State Bank of Pakistan

Prudential Regulations for Small & Medium Enterprises Financing

(Updated till December 31, 2017)

Infrastructure, Housing & SME Finance Department

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Preface

SME sector contributes significantly towards national GDP, employment generation and export earnings. Hence, the impact of financial inclusion of SMEs has important implications for economic growth, competitiveness, and job creation. The potential for this sector to contribute to the economic development objectives of Pakistan, in areas like creating jobs, increasing incomes, improving competitiveness, boosting exports and fostering economic growth is the justification for a strategy of support to unleash the sector's potential. Keeping this in view, SBP issued separate Prudential Regulations for SMEs in 2003, which were subsequently revised in 2013 and 2016 in line with the changing market dynamics.

Banks & DFIs had tilt towards larger-size medium enterprises as compared to small enterprises (SEs) in their banking business. Therefore, for improving SEs' access to finance, SME definition prescribed in the PRs issued in 2003 was segregated and small enterprises and medium enterprises were separately defined in 2013, along with formulation of specific regulations for the small enterprises (SEs). We feel that a separate definition for small enterprises is helping banks & DFIs in aligning their business strategy with the SE Financing needs.

Then in 2016, certain amendments were made in these regulations while responding to market changes. These included changes in the definition of small enterprise (SE) and medium enterprise (ME), upward revision in per party exposure limit for SE financing, requirement of audited accounts for SE Financing for exposure above Rs 15 million, waiver of general reserve requirement against SEs' non-fund based portfolio and rationalization of cash repayment requirement for immediate declassification of SE and ME restructured/ rescheduled loans.

Recently, a holistic exercise was undertaken by SBP in collaboration with concerned stakeholders to plug in the gaps in the way of smooth SME financing in the country. In this regard, 'Policy for Promotion of SME Finance' was launched by the Prime Minister of Pakistan on 22nd December 2017. In this perspective, amendments have been introduced in following SME financing PRs to allow rapid promotion of SME financing in the country:

1) Regulation SME R-1: SME Specific Credit Policy
2) Regulation SME R-2: e-CIB Report
3) Regulation SME R-9: General Measures
4) Regulation SE R-7: General Reserve against Small Enterprise Finance
5) Regulation SE R-10: Turn-Around-Time
6) Regulation ME R-6: Turn-Around-Time (newly introduced)

It is worth mentioning that providing enabling regulatory framework is one important aspect only. Visible improvement in SME Financing will only occur when banks & DFIs re-position themselves strategically in the market by appropriately aligning their business strategies with the specific needs of the SME sector. The regulatory framework will bear its intended results, only if banks & DFIs take the necessary steps including the following:

- Bring strategic change at higher level to expand share in SME portfolio.
- Use relevant/ practical cash flow estimation techniques and other proxies to assess repayment capacity of SME borrowers.
- Adopt program-based lending & down scaling strategies.
- Make appropriate alignment in their risk management processes.
- Allocate adequate resources for research & development.
- Take effective measures to capture market niche by conducting market segmentation.
- Strengthen credit appraisal and monitoring mechanism by greater use of technology and documentation to undertake effective review of SME Portfolio.
- Adopt measures for greater financial awareness of SMEs specially SEs.

State Bank of Pakistan monitors the situation closely, and works with banks & DFIs to make SME banking a viable success on sustainable basis. For this purpose, SBP is open to review any regulatory provision, if necessary, while ensuring at the same time that banks & DFIs observe due prudence and necessary oversight.

The Prudential Regulations for small and medium enterprises (SMEs) financing cover Risk Management (R) aspects. The Prudential Regulations for Corporate/ Commercial Banking may be referred to for areas concerning Corporate Governance (G) and Operations (O) aspects as well as Anti-Money Laundering and Combating the Financing of Terrorism (AML/ CFT) Regulations issued by BP&RD. However, in case of international operations, the prudential regulations of host country shall prevail.

The Prudential Regulations for small and medium enterprises (SMEs) financing do not supersede other directives issued by State Bank of Pakistan in respect of areas not covered here. Any violation or circumvention of these regulations shall render the bank/DFI officer(s) concerned liable for penalties under the Banking Companies Ordinance, 1962.

Ghulam Muhammad
Director
Infrastructure, Housing & SME Finance Department

Dated: December 31, 2017

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Chapter No: 01 Prudential Regulations – General for Small & Medium Enterprise Financing

Regulation SME R-1: SME Specific Credit Policy

Banks & DFIs shall prepare a comprehensive SME Specific Credit Policy duly approved by their Board of Directors. The Credit Policy shall give special mention to Small Enterprises (SE) financing keeping in view their specific characteristics and business conditions. The Credit Policy shall, interalia, cover following for SME financing:

i. Clearly laid down procedures on loan administration, disbursement, monitoring, and recovery mechanism.
ii. Specification of main functions, major responsibilities of various staff positions, as well as their powers/ authority relating to approval/sanctioning of financing limits.
iii. For loan size of upto Rs 2 million, it will be at the discretion of the banks & DFIs to obtain the insurance cover of the hypothecated stock/ other securities keeping in view the credit-worthiness, past experience and financial strength of the prospective borrower. However, if a bank/DFI decides to obtain an insurance cover, then it will not force to the respective borrower for arranging the same from an insurance company of the bank's/ DFI's choice.
iv. Banks & DFIs are encouraged to adopt program based lending. The Chief Executive Officer of the bank/ DFI concerned will approve conventional/ Shariah-compliant program-based products on recommendation of the respective committee. Such programs may carry objective/ quantitative parameters for eligibility of borrowers, besides standardization and simplification of loan documents required from the borrowers under the subject Program.
v. Banks & DFIs shall adopt standardized and simplified loan application forms circulated by PBA.

In case of SE Financing, following minimum points shall be covered under banks'/ DFIs' Credit Policy:

vi. Clearly devised plan of the banks & DFIs regarding their frequency of visits to be made to SE borrowers' business sites keeping in view their human resource limitations and the amount of exposure taken upon SEs. However, banks & DFIs shall ensure that at least one visit must be made to SE borrowers' sites during a year's time.
vii. In case the finance is secured against hypothecation of stock, banks & DFIs shall obtain stock report at least semi-annually.

