)

  The High Court of Sindh, whilst allowing the Scheme, held that:

  > "*19. I also find it in the public interest if the winding up proceedings are, stayed to allow the respondents an opportunity to run their textile mills as this course would not only benefit the economy of the country but would also provide employment to a large number of workmen. It will not be out of place to mention that the Government has financially supported the sick textile mills under its various schemes. I was informed at the bar that respondents Mills was the largest textile Mill before its closure in the private sector, having 1,612 workers out of which 1,264 workers have filed the claims and would be benefited by the present scheme*."

10.14. Annex N – CIRC

The relevant laws governing the CIRC included the Corporate and Industrial Restructuring Corporation Ordinance, 2000 (Ordinance) and the Corporate and Industrial Restructuring Corporation Rules, 2001 (CIRC Rules). Salient features of the CIRC Laws are:

Scope of CIRC functions/powers In 2000, the CIRC was set up with the mandate to acquire, restructure, rehabilitate, manage, dispose, and realize non-performing loans and other assets of specified banks and financial institutions (such as United Bank Limited, National Bank of Pakistan, National Development Finance Corporation, Industrial Development Bank of Pakistan and Agriculture Development Bank of Pakistan (now Zarai Taraqiati Bank Limited) – which were all, at the time, owned/controlled by the Federal Government).[129]

The scope of CIRC functions was, however, not only limited to restructuring of NPLs of these banks and DFIs.

The Ordinance refers to distressed borrowers as "Obligors" which are defined in Section 2 (o) as

> *"(o) "obligor" means any individual, proprietorship concern, company or other body corporate, trust, partnership or other entity that has, with respect to a non-performing asset, a contractual or legal obligation or duty to make payment, effect performance, provide security, or collateral with respect to any financial asset whether as principal, surety, guarantor or otherwise and whether such obligation is primary, secondary, matured or contingent;"*

Several provisions exist within the Ordinance which allow the CIRC to rehabilitate distressed borrowers/obligors in addition to restructuring of NPLs of the scheduled banks/DFIs.

The CIRC was empowered to take several actions to rehabilitate distressed borrowers as stipulated in Section 18 of the Ordinance, few relevant provisions include:

Section 18 (b) (d) in Chapter III (Powers and Functions of the Corporation) states:

> *(b) to acquire, purchase, manage, restructure, rehabilitate, sell and dispose of any **obligor being a corporation or a company**;*
>
> *(d) to purchase, take over, own, hold, sell, lease, and otherwise dispose of, re-organize, restructure, rehabilitate and otherwise enter into any settlement or contract, realize, pledge, mortgage, hypothecate, control, manage, and arrange finance for any asset, property, undertaking, collateral or security underlying or relating to or securing any financial asset or instrument, including any intellectual property, trade mark, equity, financial interest, legal and contractual right, asset, guarantee and other **undertaking** ;*

Moreover, the Chief Executive of the of the CIRC was empowered as per Sections 8 (3) (a) to,

> *"to deal with, negotiate, enter into and sign agreements and contracts with any **obligor** or financial institution in respect of the non-performing assets or related collateral and to take any and all actions, in any manner to advance the business of the Corporation as specified in section 18"*

And as per Section 8 (3) (b) to,

> *"to deal with, negotiate, enter into and sign agreements and contracts with any **obligor** or financial institution in respect of the non-performing assets or related collateral and to take any and all actions, in any manner to advance the business of the Corporation as specified in section 18;"*

The Ordinance further provides rights and remedies to the CIRC for the for the rehabilitation, management and restructuring of the obligor in Section 23. According to Section 23 (a) (b) and (c):

> "(a) *the Corporation may request the Commission as provided in section 295 of the Companies Ordinance, 1984 (XLVII of 1984)* (Management by Advisor) *to take action under section 295 of the said Ordinance if it is of the opinion that the condition of the obligor warrants such action. The Commission may in pursuance of the said section and after complying with its requirements and giving the obligor an opportunity to be head, appoint the Chief Executive or his nominee as an Administrator, hereinafter referred to as the Administrator, to manage the affairs of the obligor;*
>
> *(b) (all the provisions of section 295 of the Companies Ordinance, 1984 (XLVII of 1984) shall*

[129] Section 2(1) and Section 20 read with Schedule to the Corporate Industrial Restructuring Corporation Ordinance, 2000.

apply, as far as possible, to the functioning of the Administrator as stated herein; and

(c) *the Corporation shall be entitled to apply to the Commission to avail the benefits of section 296 of the Companies Ordinance, 1984 (XLVII of 1984)"*

Acquisition of NPLs by CIRC

Section 21 of the Ordinance, as reproduced below allows the CIRC to pay financial institutions by "mutual agreement" which are governed by the Rules.

