REGULATIONS FOR DEBT PROPERTY SWAP

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THE TEAM

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PREAMBLE

The banks/DFIs resort to settlement of non-performing loans (NPLs) through, interalia, sale of property held as collateral or otherwise. It has been observed that the risk management system adopted by the banks/DFIs to identify, assess, monitor and contain risks for the purpose of debt property swap (DPS) varies widely in terms of prudence and effectiveness. In the absence of clearly written policies and instructions, DPS transactions are likely to be handled in inconsistent manner. This may give arise to practices which are perilous to soundness of the banking system. In this view, regulations for DPS are being issued which are meant to set minimum standards to be employed by the banks/DFIs while carrying out DPS transactions.

Shaukat Zaman
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REGULATIONS FOR DEBT PROPERTY SWAP

A) APPLICABILITY:

Regulations for DPS are applicable on corporate/commercial loans, consumer loans and SME loans.

B) DEFINITIONS:

For the purpose of these regulations:

i) **Debt** is an obligation owed by the borrower to the bank/DFI.

ii) **Debt Property Swap (DPS)** is a transaction for the purpose of settlement in the event of default on debt, consummated by an agreement between and among the bank/DFI and the borrower(s), by virtue of which the bank/DFI acquires/holds property serving as collateral or otherwise against debt.

iii) **Property** refers to residential, commercial and industrial land and building but excludes agricultural land.

C) REGULATIONS:

REGULATION 1
PRE-CONDITIONS FOR DPS

1) The banks/DFIs shall have in place Board of Directors (BOD) approved policy in respect of DPS. The policy may be part of the bank's/DFI's overall credit policy or separate as deemed appropriate by the bank/DFI. If deemed appropriate, a comprehensive manual may also be formulated in light of the BOD approved policy, duly approved by the senior management as defined by the bank/DFI, which shall be disseminated down the line. In case of Islamic Banking, the policy and manual shall be approved by the bank's Shariah Advisor also. The policy shall encompass at least following aspects:

   a) Acceptable limit of real estate exposure on the bank's/DFI's books
   b) The procedure for valuation of property considering regulatory instructions
   c) Valuation of property from professional valuer(s) amongst the approved panel of Pakistan Banks Association (PBA)
   d) Appropriate terms and conditions
   e) Documentation requirements
   f) Approving authority levels corresponding to nature and size of transactions
   g) Strategy and timeline for disposal of the property keeping in view the statutory provisions and regulatory instructions
   h) Role of Risk Management and Compliance functions in the transaction processing, approval and review

i) Acceptable property areas/categories
j) Periodicity of DPS policy review

2) It is expected that credit decision of banks/DFIs shall rely on borrowers' repayment ability mainly assessed from cash flows and not on appraisal value of collateral. Considering the implications of holding immovable property, debt property swap may not be considered as a preferred option for recovery of loan.
3) DPS should be transacted only for the loans classified in the category of "Loss".
4) It shall be ensured that the customer holds absolute title to the property and has absolute right and/or authority to sell such property.

<u>REGULATION 2</u>
GENERAL REQUIREMENTS

1) A comprehensive proposal for settlement of claim or debt with property shall be made for each transaction which is to be approved by the designated authority. All risks and limitations of the property shall be stated and the proposal shall be substantiated with, interalia, justification for the transaction and cost-benefit analysis. The allied expenditures, including legal, transfer, evaluation, maintenance charges etc., shall be fully disclosed.
2) DPS transaction shall be approved by an authority higher than the one that approved the loan, with an exception to loan cases approved by the highest authority.
3) In case of Islamic Banking, the transaction shall also be reviewed by the Shariah Advisor before approval.
4) Appropriate and adequate monitoring and reporting system shall be established. The adequate reports of all DPS transactions effected, along with strategy for disposal of properties acquired, efforts made and progress on disposal during the previous reporting period and reasons for not disposing of any property as per strategy and within the defined timeline shall be presented to the Board of Directors by the management preferably quarterly but at least annually.
5) All transactions of DPS shall be reviewed by the Audit function during regular/annual audit which shall present its observations to the BOD Audit Committee.
6) The record of all properties acquired through DPS shall be centralized at the Head Office or regional office and be readily available for verification by SBP inspection team.
7) The summary of loans settled through DPS, reflecting items such as outstanding principal, markup and other charges, write-off/waiver, provision held, provision reversed, market value and forced sale value of property etc., shall also be maintained.

8) DPS arrangement shall not call for any further payments by the bank/DFI except in cases where it is clearly established and validated through legal opinion that the property is not divisible.
9) The banks/DFIs shall neither enter into DPS with affiliates/related parties nor sell the properties acquired under DPS transactions to them.
10) In case of multiple owners of the property, the bank/DFI shall satisfy itself that its interest is perfected in the property by all means. In cases where third party property is being acquired in DPS, special vigilance shall be carried out regarding authority to sell, transfer of title, physical possession etc.

REGULATION 3
LIMIT ON DPS TRANSACTIONS

The real estate assets acquired under DPS transaction shall be considered as part of exposure on real estate sector and will fall under the limits prescribed under BPRD Circular No.1 of 2014 i.e. 10% of the aggregate of their advances and investments (excluding investments in Government securities), as amended from time to time. However, the real estate assets acquired under DPS transactions shall not exceed 25% of the 10% limit of the aggregate of their advances and investments (excluding investments in Government securities). Furthermore, the acquired properties used by the bank/DFI for business purposes may not be counted towards calculation of this limit from the date when these are formally earmarked for the purpose of internal usage and are moved to the banks/DFIs' operating fixed asset register.