Regulation SME R-2: Electronic Credit Information Bureau (e-CIB) Report

While considering any credit proposal (including renewal, enhancement and rescheduling/ restructuring), banks & DFIs shall obtain e-CIB Report on their prospective borrower(s) from Electronic Credit Information Bureau (e-CIB) of State Bank of Pakistan. Banks & DFIs shall give due weightage to the credit report relating to the borrower(s) and concerned group. However, they can take exposure on defaulters keeping in view their risk management policies and criteria, provided they properly record reasons and justifications in the approval form.

Regulation SME R-3: Personal Guarantee

All facilities, except those secured against liquid assets, shall be backed by personal guarantees of the owners of SMEs. In case of limited companies, guarantees of sponsor directors shall be obtained.

Regulation SME R-4: Limit on Clean Facility

Banks & DFIs can take clean exposure (facilities secured solely against personal guarantees) on an SME borrower up to Rs 5 million. Before taking clean exposure, banks & DFIs shall obtain a declaration from the SME to ensure that the accumulated clean exposure on an SME does not exceed the prescribed limit mentioned above.

It may be noted that clean exposure limit shall not include the clean consumer financing limits (Credit Card and Personal Loans etc.) allowed to sponsors of the said SME under Prudential Regulations for Consumer Financing.

Regulation SME R-5: Proper Utilization of Loan

Banks & DFIs shall ensure that loan has been utilized for the same purposes as specified in the Loan Application Form. In case of financing to medium enterprises, banks & DFIs shall develop and implement an appropriate system for monitoring utilization of loans. Such system may include obtaining stock reports/ position of current assets in case of Working Capital Loans; and supporting documents in case of Term Loans.

With regard to small enterprise financing, banks & DFIs shall adopt the following measures:

i. In case of working capital/ revolving credits, banks & DFIs will obtain a declaration from the borrowing SE stating that it has utilized the loan proceeds for the intended purpose only.
ii. In the case of fixed assets/ project financing, banks & DFIs will adopt the same process as mentioned above in the case of medium enterprise financing.

Regulation SME R-6: Restriction on Facilities to Related Parties

Banks & DFIs shall not take any exposure on an SME in which any of its directors, major shareholders holding 5% or more of the share capital of the bank/ DFI or its Chief Executive, or an Employee or any family member of these persons is interested, except as specified in section 24 of the BCO, 1962. In this regard, it will, however, suffice if banks & DFIs obtain an undertaking from the small enterprise stating that there is no existence of any interest between the borrower and the above-mentioned related parties.

Regulation SME R-7: Translation of Loan Documents into Urdu Language

To facilitate SMEs in better understanding important terms and conditions of loans, banks & DFIs shall translate and make available Loan Application Form and other related documents, except charge documents, in Urdu as well. Further, banks & DFIs will also provide information on important terms with brief explanation of each term for convenience and better understanding of the borrowers.

Regulation SME R-8: Securities and Margin Requirements

i. Subject to the relaxation for clean facilities up to Rs. 5 million for SEs and MEs, all facilities over and above this limit shall be appropriately secured as per satisfaction of the banks & DFIs.

ii. Banks & DFIs are free to determine the margin requirements on securities against facilities provided by them to their clients taking into account the risk profile of the borrower(s) in order to secure their interests. However, this relaxation shall not apply in case of items, imports of which are banned by the Government. Banks & DFIs are advised not to open import letter of credit for banned items in any case till such time the lifting of ban on any such item is notified by the State Bank of Pakistan.

iii. Banks & DFIs shall continue to observe margin restrictions on shares/ TFCs/ Sukuk as per existing instructions under Prudential Regulations for Corporate/ Commercial Banking (R-6). Further, the cash margin requirement of 100% on Caustic Soda (PCT heading 2815.1200) for opening Import Letter of Credit as advised by the Federal Government and notified in terms of BPD Circular Letter No. 5 dated 4th May 2002, shall also continue to remain applicable.

iv. State Bank of Pakistan shall continue to exercise its powers for fixation/ reinstatement of margin requirements on financing facilities being provided by banks & DFIs for various purposes including Import Letter of Credit on a particular item(s), as and when required.

v. In addition to above, the restrictions prescribed under paragraph 5 of Regulation R-6 of the Prudential Regulations for Corporate/ Commercial Banking will also be applicable in case of financing to small and medium enterprises.

Regulation SME R-9: General Measures

i. Banks & DFIs shall establish SME Banking oriented Research & Development (R&D) divisions/ units in their institutions. These R&D divisions/ units shall fulfil research related needs of their institutes and provide them support in adopting suitable SME banking and financing practices.

ii. Banks & DFIs shall put in place an efficient MIS (Management Information System) which will support them effectively catering reporting needs of their SME financing portfolio. The system should be flexible enough to generate necessary information and at least following reports in order to enable management, take important policy decisions and/ or make appropriate modifications in their lending programs:

   a. Delinquency reports (for 30, 60, 90, 180 & 365 days and above) on monthly basis.
   b. Reports interrelating delinquencies with various customers and sectors types etc.
   c. List of SMEs having any kind of banking relationship(s) to be divisible w.r.t. organizational structure (proprietorships, partnerships, limited company etc.) and/ or nature of business (trading, service and manufacturing etc.).

iii. To address and minimize grievances of SMEs and stakeholders, banks & DFIs shall put in place an effective, simple and transparent customers' complaints resolution and helping mechanism in their institutes, on permanent basis.

iv. Banks & DFIs shall develop and offer customized lending products while adopting program based lending and supply chain financing methodologies to cater specific SME financing needs of various SME clusters. In this regard, banks & DFIs should explore mechanism for adopting advanced delivery channels (branchless banking, tele-marketing etc.) and SME credit scoring model etc.

v. Banks & DFIs are also encouraged to leverage database of their walk-in and permanent customers (depositors/ account-holders) which belong to SME sector, for cross selling of financing products. This will provide them relatively more comfort in increasing SME financing portfolio.

vi. Pricing policy of banks & DFIs that include mark-up rates (including the IRR on the loan products), processing & documentation fee, prepayment/ late-payment penalties etc. shall be mentioned explicitly in the loan agreements viz banks shall strictly avoid imposing any hidden charges in addition to those explicitly stated in the loan agreement.

vii. Banks & DFIs shall take measures for capacity building of their SME banking staff in SME related areas. In this regard, they will design and implement dedicated capacity building programs in coordination with their own training departments. Besides, SME financing staff shall also be nominated for training programs offered by external training institutes like NIBAF and IBP etc.