> *"21. Consideration for transfer of non-performing assets. The Corporation shall pay to the concerned financial institution the outstanding amount as consideration for the transfer of non-performing assets by mutual agreement upon such terms and conditions and in such manner as may be prescribed by rules to be notified in the official Gazette."*

Rule 15 of the Rules states:

> *"15. Transfer letter.- Upon the final recommendations and findings by the Governor State Bank based on the findings, report and the recommendations of the Verification Committee or in accordance with the provisions of sub-section (14) of Section 10 of the Ordinance, the Corporation shall issue to the financial institution a transfer letter for the transfer to the Corporation of the non-performing assets that are on the books of the financial institution whether such non-performing assets are held by the financial institution along or jointly with other institution or institutions as of a date specified in the transfer letter. The form of the transfer letter shall, as nearly as possible, he as set out in Appendix III.* (Transfer and Assignment Agreement)*"*

The acquisition of NPLs as per Rule 15 read with Section 21 of the Ordinance is done contractually, that is, by virtue of a Transfer and Assignment Agreement as provided in Appendix III of the Rules. However, it is important to keep in mind that the process of the transferring the NPLs is initiated per Rule 13 of the Rules, according to which the CIRC is to issue a selection letter (as set out in Appendix II of the Rules) to a financial institution informing it of its selection in the CIRC's asset rehabilitation program.

A summary of select case laws relating to CIRC Laws is in Table 34.

TABLE 34: CASE LAWS RELATING TO CIRC LAWS

S No.	Citation	Case Summary
1.	2007 CLD 1555 SHC (*East Yarn Trading Company v. United Bank Limited*)	• The grievances of the appellant were against sale of mortgaged properties on nominal sale consideration as opposed to two offers made before the SHC but did not entail any aspect of collusive, mala fide or illegal acts committed during sale process. • The Court held that the order in favor of CIRC was not against the law particularly when the sale proceeds were much higher level than the offers that had been received by nazirs of the court. • Other grievances of the appellants regarding procedural irregularities were dismissed on factual grounds.
2.	2005 CLD 422 SHC (*National Bank of Pakistan v. Pakasco Limited*)	• CIRC had offered a scheme of amicable settlement of non-performing assets in line with SBP Circular No. 29 of 2002 ("Circular") which contemplated payment of 10 percent of settled upon by borrower upon signing of settlement agreement with the remaining being paid off in quarterly instalments. • CIRC extended a similar offer towards judgment debtors on similar terms but later reneged and instead of accepting repayment in installments demanded a lump sum payment.

S No.	Citation	Case Summary
		• Albeit CIRC was neither a banking company nor a FI, the Court held that CIRC had extended the offer through a device common in commercial transactions — 'incorporation by reference' and therefore the terms of the Circular were binding on CIRC.
3.	*2005 CLD 169 (PQ Chemicals v. AW Brothers)*	• Case concerned sale through auction of two properties. Both properties were taken over as non-performing asset by CIRC and then subsequently advertised for sale by CIRC. Appellant contested that the sale in question required two separate bids for each of the two properties and that it had presented the highest bid for one of the two properties. Respondent no. 01 who had offered a consolidated bid for two properties (contrary to requirement of advertisement) had subsequently raised its bid and the sale was approved by single judge without notice to the appellant or any other bidder. This was tantamount to a material irregularity and hence the appellant sought the sale to be set aside. • The Court following examination of arguments ruled that sale through private negotiations was not precluded where it was reasonable to do so and interested parties had been notified. • When notice is claimed merely upon the principles of natural justice, the irregularity can always be rectified at the appellate or revisional stage. Upon examination that whether the offer of Respondent no. 01 could be matched, the appellant had repeatedly stated that it was only interested in one of the two properties and not both. Therefore, the Court went on to rule that under such circumstances it would have been extremely unconscionable to allow appeal particularly when less than one tenth of amount offered by Respondent no. 01 would have been recovered and a public agency (CIRC) would be required to bear additional expense of preserving and maintaining the non-performing asset. • It was argued by the Appellant that issuance of public notice on behalf of CIRC indicated that the right to recover stood transferred to CIRC and therefore the Recovery Ordinance was not applicable. Rationale for such an argument was that per section 19 of the Ordinance, CIRC would not be deemed as a banking company. This argument however stood rebutted on the basis that under section 32 of Ordinance in respect of any non-performing asset, the CIRC shall be entitled to exercise all rights and remedies available under laws relating to banking and company laws.

10.15. Annex O – List of Debt Collection Companies

A non-exhaustive list of debt collection agencies (based on web searches) operating in Pakistan is in Table 35. These companies offer debt collection, recovery, asset re-possession and similar services for consumer loans.

TABLE 35: LIST OF DEBT COLLECTION AGENCIES IN PAKISTAN

S.no	Debt Recovery/Collection Servicers	Official Website
1	ALAMS Recovery Services (Pvt) Ltd	https://alamsrecovery.com/
2	Evaluation Grid	https://evaluationgrid.co/
3	FSL Debt Recovery (Pvt) Ltd	https://fslprivate.com/Debt-Recovery.html
4	Hamza and Hamza Law Associates	https://hamzaandhamza.com/debt-recovery-services/
5	ICIL Pakistan	https://www.icilpk.com/debt-collection-services.html
6	PK Legal and Associates	https://pklegal.org/legal-services-related-to-debt-recovery-cases-in-pakistani-courts/
7	Solution Seekers Pakistan	http://solutionseekerspakistan.com/
8	Tamweel Solutions	http://www.tamweelsolutions.com/
9	Zafar and Associates LLP	https://zallp.com/practice/debt_recovery/
10	24 Justice	https://24justice.pk/debt-recovery-in-pakistan/

10.16. Annex P - Project Scope & Methodology

The key areas of focus of NPL Diagnostic Assessment Report are:

- Review of market conditions to identify key gaps in the legal and regulatory and operating environment which will include bottlenecks related to the infrastructure for debt servicing, debt enforcement, out-of-court workouts (OCW), debt recovery and restructuring, debtor restructuring and recapitalization, court insolvency resolutions. It also assessed the state of the primary market for NPL resolution, impediments to scaling the primary market for NPL resolution and to creating a secondary market for NPLs, including addressing gaps in commercial, financial, regulatory, legal, judicial, extra-judicial, supervisory, prudential, macro prudential, tax and accounting frameworks and any incentives for stakeholders. Review of NPL sale by law and practice, NPL resolution by law and practice, and the frameworks and existing legislation relating to NPL Investment.
- A market assessment and scoping of private and public stakeholders/investors, identifying what limits them from investments in the sector and asset class in the current legal environment, and defining and developing potential NPL transaction structures to execute a transaction for NPL market creation.
- Recommendations on key reforms, solutions and capacity building that could facilitate market entry for NPL investors.

Scope & Objectives

The purpose of this NPL Market Assessment Diagnostic Report is to analyze and review various aspects of the non-performing loans (NPL) market to identify bottlenecks and practical areas that could be addressed in the short and medium term to create a market for NPLs in Pakistan. In doing so, the following areas have been reviewed:

1. Legal and Regulatory Assessment: Review of the existing legal, regulatory, and procedural impediments in Pakistan related to the NPLs. Review the court system, relevant laws, legal processes and options available to regulated banks, regulated debt recovery or collection entities, and other non-regulated NPL servicers to recover or restructure debt claims. Review the legislation including basic banking laws to understand the existing provisions applicable to the setting-up of NPL servicers and AMCs in Pakistan. Identifying legal obstacles, problems in creation of secondary market for NPLs. Provide recommendations to facilitate market conditions for NPL investors.

2. Tax Treatment of NPLs: Review of tax treatment of NPLs in law and in practice requirements for allowing deductibility of losses when making provisions or recognizing write offs, analysis of loan loss provisions and write offs, mandatory write offs. Tax treatment of the sale of NPLs below net book value. Tax treatment, including deductibility, of losses incurred by FIs in NPL related transactions.

3. Accounting and Prudential Treatment: Identify, review, and analyse impediments related to the supervisory regime, accounting, and prudential treatment of NPL recognition and management by FIs. Reviewing the Prudential requirements as to the accounting treatment of NPL related transactions. Assessment of NPL reporting framework, alignment with accounting standards and other global regulations. Reviewing the financial limits pertaining to NPL and analyse credit information and credit risk management frameworks and resolution policies, procedures, and practices of financial institutions.

4. Collateral Valuation: Review and analysis of collateral valuation framework for NPLs and under what conditions are banks required to use licensed external evaluators. Review of the valuation methods being used as well as those allowed by the regulator. Evaluation of price gap between bank collateral valuation and market value. Scoping out local property developers/operators well-versed in property completion, rehabilitation, and repositioning.

5. NPL Servicing Infrastructure and AMCs: Analysis of licensing requirements and appointment of NPL Servicers to conduct NPL Servicing on behalf of banks and non-bank entities. Review of data availability, information technology and cultural impediments to NPL Servicing by bank and non-bank NPL Servicers. Review the regulatory obstacles to licensing and operations for private and public AMC and highlighting any restriction on ownership of NPLs depending on type of purchasers' entity.

6. NPL Resolution Models and Market Analysis: Review of the prevailing market conditions and operating environment of primary and secondary markets of NPL. A mapping of stakeholders involved in NPL ownership, management, and oversight. Present NPL sectoral distributions, volumes, and trends across various

financial institutions. Identify optimal legal transaction models for NPL transactions, for both domestic and foreign investors. Evaluate existing corporate restructuring companies and providing recommendations to improve the investment climate for NPL investors, purchasers, and servicers.

Methodology

To prepare this NPL Diagnostic Study Report. The following methodology was followed:

1. Project Kick-Off Phase

- Introducing the EYFR project team to the IFC team
- Further refining and reinforcing the key objectives/ outcomes of the project
- Agreeing communication and escalation protocols between EYFR and IFC team.
- Identifying and designating points of contact.
- Outlining the operating model of how the project will be delivered.
- Agreeing the detailed timelines, protocols for approvals, work-, and milestones.

2. Inception Phase

We followed a top-down approach and developed a Level 1 (high level) outline of the NPL Diagnostic Assessment Report based on the objectives of the project provided in the ToRs. Level 1 outline lays out the key parameters of the study and key questions to be asked during the research to be conducted. The level 1 outline is mapped with the research questions given in the Scope of Work from items 1 to 6 in ToRs.