REGULATION 4
DISCLOSURE REQUIREMENTS

1) The DPS agreement between the parties shall include complete disclosure of all terms and conditions of DPS and associated costs to be borne by each party.
2) Actual gain/loss realized on the sale of each one of these properties shall be separately disclosed in the notes to the annual financial statements.
3) Provision reversal and NPL reduction, as a result of settlement through DPS, shall also be disclosed in the notes to the annual financial statements.

REGULATION 5
VALUATION/REVALUATION

Valuation of property is mandatory subject to the following:

1) Forced Sale Value (FSV) of the property along with market value shall also be used as the reference price for DPS. For outstanding loan up to Rs. 2 million, the banks/DFIs may conduct self-assessment. For outstanding loan exceeding Rs. 2 million, valuation report(s) shall not be older than six months at the time of

conclusion of DPS transaction and the valuation reports shall be obtained by the bank/DFI from evaluators on the panel of PBA as per following criteria:

a) At least one valuation report for DPS transaction amount of up to Rs. 20 million.
b) At least two valuation reports for DPS transaction amount of up to Rs. 50 million
c) At least three valuation reports for DPS transaction amount of more than Rs. 50 million.

In case more than one valuation reports are required as per above criteria, the same shall be obtained from different evaluators and the settlement value used for DPS shall not in any case exceed the average of market values of lowest two valuation reports so obtained.

2) After initial full-scope valuation of the property acquired in DPS, desktop valuation shall be carried out on annual basis and full-scope valuation after every three years. Full-scope valuation shall also be carried out by the bank/DFI at the time of selling the property if the latest valuation is older than one year or the value of property is more than Rs.10 million.

3) The valuation/revaluation system shall consider all relevant factors such as the legal enforceability of claims on property, ease of realization of DPS property and current market conditions etc.
4) Treatment of subsequent valuation of property shall be done on individual property basis and not on portfolio basis i.e. deficit/loss on one property cannot be adjusted against surplus on other property.

REGULATION 6
DOCUMENTATION, TRANSFER OF TITLE, PHYSICAL POSSESSION AND RECORDING

1) Legal documents shall be complete in all respects including registration with the relevant authorities and transfer of title in favor of the bank/DFI in the Revenue record. The registration and transfer of title shall be verified by the concerned department of the bank/DFI. Further, all documentation shall be vetted by an independent law firm.
2) The bank/DFI shall have unrestricted physical possession of the property and the same shall be supported by the visit report signed by the bank's/DFI's official not below the SVP (or equivalent) level.
3) The property acquired shall be recorded in the books at the date the title transfers to the bank/DFI.

REGULATION 7
REPURCHASE/BUY BACK/RENTING ARRANGEMENTS

1) If DPS agreement contains such clause which provides option of repurchase as a first right to the borrower, it shall not be detrimental to the interest of the bank/DFI in any way.

2) The bank/DFI shall have strong justification for repurchase arrangement. The justification shall also explain how the bank/DFI anticipates improvement in the borrowers' financial condition enabling repurchase of the property.
3) The bank shall allow repurchase/buy back of the property at a price which is highest of (a) acquisition cost including any additional cost incurred by the bank/DFI, (b) loan along with its pricing settled for the tenor of repurchase/buy back, or (c) market value at the time of repurchase/buy back.
4) The bank/DFI shall also include timeline for repurchase, not exceeding three years, in the agreement. After expiry of such agreed timeline, the bank/DFI shall dispose of the property as per policy/law.
5) If the bank/DFI decides to rent out DPS property to the same borrower, it shall be at arm's length basis and on market terms.

REGULATION 8
INSURANCE OF THE PROPERTY

Where applicable, the property shall remain insured at all times and depreciation shall be charged as per policy of the bank/DFI for fixed assets.

REGULATION 9
ACCOUNTING AND PROVISIONING

1) The properties acquired in DPS transactions shall be disclosed under the sub-head "non-banking assets acquired in satisfaction of claims" of the head "other assets", in the financial statements.
2) On acquisition of property under DPS transaction, the banks/DFIs shall adjust the outstanding principal first. Any amount over and above the outstanding principal can be taken into income account as markup/profit, other income etc., either directly or through reversal of accruals in suspense account, only when actually realized in cash, through sale of property or otherwise received from the borrower. The deferred profit on account of acquisition of property shall, however, be kept in other liabilities account until realization.
3) The banks/DFIs shall charge the deficit arising from revaluation of property held under DPS to Profit & Loss Account and revaluation surplus shall be transferred to "Surplus on Revaluation of Fixed Assets Account" as required under Section 235 of the Companies Ordinance, 1984. However, this revaluation surplus shall not be admissible for calculating bank's/DFI's Capital Adequacy Ratio (CAR) and exposure limits under Prudential Regulations. The surplus can be adjusted upon realization of sale proceeds.
4) Legal fees, transfer costs and direct costs of acquiring title to property shall be expensed when incurred and shall not be capitalized. All costs in relation to valuation and acquisition of title to the property should be recorded in the appropriate expense account during the accounting period in which they have incurred.

5) The banks/ DFIs shall not reverse the specific provision held on such classified advances for which they enter into DPS, until and unless the property is transferred in favor of the bank/DFI in the Revenue Record.

REGULATION 10
REPORTING IN E-CIB & NPLs

In case only partial liability is settled through DPS, the banks/DFIs shall report the outstanding amount in its respective overdue/classification category of eCIB and NPLs reporting.

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