Chapter No: 02 Prudential Regulations for Small Enterprise Financing

Regulation SE R-1: Definition of Small Enterprise

A Small Enterprise (SE) is a business entity, which meets the following parameters:

Number of Employees	Annual Sales Turnover
*Up to 50	Up to Rs. 150 million

*****_including contract employees_.

Further, an entity has to fulfill both the criteria of number of employees and sales turnover for categorization as small enterprise. However, in cases where an entity fulfils one parameter of SE and its second parameter falls within the range prescribed for medium enterprise (ME) or above the upper limit prescribed for ME, then the subject entity shall be classified as ME or commercial/ corporate entity as the case may be.

Regulation SE R-2: Per Party Exposure Limit

Small Enterprise can avail exposure up to Rs 25 million from a single bank/ DFI or from all banks & DFIs. Banks & DFIs are allowed to deduct the liquid assets (encashment value of bank deposits, certificates of deposit/ investment, Pakistan Investment Bonds, Treasury Bills and National Saving Scheme Securities) held under their perfected lien for the purpose of calculation of per party exposure limit.

Regulation SE R-3: Requirement of Audited Accounts

Banks & DFIs are not required to obtain copy of audited accounts in case of lending to the small enterprises for exposure upto Rs 15 million. However, in such cases**,** banks & DFIs may ask the borrower to submit financial accounts in some form, signed by the borrower, to help banks & DFIs assess SEs' cash flows or carry out counter verification etc.

In case of lending to small enterprises above Rs 15 million, banks & DFIs shall obtain from the small enterprises a copy of financial statements duly audited by a practicing Chartered Accountant or a practicing Cost and Management Accountant for analysis and record. However, banks & DFIs may waive the requirement of obtaining audited copy of financial statements when the exposure net of liquid assets does not exceed the limit of Rs 15 million**.**

Regulation SE R-4: Repayment Capacity of the Borrower and Cash Flow Based Lending

Normally, small enterprises do not maintain proper financial accounts for the satisfaction of banks & DFIs. Their record generally contains sale/ purchase books and cash received/ paid records in a rudimentary form. Banks & DFIs shall use relevant/ practical cash flow estimation techniques and other proxies to assess repayment capacity of SE borrower. To supplement, banks & DFIs are encouraged to use the available sector/ cluster specific financial models that can capture cost structure, revenue streams and margins in the sectors. For program-based lending, banks & DFIs may also use, as a substitute, Income Estimation Models to assess repayment capacity of the borrowers.

Regulation SE R-5: Collateral Valuation

For valuation of securities against loans up to Rs 5 million, banks & DFIs at their own discretion may either use the services of their own evaluating staff or the services of PBA approved evaluator. However, valuation of securities for loans above Rs 5 million shall be done only by an evaluator on the approved panel of PBA.

Regulation SE R-6: Recovery of Outstanding Dues

To facilitate the recovery efforts, banks & DFIs are allowed to undertake cash collection/ recovery at places other than their authorized places of business as stipulated in the 'Fair Debt Collection Guidelines' issued by Banking Policy and Regulations Department. However, in order to prevent fraud and misappropriation of collected cash, adequate security and risk management measures (including but not limited to adequate insurance cover all the time) must be in place and this process should be appropriately documented, and audited at the bank/ DFI level. The banks & DFIs are also encouraged to make use of mobile and wireless technologies/ devices for instant updating of cash collection from field into their books and accounts, and sending confirmatory SMS/ alert messages to borrowers.

Regulation SE R-7: General Reserve against Small Enterprise Finance

Banks & DFIs shall maintain general reserve equivalent to 1% of their unsecured SE portfolio to protect them from the risks associated with the economic and cyclical nature of this business. This reserve requirement shall, however, be maintained only for the performing fund based SE portfolio of banks & DFIs. In order to calculate the general reserve, liquid securities under perfected lien (encashment value of bank deposits, certificates of deposit/ investment, Pakistan Investment Bonds, Treasury Bills and National Saving Scheme Securities) held against banks'/ DFIs' fund-based SE portfolio shall be netted.

Regulation SE R-8: Classification and Provisioning for Loans/ Advances

1. Banks & DFIs shall observe prudential guidelines given in this Regulation and at Annexure I & II of these Regulations in the matter of classification of their SE asset portfolio and provisioning there-against.
2. In addition to the time-based criteria prescribed in Annexure I, subjective evaluation of performing and non-performing credit portfolio may be made for risk assessment purpose and, where considered necessary, any account including the performing account shall be classified, and the category of classification determined on the basis of time based criteria shall be further downgraded. However, classification for program-based lending shall be done based on objective (time-based) criteria only, though banks & DFIs at their own discretion may also classify such portfolio on subjective basis.
3. In case of revolving/ running finance accounts, if the borrower pays mark-up regularly without showing turn-over in the principal portion of the account, and bank/ DFI is satisfied with this conduct and is willing to roll over the facility periodically; then such account will not

attract 'subjective classification' on the basis of lower/ nil activity in the principal account. However, banks & DFIs can classify, at their discretion, such accounts as per their own policy.

4. Banks & DFIs can avail the benefit of Forced Sale Value (FSV) of collateral held against loans/ advances, determined in accordance with the guidelines laid down in Annexure II, before making any provision.
5. Party-wise details of cases, where banks & DFIs have taken the benefit of FSV shall be maintained for verification by State Bank's teams during their regular/ special inspection.
6. Banks & DFIs shall review, at least on a quarterly basis, the collectability of their loans/ advances portfolio and shall properly document the evaluations so made. Shortfall in provisioning, if any, determined, because of quarterly assessment shall be provided for immediately in their books of accounts by the banks & DFIs on quarterly basis.
7. In case of cash recovery, other than rescheduling/ restructuring, banks & DFIs may reverse specific provision held against classified assets only to the extent that required provision as determined under this Regulation is maintained.
8. Banks & DFIs will make suitable arrangements for ensuring that FSV used for taking benefit of provisioning is determined accurately as per guidelines contained in these PRs and is reflective of market conditions under forced sale situations.
9. The external auditors shall, as part of their annual audits of banks & DFIs, verify that all requirements as stipulated above and in Annexure I & II for classification and provisioning have been complied with. State Bank of Pakistan shall also check the adequacy of provisioning during on-site inspection.