- Working with the project team to prepare a more detailed Level 2 (detailed) outline. Level 2 outline expands on the level 1 outline goes in greater depth to lay out details of the parameters of the study.
- Prepared a list of well-known credible potential list of stakeholder and sources of information and mapped with Level 1 outline prepared. These sources comprise:
    a) The World Bank / IFC /ADB and IMF reports
    b) Regulatory bodies such as the State Bank of Pakistan, SECP and other laws/ statutes
    c) EY's internal knowledgebase regarding NPLs markets and similar subjects.
    d) Information published by the Government such as through Economic Survey or the Bureau of Statistics.
- A list of external stakeholders, such as personnel in banking or regulatory space was prepared who would need to be interviewed to augment the research performed, validate the suggestions laid out or to understand the information that is not publicly available.
- A proposed list of benchmark countries or models was presented in the Inception Report with the reasons for selection.
- Prepared a resource plan assigning the report outline (level 2) with potential information sources to the concerned team members.
- Finalization of the Inception Report including the Report Outline

3. Information Collection and Analysis

On completion of inception phase, the information collection and desk-research were performed to understand and document the current state of affairs, identify and highlight the challenges being faced, and suggesting key recommendation (across all areas of study) to address the key challenges. This phase comprises the following three steps:

Step 1: The information sources finalized during the Inception phase have been reviewed and studied. Knowledge and data obtained is drawn and mapped against the level 2 outline prepared. The research material

and sources may be expanded if required. The as-is situation key challenges and recommendations are identified and documented.

With respect to the legal and regulatory assessment, following tasks have been specifically performed:

- Preparing a list of laws relevant for the purposes of preparing and submitting the deliverables
- Researching the relevant laws pertaining to NPLs, recovery and/or restructuring of loans
- Researching the various circulars/notifications issued by the State Bank of Pakistan in connection with NPLS (including but not limited to BPD Circular No. 29 of 2002 and the Prudential Regulations), recovery and/or restructuring of loans
- Researching the relevant laws relating to securitization issued by the State Bank of Pakistan and the Securities and Exchange Commission of Pakistan
- Researching the relevant case laws pertaining to recovery and/or restructuring of loans and sale and purchase of loans
- Reviewing the relevant laws pertaining to NPLs, recovery and/or restructuring of loans, including but not limited to the Banking Companies Ordinance, 1962, the Corporate Restructuring Companies Act, 2016, the Financial Institutions (Recovery of Finances) Ordinance, 2001, the Companies Act, 2017, the Financial Institutions (Secured Transactions) Act, 2016 and the rules issued thereunder, the Contract Act, 1872, the Transfer of Property Act, 1882, the Registration Act, 1908
- Preparing a general overview of the legal framework for the NPL market including legal treatment of NPLs, recovery proceedings (including court and out-of court workout), securitization and restructuring of NPLs, including sale and purchase of loans, establishing and regulating NPL Servicers and AMCs (if any) and the role of PCRCL
- Allocating resources and preparing responses to any questionnaires provided by IFC-WBG Team
- Preparing responses to specific questions raised in the TORs (such as Can an outstanding loan or security interest be assigned without consent and notification which is under litigation or otherwise? Does the transfer of mortgage or collateral require consent from or notification to the borrower? Does the securitization law allow the sale of NPLs (and the underlying secured collateral) at any stage)?
- Identifying the bottleneck and legal remedies available to financial institutions for recovery of NPLs and identifying legal obstacles in relation to creation of secondary market for NPLs.

Step 2: Study of global models (as listed in the Inception phase) will be performed. The first step will be to draw a framework to be used for the study of global models. This framework includes the key parameters to study and key questions to ask during the research of every global model to be studied.

Step 3: As necessary, working group / stakeholder session have been performed to discuss the findings of the research performed. We consider stakeholders will comprise participants from (i) the banking (and financial services) industry, (ii) State Bank of Pakistan (being the regulator), (iii) Securities and Exchange Commission of Pakistan (being the regulator of Non-Banking Financial Institutes/Companies, having an overlapping role with SBP), (iv) Litigations lawyers, (v) Potential investors and (vi) Experts and members from appropriate government bodies. During the stakeholder sessions, the objective has been primarily to discuss the challenges and recommendations identified during the above two steps.

10.17. Annex Q – COVID Relief measures adopted by SBP

SBP vide its BPRD circular letter No. 13 of 2020, has provided regulatory relief to dampen the effects of COVID-19 and allowed banks to offer deferral of principal component of instalments to its borrowers for one year, provided that the borrower will continue to service the mark-up amount as per agreed terms & conditions. The specific relief measures for corporate and consumer loans are:

For Corporate/ Commercial Banking

i. At the request of obligor received before 30 June 2020, banks or DFIs will defer repayment of principal loan amount by 1 year and will convey their decision to an obligor within 15 working days of the written request. In case of declination of request, banks or DFIs are to record reasons and send it to obligor and send a copy to Director, Offsite Supervision and Enforcement Department (OSED), SBP. Banks are to weekly submit deferments details to Director, OSED. Deferment will not affect the credit history of the obligor and will not be reported in the Credit Information Bureau ["CIB"] as restructuring.

ii. Deferment of financing facilities exceeding one year, may be rescheduled at the request of obligor. If the rescheduling is done within 180 days of the loans being past due, such financing facilities be treated as regular and reported in the e-CIB.

iii. Unless the payment obligations are past due by 180 days, banks or DFIs shall not classify financing facilities of obligors which have requested for rescheduling / restructuring. If the rescheduling / restructuring is not executed within 180 days, such financing facilities to be classified as "Doubtful".

iv. Treatment of accrued mark-up income of regular financing facilities which have been rescheduled / restructured more than once, shall not be applicable on financing facilities in bullet point 1 and 2 above.