Regulation SE R-9: Restructuring/ Rescheduling of Loans/ Advances

1. The banks & DFIs may reschedule/ restructure problem loans as per their own policy duly approved by their Board of Directors. However, the rescheduling/ restructuring of non-performing loans shall not change the status of classification of a loan/ advance etc. unless the following minimum conditions are met:
   i. At least 10% of the outstanding loan amount is recovered in cash and the terms and conditions of rescheduling/ restructuring are fully met for a period of at least 6 months (excluding grace period, if any) from the date of such rescheduling/ restructuring**.** However, the condition of 6 Months retention period, prescribed for restructured/ rescheduled loan account to remain in the classified category, shall not apply in case the borrower has repaid or adjusted in cash at least 35% of the total restructured loan amount (principal + mark-up), either at the time of restructuring agreement or later-on any time before the completion of 6 Months period as above mentioned.
   ii. Rescheduling shall not be done simply to avoid classification.
   iii. While reporting to the Credit Information Bureau (e-CIB) of State Bank of Pakistan, such loans/ advances may be shown as 'rescheduled/ restructured' instead of 'default'.
   iv. Restructuring/ rescheduling of a loan account shall not lead to disqualification of the borrower for fresh credit facilities or enhancement in the existing limits. Such fresh

loans may be monitored separately, and shall be subject to classification on the strength of their own specific terms and conditions.

v. Where a borrower subsequently defaults (either principal or mark-up) after the rescheduled/ restructured loan has been declassified by a bank/ DFI, the loan shall again be classified in the same category it was in at the time of rescheduling/ restructuring and the unrealized markup on such loans taken to income account shall also be reversed. However, banks & DFIs at their discretion may further downgrade the classification, taking into account the subjective criteria.

Regulation SE R-10: Turn-Around-Time

Banks & DFIs shall not take more than 15 working days for the credit approval process (from the date of receipt of complete information). In this respect, the following minimum points shall also be considered:

i. The pre-approval requirements and post-approval requirements (security/ collateral documentation etc.) shall be advised preferably in one go.

ii. The facility shall be disbursed only after security documentation is completed by the customer.

Chapter No: 03 Prudential Regulations for Medium Enterprise Financing

Regulation ME R-1: Definition of Medium Enterprise

Medium Enterprise (ME) is a business entity, ideally not a public limited company which meets the following parameters:

*Number of Employees	Annual Sales Turn-Over
51-250 (Manufacturing & Service MEs) 51-100 (Trading MEs)	Above Rs 150 million and up to Rs 800 million (All types of Medium Enterprises)

*****_including contract employees_.

Further, an entity has to fulfill both the criteria of number of employees and sales turnover for categorization as medium enterprise. However, when an entity's one parameter is as per ME criteria and its second parameter is as per SE criteria, than subject entity would be categorized as ME. Similarly, when an entity's one parameter is as per ME and its second parameter is above the upper limit prescribed for ME, then the subject entity shall be categorized as commercial/ corporate entity.

Regulation ME R-2: Repayment Capacity and Cash Flow Based Lending

1. Banks & DFIs shall specifically identify the sources of repayment and assess the repayment capacity of the borrower on the basis of assets conversion cycle and expected future cash flows. In order to add value, banks & DFIs are encouraged to assess conditions prevailing in the particular sector/ industry they are lending to and its future prospects. Banks & DFIs should be able to identify the key drivers of their borrowers' businesses, the key risks associated with their businesses and their risk mitigants. Banks & DFIs may also use Income Estimation Models specially in program-based lending to assess repayment capacity of the borrowers.
2. The rationale and parameters used to project the future cash flows shall be documented and annexed with the cash flow analysis undertaken by banks & DFIs.

Regulation ME R-3: Per Party Exposure Limit

Medium Enterprise can avail financing (including leased assets) upto Rs 200 million from a single bank/ DFI or from all banks & DFIs. It is expected that Medium Enterprises approaching this limit should have achieved certain sophistication as they migrate into larger firms and should be able to meet the requirements of Prudential Regulations for Corporate/ Commercial Banking.

Banks & DFIs are allowed to deduct the liquid assets (encashment value of bank deposits, certificates of deposit/ investment, Pakistan Investment Bonds, Treasury Bills and National Saving Scheme Securities) held under their perfected lien for the purpose of calculation of per party exposure limit.

Regulation ME R-4: Requirement of Audited Accounts

In case of lending to medium enterprises, banks & DFIs shall obtain a copy of financial statements duly audited by a practicing Chartered Accountant, from the medium enterprise who is a limited company or where the exposure of a bank/ DFI exceeds Rs 10 million, for analysis and record. Banks & DFIs may also accept a copy of financial statements duly audited by a practicing Cost and Management Accountant in case of a borrower other than a public company or a private company, which is a subsidiary of a public company. However, banks & DFIs may waive the requirement of obtaining audited copy of financial statements when the exposure net of liquid assets does not exceed the limit of Rs 10 million.

Regulation ME R-5: Classification and Provisioning for Assets

Loans/ Advances

1. Banks & & DFIs shall observe the prudential guidelines given at Annexure III & IV in the matter of classification of their ME asset portfolio and provisioning there-against. In addition to the time-based criteria prescribed in Annexure III, subjective evaluation of performing and non-performing credit portfolio may be made for risk assessment purpose and, where considered necessary, any account including the performing account shall be classified, and the category of classification determined on the basis of time based criteria shall be further downgraded. Such evaluation shall be carried out on the basis of 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. However, classification for program-based lending shall be based on objective criteria. Nevertheless, banks & DFIs may, at their own discretion, also classify such portfolio on subjective basis.
2. Banks & DFIs shall classify their loans/ advances and make provisions in accordance with the criteria prescribed above, and further stipulated in Annexure III & IV and also keeping in view the following:
   a. Banks & DFIs may avail the prescribed benefit of FSV subject to compliance with the following conditions:
      I. The additional impact on profitability arising from availing the benefit of FSV against the pledged stocks, plant & machinery under charge, and mortgaged residential, commercial & industrial properties shall not be available for payment of cash or stock dividend.
      II. Heads of Credit of respective banks & DFIs shall ensure that FSV used for taking benefit of provisioning is determined accurately as per guidelines contained in PRs and is reflective of market conditions under forced sale situations; and
      III. Party-wise details of all such cases where banks & DFIs have availed the benefit of FSV shall be maintained for verification by State Bank's inspection team during regular/ special inspection.
   b. Any misuse of FSV benefit detected during regular/ special inspection of SBP shall attract strict punitive action under the relevant provisions of the Banking Companies Ordinance,

1962. Further, SBP may also withdraw the benefit of FSV from banks & DFIs found involved in its misuse.

Rescheduling/ Restructuring

3. The rescheduling/ restructuring of non-performing loans shall not change the status of classification of a loan/ advance etc. unless the terms and conditions of rescheduling/ restructuring are fully met for a period of at least one year (excluding grace period, if any) from the date of such rescheduling/ restructuring and at least 10% of the outstanding amount is recovered in cash. However, the condition of one year retention period, prescribed for restructured/ rescheduled loan account to remain in the classified category, shall not apply in case the borrower has repaid or adjusted in cash at least 35% of the total restructured loan amount (principal + mark-up), either at the time of restructuring agreement or later-on any time before the completion of one year period as above mentioned. Further, banks & DFIs may credit their income account to the extent of cash recovery made against accrued markup on the restructured/ rescheduled loans.
4. Banks & DFIs shall ensure that Rescheduling is not done simply to avoid classification. While reporting to the Credit Information Bureau (e-CIB) of State Bank of Pakistan, such loans/ advances may be shown as 'rescheduled/ restructured' instead of 'default'.

   Where a borrower subsequently defaults (either principal or mark-up) after the rescheduled/ restructured loan has been declassified by a bank/ DFI as per above guidelines, the loan shall again be classified in the same category it was in at the time of rescheduling/ restructuring and the unrealized markup on such loans taken to income account shall also be reversed. However, banks & DFIs may, at their discretion, further downgrade the classification, taking into account the subjective criteria.

   At the time of rescheduling/ restructuring, banks & DFIs shall consider and examine the requests for working capital strictly on merit, keeping in view the viability of the project/ business and appropriately securing their interest etc.

   All fresh loans granted by the banks & DFIs to a party after rescheduling/ restructuring of its existing facilities may be monitored separately, and will be subject to classification under this Regulation on the strength of their own specific terms and conditions.

Timing of Creating Provisions

5. Banks & DFIs shall review, at least on a quarterly basis, the collectability of their loans/ advances portfolio and shall properly document the evaluations so made. Shortfall in provisioning, if any, determined, as a result of quarterly assessment shall be provided for immediately in their books of accounts on quarterly basis.

Reversal of Provision

6. In case of cash recovery, other than rescheduling/ restructuring, banks & DFIs may reverse specific provision held against classified assets only to the extent that required provision as determined under this Regulation is maintained. While calculating the remaining provision

required to be held after cash recovery and reversal of provision there-against, banks & DFIs shall still enjoy the benefit of netting-off the amount of liquid assets and FSV of collateral from the outstanding amount, as described in this regulation. Further, the provision made on the advice of State Bank of Pakistan except where cash recovery is made shall not be reversed without prior approval of State Bank of Pakistan.

Verification by the Auditors

7. The external auditors shall verify as part of their annual audits of banks & DFIs that all requirements as stipulated above and Annexure III & IV for classification and provisioning for assets have been complied with. State Bank of Pakistan shall also check the adequacy of provisioning during on-site inspection.

Regulation ME R-6: Turn-Around-Time

Banks & DFIs shall not take more than 25 working days for the credit approval process (from the date of receipt of complete information). In this respect, the following minimum points shall also be considered:

i. The pre-approval requirements and post-approval requirements (security/ collateral documentation etc.) shall be advised preferably in one go.
ii. The facility shall be disbursed only after the customer completes security documentation.

Annexures to Prudential Regulations for Small & Medium Enterprises Financing

ANNEXURE-I

Small Enterprise Financing (Regulation SE R-8)
Guidelines in the Matter of
Classification and Provisioning for Loans/ Advances

All Financing Facilities (including Short, Medium and Long Term)

CLASSIFICATION	DETERMINANT	TREATMENT OF INCOME	PROVISIONS TO BE MADE
(1)	**(2)**	**(3)**	**(4)**
1. OAEM (Other Assets Especially Mentioned).	Where mark-up/ interest or principal is overdue by 90 days or more from the due date.	Unrealized mark-up/ interest to be kept in Memorandum Account and not to be credited to Income Account except when realized in cash. Unrealized markup/ interest already taken to income account to be reversed and kept in Memorandum Account.	Provision of 10% of the difference resulting from the outstanding balance of principal less the amount of liquid assets realizable without recourse to a Court of Law and Forced Sale Value (FSV) of pledged stocks, plant & machinery under charge and mortgaged residential, commercial and industrial properties (land & building only) to the extent allowed in Annexure II.
2. Substandard.	Where mark-up/ interest or principal is overdue by 180 days or more from the due date.	As above.	Provision of 25% of the difference resulting from the outstanding balance of principal less the amount of liquid assets realizable without recourse to a Court of Law and Forced Sale Value (FSV) of pledged stocks, plant & machinery under charge and mortgaged residential, commercial and industrial properties (land & building only) to the extent allowed in Annexure II.
3. Doubtful.	Where mark-up/ interest or principal is overdue by 1 year or more from the due date.	As above.	Provision of 50% of the difference resulting from the outstanding balance of principal less the amount of liquid assets realizable without recourse to a Court of Law and Forced Sale Value (FSV) of pledged stocks, plant & machinery under charge and mortgaged residential, commercial and industrial properties (land & building

			only) to the extent allowed in Annexure II.
4. Loss.	(a) Where mark-up/ interest or principal is overdue by 18 months or more from the due date. (b) Where Trade Bills (Import/ Export or Inland Bills) are not paid/ adjusted within 180 days of the due date.	As above	Provision of 100% of the difference resulting from the outstanding balance of principal less the amount of liquid assets realizable without recourse to a Court of Law and Forced Sale Value (FSV) of pledged stocks, plant & machinery under charge and mortgaged residential, commercial and industrial properties (land & building only) to the extent allowed in Annexure II.