For Consumer Financing Facilities

i. At the request of borrower received by 30th June 2020, the payment of principal instalments may be deferred for one year at no fee or increase in mark-up rate, for instance if a borrower continues to pay mark-up on agreed terms & conditions.

ii. Decision on request is to be made within 15 working days from the receipt of request. In case of refusal, decision should be supported by reason for refusal.

iii. Banks and DFIs to report weekly to SBP details of deferments granted by them to their borrowers.

iv. In case borrower is unable to pay mark-up or need deferment exceeding one year, financing facilities, upon request, may be rescheduled or restructured.

v. If the rescheduling / restructuring done within 180 days of loans being past due, such financing facilities:

   a) continued to be treated as regular

   b) not to affect the credit history of the borrower

   c) not be reported in the ECIB / private credit Bureau as restructuring

vi. The financing facilities not to be (adversely) classified unless payment obligations are past due by 180 days. In case of being 180 days past due, such financing facilities will be classified under the instructions of prudential regulations of consumer financing.

vii. Certain restrictions on rescheduling/ restructuring will not be applicable on Consumer Financing loan, which is rescheduled / restructured before March 31, 2021.

viii. The aforesaid instructions, except for the bullet points 1,2 and 3 shall stand expired on 31 March 2021 and will not be applicable on the non-performing loans as on 31 December, 2019.

10.18. Annex R – EBA disclosure on NPLs and Forborne Exposures

These guidelines require the following disclosures from all banks on account of NPLs and Forborne Exposures:

- 'Credit quality of forborne exposures', in which banks are required to disclose the gross carrying amount, broken down by exposure class, of FBEs, the related accumulated impairment, provisions, changes in fair value, and the collateral and financial guarantees received, and to explain the drivers of any significant changes over the time.
- 'Credit quality of performing and non-performing exposures by past due days', in which banks are required to disclose the gross carrying amount, broken down by exposure class, of performing and non-performing exposures, including a further breakdown of past-due exposures by the number of days that they have been past due. Credit institutions are also required to explain the drivers of any significant changes across the time periods.
- 'Performing and non-performing exposures and related provisions', in which banks are required to disclose information on the gross carrying amount of impairments, provisions, accumulated changes in fair value due to credit risk, accumulated partial write offs, and collateral and financial guarantees received – for both performing and non-performing exposures – with a breakdown by exposure class. Further details are requested on the stage of the exposures for banks governed by International Financial Reporting Standards (IFRS).
- Collateral obtained by taking possession and execution processes, in which banks are required to disclose information on the instruments and value of the collateral obtained by taking possession.

  In addition to the above, these guidelines require the following further disclosures from (significant) banks with more than 5 percent Gross NPL Ratio on account of NPLs and Forborne Exposures:

  - 'Quality of forbearance', in which banks are required to disclose the number of times that an exposure has been forborne and provide information about the non-performing FBEs that have failed to meet the nonperforming exit criteria.
  - 'Quality of non-performing exposures by geography', in which banks are required to disclose the gross carrying amount of performing and non-performing exposures and the related accumulated impairment, provisions and accumulated change in fair value due to credit risk by or country.
  - 'Credit quality of loans and advances by industry', in which banks are required to disclose the gross carrying amount of loans and advances to non-financial corporations and the related accumulated impairment and accumulated change in fair value due to credit risk by industry/sector of activity of the counterparty.
  - 'Collateral valuation – loans and advances', in which banks are required to disclose information on the gross carrying amount of loans and advances collateralized, the related accumulated impairment, and the value of the collateral/financial guarantees received and the partial write offs for these exposures. All this information is to be broken down by past-due bucket. In addition, further detailed information is to be provided broken down by loan-to-value bucket.
  - Changes in the stock of non-performing loans and advances', in which banks are required to disclose information on the movements of the gross carrying amount of NPLs and advances during the period, with specific details on the net cumulative recoveries related to these changes.
  - 'Collateral obtained by taking possession and execution processes – vintage breakdown', in which banks are required to disclose information on the value and the related impairment of assets cancelled in exchange for the collateral obtained by taking possession, on the value and the related impairment of the collateral obtained, and on the vintage of the foreclosed assets.

In addition to the above, the ECB has stated the following supervisory expectations with respect to reporting and disclosures of NPLs and Forborne Exposures through its Guidance for Banks on NPLs issued in 2017.

- NPL Strategy: High NPL banks are required to report their NPL strategy to their Joint Supervisory Teams (JSTs) in the first quarter of each calendar year. To facilitate comparison, banks also submit the standard template, summarizing the quantitative targets and the level of progress made in the past 12 months against the plan. Specific details in the template include volumes of non-performing exposures which are

unlikely to be paid, total gross loans along with non-performing exposure ratios, transitions from performing to non-performing and vice versa, non-performing exposure increases or decreases, cash recoveries, loss budget and forborne exposures.