Note:

Classified loans/ advances that have been guaranteed by the Government would not require provisioning. However, mark up/ interest on such accounts would be taken to Memorandum Account instead of Income Account.

ANNEXURE-II

Small Enterprise Financing (Regulation SE R-8)

<u>Uniform Criteria for Determining the Value of Pledged Stock, Plant & Machinery Under Charge and Mortgaged Properties</u>

1. Banks & DFIs are allowed to take the benefit of Forced Sale Value (FSV) of pledged stocks, plant & machinery under charge, and mortgaged residential, commercial and industrial properties held as collateral against Non Performing Loans (NPLs) for calculating provisioning requirement as tabulated below:

Category of Asset	Forced Sale Value Benefit allowed from the date of classification
Mortgaged residential, commercial and industrial properties (Land & building only)	• 75% for first year • 60% for second year • 45% for third year • 30% for fourth year, and • 20% for fifth year
Plant & Machinery under charge	• 30% for first year • 20% for second year, and • 10% for third year
Pledged stock	• 40% for first, second, and third year

The benefit of FSV against NPLs shall not be available after the period prescribed above.

2. While taking benefit of FSV and arriving at its value, the following minimum points shall be taken into account:

a) At the time of classification, valuation shall not be more than 3 years old.
b) Valuations shall be carried out by an independent professional evaluator who should be listed on the panel of evaluators maintained by the Pakistan Banks' Association (PBA).
c) Only liquid assets, pledged stock, plant & machinery under charge and property having registered or equitable mortgage shall be considered for taking benefit for provisioning, provided no NOC for creating further charge to another bank/ DFI/ NBFC has been issued by the bank/ DFI. Assets having pari-passu charge shall be considered on proportionate basis of the outstanding amount.
d) Hypothecated assets and assets with second charge & floating charge shall not be considered for taking the benefit for provisioning purposes.
e) The evaluator, while assigning any values to the pledged stock, plant and machinery under charge and mortgaged residential, commercial and industrial properties (land and building only), shall take into account all relevant factors affecting the salability of such assets including any difficulty in obtaining their possession, their location, condition and the prevailing economic conditions in the relevant sector, business or industry. The values of pledged stock, plant and machinery under charge and mortgaged property so determined by the evaluators have to be reasonably good estimate of the amount that could currently be obtained by selling such assets in a forced/ distressed sale condition.

The evaluators should also mention in their report the assumptions made, the calculations/ formulae/ basis used and the method adopted in determination of the values i.e. the forced sales value (FSV).

f) In cases where the evaluators are not allowed by the borrowers to enter in their premises, the benefit of FSV shall not be accepted for provisioning purposes.

g) The additional impact on profitability arising from availing the benefit of FSV against pledged stocks, plant and machinery under charge, and mortgaged residential, commercial and industrial properties (land and building only) shall not be available for payment of cash or stock dividend.

3. Any misuse of FSV benefit detected during regular/ special inspection of SBP shall attract strict punitive action under the relevant provisions of the Banking Companies Ordinance, 1962. Further, SBP may also withdraw the benefit of FSV from banks & DFIs found involved in its misuse.

4. Various categories of assets to be considered for valuation would be as under (no other assets shall be taken into consideration):

a) <u>Liquid Assets</u>:

Valuation of Liquid Assets shall be determined by the bank & DFI itself and verified by the external auditors. However, in the case of pledged shares of listed companies, values should be taken at market value as per active list of Stock Exchange on the balance sheet date. Moreover, valuation of shares pledged against loans/ advances shall be considered only if such shares are in dematerialized form in the Central Depository Company of Pakistan (CDC), otherwise these will not be admissible for deduction as liquid assets while determining required provisions.

b) <u>Mortgaged Property and Plant & Machinery under Charge</u>:

Valuation of residential, commercial and industrial property (land and building only) and plant & machinery would be accepted as determined by the evaluators in accordance with the criteria given above.

c) <u>Pledged Stocks</u>:

In case of pledged stocks of perishable and non-perishable goods, forced sale value should be provided by evaluators, and such valuation should not be more than six months old, at each balance sheet date. The goods should be perfectly pledged, the operation of the godown (s) or warehouse(s) should be in the control of banks & DFIs and relevant documents should be available. In case of perishable goods, the evaluator should also give the approximate date of complete erosion of value of pledged stock.

ANNEXURE-III

Medium Enterprise Financing (Regulation ME R-5)

Guidelines in the Matter of Classification and Provisioning for Assets

All Financing Facilities (including Short, Medium and Long Term)

CLASSIFICATION	DETERMINANT	TREATMENT OF INCOME	PROVISIONS TO BE MADE
(1)	(2)	(3)	(4)
1. Substandard.	Where mark-up/ interest or principal is overdue by 90 days or more from the due date.	Unrealized mark-up/ interest to be kept in Memorandum Account and not to be credited to Income Account except when realized in cash. Unrealized markup/ interest already taken to income account to be reversed and kept in Memorandum Account.	Provision of 25% of the difference resulting from the outstanding balance of principal less the amount of liquid assets realizable without recourse to a Court of Law and Forced Sale Value (FSV) of pledged stocks, plant & machinery under charge and mortgaged residential, commercial and industrial properties (land & building only) to the extent allowed in Annexure IV.
2. Doubtful.	Where mark-up/ interest or principal is overdue by 180 days or more from the due date.	As above.	Provision of 50% of the difference resulting from the outstanding balance of principal less the amount of liquid assets realizable without recourse to a Court of Law and Forced Sale Value (FSV) of pledged stocks, plant & machinery under charge and mortgaged residential, commercial and industrial properties (land & building only) to the extent allowed in Annexure IV.

1.	Loss.	(a) Where mark-up/ interest or principal is overdue by one year or more from the due date. (b) Where Trade Bills (Import/ Export or Inland Bills) are not paid/adjusted within 180 days of the due date.	As above.	Provision of 100% of the difference resulting from the outstanding balance of principal less the amount of liquid assets realizable without recourse to a Court of Law and Forced Sale Value (FSV) of pledged stocks, plant & machinery under charge and mortgaged residential, commercial and industrial properties (land & building only) to the extent allowed in Annexure IV.

Note:

Classified loans/advances that have been guaranteed by the Government would not require provisioning; however, mark up/interest on such accounts would be taken to Memorandum Account instead of Income Account.

ANNEXURE-IV

Prudential Regulations for Medium Enterprise Financing (Regulation ME R-5)

Uniform Criteria for Determining the Value of Pledged Stock, Plant & Machinery under Charge and Mortgaged Properties

1. Only liquid assets, pledged stock, plant & machinery under charge and residential, commercial and industrial property having registered or equitable mortgage shall be considered for taking benefit for provisioning, provided no NOC for creating further charge to another bank/ DFI/ NBFC has been issued by the bank/ DFI. The aforesaid assets having pari-passu charge shall be considered on proportionate basis of outstanding amount.

2. Hypothecated assets and assets with second charge & floating charge shall not be considered for taking the benefit for provisioning.

3. Banks & DFIs are allowed to take the benefit of Forced Sale Value (FSV) of pledged stocks, plant & machinery under charge, and mortgaged residential, commercial and industrial properties held as collateral against Non Performing Loans (NPLs) for calculating provisioning requirement as tabulated below:

Category of Asset	**Forced Sale Value Benefit allowed from the date of classification**
Mortgaged residential, commercial and industrial properties (land & building only)	• 75% for first year • 60% for second year • 45% for third year • 30% for fourth year, and • 20% for fifth year
Plant & Machinery under charge	• 30% for first year • 20% for second year, and • 10% for third year
Pledged stock	• 40% for first, second, and third year

The benefit of FSV against NPLs shall not be available after the period prescribed above.

4. Valuations shall be carried out by an independent professional evaluator who should be listed on the panel of evaluators maintained by the Pakistan Banks' Association (PBA). For selection and listing of the evaluators, PBA lays down the minimum eligibility criteria with the prior approval of the State Bank of Pakistan. The evaluator, while assigning any values to the pledged stock, plant & machinery under charge and residential, commercial and industrial mortgaged property, shall take into account all relevant factors affecting the salability of such assets including any difficulty in obtaining their possession, their location, condition and the prevailing economic conditions in the relevant sector, business or industry. The values of pledged stock, plant & machinery under charge and residential, commercial and industrial mortgaged property so determined by the evaluators must have to be a reasonably good estimate of the amount that could currently be obtained by selling such assets in a forced/ distressed sale condition. The evaluators should also

mention in their report the assumptions made, the calculations/ formulae/basis used and the method adopted in determination of the values i.e. the forced sale value (FSV).

5. The valuation process shall include conducting a 'Full-Scope Valuation' of the assets in the first year and then followed by 'Desktop Evaluations' in the second and third year. Full-scope valuation shall be valid for three years from the date of last Full-scope valuation.

6. The following may be noted in respect of the Desktop and Full-Scope Valuations:

- Desktop Evaluation is defined as "an Interim Brief Review of Full-Scope Evaluation, so that any significant change in the factors, on which the full-scope valuation was based, is accounted for and brought to the notice of the lending bank/ DFI."

- In case the loans exceed Rs 100 million, the Desktop Valuation shall be done by the same evaluator, who had conducted the Full-Scope Valuation (the evaluator should be on the approved panel of the PBA) whereas for loans below this threshold, the Desktop Valuation may be done by banks & DFIs themselves or by the approved evaluators. For conducting Desktop Evaluation, the evaluators shall pay a short visit to the borrower's site. Banks'/ DFIs' responsibility in this respect will be to ensure that the evaluator is contacted for conducting Desktop Valuation, and is provided all necessary information which is materially important for the interim review.

- Desktop Valuation shall be used for determining any additional provisioning requirement only and will not be applied for reducing the provisioning requirement, assessed on the basis of Full-Scope Valuation.

- In cases where the evaluators are not allowed by the borrowers to enter in their premises, the Full-Scope Valuation, conducted as such, will not be accepted for provisioning benefit.

7. State Bank of Pakistan may check the valuations of the assets under mortgage/ charge, through an independent evaluator, on random basis, to verify the reasonableness of the valuations. The unjustified differences in the valuations of banks & DFIs and State Bank of Pakistan shall render the concerned bank/ DFI and evaluator to penal actions including, interalia, withdrawal of FSV benefit.

8. Various categories of assets to be considered for valuation would be as under (no other assets shall be taken into consideration):

a) <u>Liquid Assets:</u>
Valuation of Liquid Assets shall be determined by a bank/ DFI itself and verified by the external auditors. However, in the case of pledged shares of listed companies, values should be taken at market value as per active list of Stock Exchange(s) on the balance sheet date. Moreover, valuation of shares pledged against loans/ advances shall be considered only if such shares are in dematerialized form in the Central Depository Company of Pakistan (CDC); otherwise, these will not be admissible for deduction as liquid assets while determining required provisions.

b) <u>Mortgaged Property and Plant & Machinery under Charge:</u>
Valuation of residential, commercial and industrial mortgaged property (land and building only) and plant & machinery would be accepted as determined by the evaluators in accordance with the criteria given above.

c) <u>Pledged Stocks:</u>
In case of pledged stocks of perishable and non-perishable goods, forced sale value should be provided by evaluators, and such valuation should not be more than six months old, at each balance sheet date. The goods should be perfectly pledged, the operation of the godown(s) or warehouse(s) should be in the control of banks & DFIs and regular valid insurance and other documents should be available. In case of perishable goods, the evaluator should also give the approximate date of complete erosion of value.

ANNEXURE-V

DEFINITIONS OF IMPORTANT TERMS

For the purpose of these regulations:

1. **Bank** means a banking company as defined in Banking Companies Ordinance, 1962.

2. **Borrower** means a person on which a bank/ DFI has taken any exposure during the course of business.

3. **Contingent liability** means:
   (a) a possible obligation that arises from past events and whose existence shall be confirmed only by the occurrence or non- occurrence of one or more uncertain future events not wholly within the control of the enterprise; or
   (b) a present obligation that arises from past events but is not recognized because:
      (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
      (ii) the amount of the obligation cannot be measured with sufficient reliability; and includes letters of credit, letters of guarantee, bid bonds/ performance bonds, advance payment guarantees and underwriting commitments.