- NPL governance and operations: Material and structural changes in the NPL operating model control framework are communicated to the respective supervisory teams in a timely fashion. Furthermore, high NPL banks proactively share periodic NPL monitoring reports, at a suitable level of aggregation, with the supervisor. Specific details have not been prescribed by the regulator in this regard.
- Forbearance: Disclosures are required on forbearance, especially on key areas including credit quality of forbearance, quality and effectiveness of forbearance and ageing profile of forbearance on a regulatory portfolio basis. To facilitate consistent disclosures on forbearance, banks are required to submit the quantitative information and standard templates. Specific details in the template include:
    - Credit quality of forborne exposures (performing, non-performing, defaulted, and impaired), associated amount of impairment raised (performing and non-performing)
    - Quality of forbearance: including forborne exposures by number of forbearance measures granted in the past and re-defaults having occurred in the past 12 months
    - Ageing of forborne exposures: time since the granting of forbearance measures, across a sufficient number of time brackets (<3 months, 3-6 months, 6-12 months and >12 months)
    - Net present value impact of forbearance measures granted in the past 6/12/24 months.
- NPL impairment and write offs: The supervisor can request banks to provide data regarding the models they use to calculate impairment allowances for NPLs on a collective basis. The data should be provided on an annual basis or more regularly if requested by supervisors. The specific information to include, description of each granular group of exposures with shared credit risk characteristics created for the purpose of the collective estimation of provisions; description of the non performing exposure portfolios to which the segments (product type, collateralization, client segment) pertain; description of loss given default as applied at the level of the segment; cure rate for NPLs as applied at the level of the segment and aggregated non performing exposure at default at the level of the segment.
- Interest Accrued on NPLs: Regarding the interest accrued on NPLs, on an annual basis or more regularly if requested by supervisors, banks should share the relevant information which includes total loans, performing loans, individually assessed non-performing loans (impaired and non-impaired), collectively assessed non-performing loans (impaired and non-impaired). These details should be provided for original effective interest income in Profit & Loss (before impairment), accrued effective interest income after consideration of impairment and unwinding and cash collected (only Interest-related).

10.19. Annex S – Key common features of restructuring policy and practices in banks in Pakistan

Having looked at the policies and practices of some of the leading banks, there are some common features with respect to rescheduling or restructuring of loans. The Board of Directors delegates its powers for credit write offs, rescheduling, restructuring, litigation and recovery to the President of the Bank. The President exercises these powers in accordance with the restructuring or rescheduling policy and any SBP rules and guidelines issued from time to time. The President may further delegate this authority for rescheduling or restructuring, as deemed appropriate.

- Policies provide that rescheduling or restructuring is not intended to defer identification of problems and consequent misrepresentation or misclassification of risk and inaccurate reflection of reserves. Meaning that while rescheduling and restructuring is permissible, it is not to be done simply to break time frame and to allow an unwarranted improvement in the classified category of the loan.
- In line with the PRs, banks' policies of rescheduling or restructuring of loans is also based on the principal of granting concessions, that they would not otherwise consider, for borrowers whose accounts present problems due to economic or legal reasons. However, before setting out to consider any concessions, banks attempt to satisfy or conclude:
  - a) Where other financial institutions are involved, or in case of a syndicated loan, other lenders must agree, in writing, to the proposed rescheduling or restructuring
  - b) The default is not willful, (the borrower is not misrepresenting actual facts with the purpose of securing concessions)
  - c) The borrower has a viable business plan for the future, as demonstrated by financial projections; such projections are to be thoroughly examined to assess the validity of assumptions used and the veracity of cash flows projected
  - d) The management, despite the initial setback has a demonstrated competence and ability to run the business profitably in the future
  - e) Willingness and ability of the sponsors to participate in a rescue program by injecting fresh equity or equivalent such as sponsors or subordinated loans to demonstrate commitment to the business, and make the whole exercise a meaningful one
  - f) There should be reasonable down payment to indicate the seriousness of the management towards the proposed plan. (Repayment made by the borrower during the preceding one year may be given due weightage in determining the amount of down payment)
- In terms of the recovery options available to a bank, it may be decided to grant concession in the form of rescheduling or restructuring of the financial obligations. Key considerations are to ensure that the discounted expected monetary value (the amount of cash flow multiplied by its estimated probability of inflows accruing to the Bank) if concession is granted, significantly exceeds the net (net of legal and other expenses) present value of cash flow arising from liquidation of available securities.
- Normally, rescheduling or restructuring proposals are not considered or initiated unless the proposed restructuring plan results in substantive improvement in a Bank's risk. This may be achieved through enhancement of security or collateral or through injection of fresh equity (or equivalent) or a combination of these.
- The mark-up/interest outstanding at the time of rescheduling or restructuring is usually added to unpaid principal in accordance with the contractual loan (restructuring) agreement. Having said that, capitalization of interest / mark-up / principal may not be undertaken if any part of the borrower's obligations towards a Bank are classified substandard or worse. In doing so, banks ensure that compounding of mark-up does not take place because of capitalization in violation of SBP Circular No. 13 dated 20 June 1984. Similarly, there should be no penal mark-up, as prohibited under SBP Circular No. 32 dated 26 November1984.
- The restructured repayment schedule agreed with the borrower should be based upon the cash generation capacity of the business, sponsor's ability to inject funds into the business, and the remaining economic life of the business (plant & machine, in case of manufacturing concerns). As a rule of thumb, the post restructuring repayment period is restricted to seven to nine years with the grace period not exceeding one year.