4. **DFI** means Development Financial Institution and includes the Saudi Pak Industrial and Agricultural Investment Company Limited, the Pak Kuwait Investment Company Limited, the Pak Libya Holding Company Limited, the Pak Oman Investment Company (Pvt.) Limited, Pak-Brunei Investment Company Limited, Pak-China Investment Company Limited, Pak-Iran Joint Investment Company Limited, House Building Finance Corporation and any other financial institution notified under Section 3-A of the Banking Companies Ordinance, 1962.

5. **Documents** include vouchers, cheques, bills, pay-orders, promissory notes, securities for leases/advances, and claims by or against banks & **DFIs** or other papers supporting entries in the books of a bank & DFI.

6. **Exposure** means financing facilities whether fund based and/or non-fund based and include:
   (i) Any form of financing facility extended or bills purchased/discounted except ones drawn against the L/Cs of banks & DFIs rated at least 'A' by Standard & Poor, Moody's, Fitch-Ibca or credit rating agency on the approved panel of State Bank of Pakistan and duly accepted by such L/C issuing banks & DFIs
   (ii) Any financing facility extended or bills purchased/discounted on the guarantee of the person
   (iii) Subscription to or investment in shares, Participation Term Certificates, Term Finance Certificates, Sukuk or any other Commercial Paper by whatever name called (at book value) issued or guaranteed by the persons
   (iv) Credit facilities extended through corporate cards
   (v) Any financing obligation undertaken on behalf of the person under a letter of credit including a stand-by letter of credit, or similar instrument
   (vi) Loan repayment financial guarantees issued on behalf of the person

(vii) Any obligations undertaken on behalf of the person under any other guarantees including underwriting commitments
(viii) Acceptance/ endorsements made on account
(ix) Any other liability assumed on behalf of the client to advance funds pursuant to a contractual commitment

7. **Forced Sale Value (FSV)** means the value, which fully reflects the possibility of price fluctuations and can currently be obtained by selling the mortgaged/ pledged assets in a forced/ distressed sale conditions.

8. **Government Securities** include such types of Pak. Rupee obligations of the Federal Government or a Provincial Government or of a Corporation wholly owned or controlled, directly or indirectly, by the Federal Government or a Provincial Government and guaranteed by the Federal Government as the Federal Government may, by notification in the Official Gazette, declare, to the extent determined from time to time, to be Government Securities.

9. **Group** means persons, whether natural or juridical, if one of them or his dependent family members or its subsidiary, have control or hold substantial ownership interest over the other. For the purpose of this:

   (a) **Subsidiary** shall have the same meaning as defined in sub-section 3(2) of the Companies Ordinance, 1984 i.e. a company or a body corporate shall deemed to be a subsidiary of another company if that other company or body corporate directly or indirectly controls, beneficially owns or holds more than 50% of its voting securities or otherwise has power to elect and appoint more than 50% of its directors.

   (b) **Control** refers to an ownership directly or indirectly through subsidiaries, of more than one-half of voting power of an enterprise.

   (c) **Substantial ownership/affiliation** means beneficial shareholding of more than 25% by a person and/or by his dependent family members, which shall include his/her spouse, dependent lineal ascendants and descendants and dependent brothers and sisters. However, shareholding in or by the Government owned entities and financial institutions shall not constitute substantial ownership/affiliation, for the purpose of these regulations.

10. **Liquid Assets** are the assets which are readily convertible into cash without recourse to a court of law and mean encashment/realizable value of government securities, bank deposits, gold ornaments, gold bullion, certificates of deposit, shares of listed companies which are actively traded on the stock exchange, NIT Units, certificates of mutual funds, Certificates of Investment (COIs) issued by DFIs/NBFCs rated at least ‘A’ by a credit rating agency on the approved panel of State Bank of Pakistan, listed TFCs rated at least ‘A’ by a credit rating agency on the approved panel of State Bank of Pakistan and certificates of asset management companies for which there is a book maker quoting daily offer and bid rates and there is active secondary market trading. These assets with appropriate margins should be in possession of the banks & DFIs with perfected lien.

Guarantees issued by domestic banks & DFIs when received as collateral by banks & DFIs shall be treated at par with liquid assets whereas, for guarantees issued by foreign banks, the issuing banks' rating, assigned either by Standard & Poors, Moody's, or Fitch-Ibca should be 'A' and above or equivalent.

The inter-branch indemnity/guarantee issued by the bank's overseas branch in favor of its sister branch in Pakistan, would also be treated at par with liquid assets, provided the bank is rated 'A' and above or equivalent either by Standard & Poors, Moody's or Fitch-Ibca. The indemnity for this purpose should be similar to a guarantee i.e. unconditional and demand in nature.

11. **Medium and Long Term Facilities** mean facilities with maturities of more than one year and Short Term Facilities mean facilities with maturities up to one year.

12. **NBFC** means Non-Banking Finance Company and includes a Leasing Company, Housing Finance Company, Investment Bank, Discount House, Asset Management Company and a Venture Capital Company.

13. **Other Form of Security** means hypothecation of stock (inventory), assignment of receivables, lease rentals, contract receivables, etc.

14. **PBA** means Pakistan Banks Association.

15. **Readily Realizable Assets** mean and include liquid assets and stocks pledged to the banks & DFIs in possession, with 'perfected lien' duly supported with complete documentation.

16. **Secured** means exposure backed by tangible security and any other form of security with appropriate margins (in cases where margin has been prescribed by State Bank, appropriate margin shall at least be equal to the prescribed margin). Exposure without any security or collateral is defined as clean.

    The banks & DFIs may also take exposure against Trust Receipts. They are, however, free to take collateral/securities, to secure their risks/exposure, in addition to the Trust Receipts.

    Banks & DFIs shall be free to decide about obtaining security/collateral against the L/C facilities for the interim period, i.e. from the date of opening of L/C till the receipt of title documents to the goods.

17. **Tangible Security** means readily realizable assets (as defined in these Prudential Regulations), mortgage of land, plant, building, machinery and any other fixed assets.