- Where the restructuring package for a business involves a change in sponsors/ management, due care is exercised to ensure that the incoming management has integrity, the capability to successfully manage the business and is considered credit-worthy:
  a) In case of change of management, where incoming management has no relationship whatsoever with the outgoing one, the account is considered as a new relationship
  b) Personal Guarantees of outgoing directors are not released until and unless proper security for the outstanding amount of the loan including personal guarantees of the incoming directors are obtained
  c) Further, rescheduling or restructuring in 'litigation' cases (if required) is implemented through the court except otherwise advised by the legal counsel
- For all restructured loans, the income recognition is on cash basis (as a conservative measure). Accrued mark-up is not taken to income account. No incremental financial accommodation (fund based or non-fund based) is granted to the borrower who has already been given financial relief in the shape of mark-up waiver, say, for more than three years as part of the restructuring package; and
- A specialist watch-list category for close monitoring of restructuring loans for a post-restructuring period of six months to one year (from the date of restructuring/rescheduling) is created to closely monitor and measure the success and performance of the restructured package.

10.20. Annex T – Provisions Against NPLs According to the PRs

The SBP has issued PRs for multiple financing facilities. This means the NPL classification and provisioning percentages to vary from one PR to another. Table 36 lists all the PRs along with their respective NPL classification categories and provision percentages depending on the days past due.

TABLE 36: PROVISIONS AGAINST NPLS ACCORDING TO THE PRS

Prudential Regulation / Days Past Due	More than 30 days	More than 60 days	More than 90 days	More than 180 days	More than 365 days	More than 548 days	More than 730 days
Corporate and Commercial Financing			Substandard 25% Provision	Doubtful 50% Provision	Loss 100% Provision		
Small Enterprise (SE) Financing SE is defined as having number of employees up to 50 and Annual Sales Turnover of up to PKR 150 Million.			OAEM 10% Provision	Substandard 25% Provision	Doubtful 50% Provision	Loss 100% Provision	
Medium Enterprise (ME) Financing ME is defined as having number of employees b/w 51-250 and Annual Sales Turnover b/w PKR 150 - 800 Million.			Substandard 25% Provision	Doubtful 50% Provision	Loss 100% Provision		
Infrastructure Project Financing			OAEM 0% Provision	Substandard 25% Provision	Doubtful 50% Provision		Loss 100% Provision
Agriculture Financing			OAEM 0% Provision		Substandard 20% Provision	Doubtful 50% Provision	Loss 100% Provision
Credit Card Finance				Loss 100% Provision			

Prudential Regulation / Days Past Due	More than 30 days	More than 60 days	More than 90 days	More than 180 days	More than 365 days	More than 548 days	More than 730 days
Auto Loans Finance			Substandard 25% Provision	Doubtful 50% Provision	Loss 100% Provision		
Personal Loans Finance			Substandard 25% Provision	Loss 100% Provision			
Microfinance Banks Finance	OAEM 0% Provision	Substandard 25% Provision	Doubtful 50% Provision	Loss 100% Provision			
Housing Loan Finance			OAEM 0% Provision	Substandard 25% Provision	Doubtful 50% Provision		Loss 100% Provision

10.21. Annex U – Debt Collection Agencies: Eligibility/Other Criteria for Approved Agencies

Certain eligibility criteria for enlistment as Approved Agencies under the PBA Guidelines and other requirements in connection therewith may be noted:

Eligibility Criteria for Approved Agencies

The following information is required for qualification of applicants to be on the list of Approved Agencies:

- Duly Completed Application Form
- Detailed Company Profile
- Bank statements for last one year
- Ownership guidelines or rent deed of premise (for example the main office)
- Bank Letter stating CNIC Number, A/C Opening Date, Account Number and Name of the Proprietor/ Partner/ Director of the account or Proof of Ownership
- Authorized Signatory List with contact details
- Letter of Recommendation from at least one FI
- Undertaking/ Certificate of Compliance as per PBA format
- Copy of CNIC of Owner(s) and Authorized Signatories
- Copies of Legal Agreements signed with FI – if any

Appraisal & Assessment of Applicants

On the basis of the data provided by the agency, both at the time of enlistment and on a periodic basis, PBA calculates the weighted average scores of all the enrolled agencies. The score is calculated based on:

- Number of years of experience in collection/recovery
- Number of FIs for which collection/recovery is carried out
- Number of cities in which collection/recovery is carried out
- Size of professional team
- Number of repossession cases handled and concluded during the year
- Performance Rating of FIs (to be sought from FIs directly by PBA)

At the time of enlistment, the agency's rating is calculated based on the first four factors only. For annual reviews, the last two factors are also considered.

Fee Structure for Approved Agencies

Following types of fees are applicable on the Approved Agencies:

- Processing Fee (PKR 5,000) – For processing of fresh applications, all applicants are charged a processing fee with the application for enlistment.
- Annual Subscription (PKR 15,000) – This is the renewal fee, payable for the first time and thereafter in December each year for subsequent renewal.

Renewals of Agency Contract with Approved Agencies

Approved Agencies are to be enlisted a period of one year, beginning January 1 and ending December 31, renewable for every subsequent year subject to compliance of the prescribed terms and conditions. Renewals will be based on annual reviews, which will be carried out for approved agencies that have completed six months of enlistment.[130] This would ensure that the Approved Agency has put into place all processes and procedures which are necessary in abiding by the rules defined by PBA. Agencies that have not completed six

[130] Please see paragraph 5.06 of the PBA Guidelines.

months of enlistment by the time of reviews are renewed without Annual Reviews. Their reviews will fall due from the ensuing year.

Compliance with Code of Conduct and de-listing[131]

Sub-contracting of outsourcing arrangements by Approved Agencies is strictly prohibited and Approved Agencies cannot induct any contractual or third-party staff for the outsourced assignment for FIs, ensuring that all the staff are hired by the Approved Agency itself. The Code generally instructs the Approved Agency or its staff to treat all the customers (including customers who are late in paying outstanding amount(s) owed by them to the FIs and/or are in default) with respect, dignity, and courtesy for discharging the responsibilities imparted to them by the financial institutions.

The Approved Agencies are required to take an undertaking and /or a certificate affirming their compliance with the "Guidelines for Collection, Recovery and/or Repossession Agencies" along with the Prudential Regulations and relevant circulars/notifications issued by the SBP. The contents of the undertaking provided to the PBA is binding on Approved Agencies. Non-compliance with these guidelines can lead to delisting of the collection agency.

Engagement of Approved Agencies by Banks/DFIs

The regulatory framework permits an agency relationship between banks or DFIs and Approved Agencies (Approved Agents only have negligible discretionary powers and prior approval of the bank or DFI is required for debt recovery/collection/repossession actions). Banks and DFIs may use the services of or renew the contracts with Approved Agencies only.[132]

Banks and DFIs already using the services of unlisted agencies at the time of issuance of list of approved agencies may continue to do so till the expiry of the current term of the agreement.[133]

Each bank and DFI should enter into separate legal agreements with their respective Approved Agencies and banks/DFIs should incorporate an escape clause in agreements with Approved Agencies to enable cancellation of contracts with the Approved Agencies that are delisted by PBA.[134]

Further sub-contracting of outsourcing arrangements by Approved Agencies is strictly prohibited.[135]

Considerations for FIs seeking Debt Recovery/Collection though Approved Agencies

Individual Financial Institutions can enter into separate legal agreements with the respective Approved Agencies. The legal agreement as a minimum should address service levels and performance requirements, audit and monitoring procedure, business continuity plan, default arrangements and termination provisions, pricing and fee structure, dispute resolution arrangements, liability and indemnity, confidentiality, privacy, and security of information and ensuring SBP access to documentation and accounting records in relation to the activity performed and right to conduct onsite visits at the agency.

Further, banks notify PBA the names of Approved Agencies de-listed by the bank or blacklisted by them for reasons of performance issues or irregularities. PBA will then deduct points from the score of the agencies for each bank that has delisted them and will confidentially circulate the names of such Agencies to the banking industry for information. Banks are also instructed to abide by the "Guidelines on Outsourcing Arrangements" issued by the SBP when seeking arrangements with Approved Agencies.

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[131] Please see paragraph 4 of the PBA Guidelines.
[132] Please see paragraph 3.01(a) of the PBA Guidelines.
[133] Please see paragraph 3.01(c) of the PBA Guidelines.
[134] Please see paragraph 3.01(d) and (e) of the PBA Guidelines.
[135] Please see paragraph 3.02(a) of the PBA Guidelines.

10.22. Annex V – Mechanism for Collection of Periodic Cash Flows

For the NPL transaction structure explained in Section 9.4 (Option 2), it is assumed that the investors will be able to collect cashflows from the PCRCL fund(s) or trust(s), periodically, through dividend distributions and/or through redemption of units owned by the investors. The details of these two options are further explained in this annex.

Dividend Distribution

Currently, there is no specific law or regulation that regulates the operation of unit trust(s) set up by a CRC, similarly, in terms of the general trust laws, there are no restrictions or limitations on the amount or the frequency of dividend declaration(s) by a fund or unit trust of a CRC. It is also important to note that, the requirement of the Companies Act, 2017 restricting dividend distributions to be out of profits only, does not apply to unit trusts. Therefore, by interpretation and in the absence of any other specific law, it may be possible for the investors of funds and unit trusts to sweep full cash flows on a periodic basis by way of dividend declarations. Taxation and other foreign exchange remittance laws and requirements will apply as described in Section 9.4 (Option 2).

Redemption of Units of Funds/Trusts

In addition to dividend distributions or otherwise exclusively, investors of PCRCL funds/trusts will be able to sweep full cash flows periodically through redemption of fund or trust units they own. This option may be exercised in the following way:

- Fund/trust issues units at a discount to the par value. The par value equals the total future value (recoverable value) of the portfolio. The discounted value or the purchase price of the units represents the initial purchase price of the portfolio.
- The transaction structure allows for the redemption of units at the par value at an agreed frequency for example on a monthly basis. This will enable investors to recover cash flows in excess of the initial net asset value of the portfolio.
- The fund/trust books revenue at a predetermined IRR (internal rate of return). Servicing fee, taxes and other similar expenses are accounted for in the normal course.
- By the end of the portfolio term, assuming no changes to the initial projected cash flows, the total cash flows redeemed through redemption of units at par value will have been equal to the sum of the initial purchase price and any surplus recovered on the portfolio.
- Taxation and other foreign exchange remittance laws and requirements will apply as described in Section 9.4 (Option 2).

With not specific law applying to unit trusts set up by CRC there are also no general restrictions on the issuance of units at a discount or in relation to the terms of redemption. This means unit trusts or funds set up by CRC may issue units at a discount which are redeemable at par value at agreed frequencies.

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