Provisioning Criteria for Non-Performing Debt Securities

Securities

Securities where we can carry provisioning due to default are as following;

I. Certificate of Investments (COIs)
II. Letter of Placements (LOPs)
III. Certificate of Deposit (CODs)
IV. Certificate of Musharaka (COMs)
V. Debt Securities (TFCs, Bonds, Debentures, Sukuks and Commercial Papers)

1. Eligibility Criteria for debt security and other for making provision

Eligibility criteria for debt security and other for making provisions is when the interest and or principal amount is past or over due by 15 calendar days from the due date, and the debt security has been classified as non-performing exposure.

2. Criteria for Classification of Non-performing Exposure

A debt security shall be classified as non-performing, if the interest and or principal amount is past or over due by 15 calendar days from the due date.

3. Provisioning Requirement

NAFA Funds at all times will follow minimum provisioning criteria as defined by SECP circular no. 01 of 2009 and such other circulars as issued by SECP from time to time. Excess provisioning over and above the minimum criteria as defined by the SECP will be carried by NAFA Funds on the basis of thorough analysis of all pertinent fundamentals related to company by the Investment Committee. These fundamentals are outlined in Annexure 'A'.

4. Criteria for Suspension of Mark Up

The accrual of interest /profit shall be suspended from the first day the interest/profit payment falls due and is not received. All interest/profit accrued and recognized in the books of the Funds shall be reversed immediately once the debt security is classified as non-performing.

5. Reversal of Regulatory Provisioning:

As per Annexure II of SECP Circular No: 01 of 2009 (see attached)

6. Criteria for Provisioning/Reversal of Excess provisioning

Once NAFA Investment Committee conducts an analysis based on the factors mentioned in Annexure 'A'. It will determine the amount of excess provisioning required or the amount of reversal of excess provisioning. The same will be carried subject to the approval of the Board and disclosure in the quarterly accounts.

ANNEXURE 'A'

The Investment Committee will decide the excess provisioning and the reversal of the excess provisioning of the non-performing debt securities based on thorough analysis of the following five factors:

1. Macro-economic outlook
2. Industry fundamentals
3. Company fundamentals
4. Company specific events
5. Collateral/ Security of the debt security
6. Restructuring of the Debt

1. Macro-economic outlook

The Investment Committee will form its view on the economy of Pakistan by analyzing macro-economic variables including:

- Interest Rates, State Bank stance, Monetary Policy statement, liquidity of banking system
- Inflation data, Money Supply
- Fiscal Deficit, Allocation to Public Sector Development Program, trend of tax receipts, fiscal deficit as percentage of GDP
- Balance of Payments, Current account deficit and Trade Accounts, Import/ Export trends, capital and financial inflows/ outflows including FDI, developmental loans, grants etc.
- GDP growth and its projections
- Manufacturing sector/ services sector performance and outlook

2. Industry fundamentals

The Investment Committee will form its view on the specific industry of the non-performing entity by analyzing the following factors:

- Sales, volumes and price growth of the entire sector
- Nature of industry e.g., consumer, industrial, cyclical, supplier/ company/ customer bargaining power and profile, concentration of participants i.e. dominated by few or segmented
- Margins of the sector, inputs prices, input supply side availability, products pricing, demand of products/ services
- Existing Government Regulations including taxation, extent and likelihood of changes in Government Regulations
- Factors to which the industry is sensitive e.g. export oriented or domestic usage of the sector's output, Rupee rates, economy and per capita income, inflation, demand/ supply of inputs, impact from related sectors

3. Company fundamentals

The company fundamentals will be evaluated by the Investment Committee based on the following factors

S. No.	Criteria	Financials	Sub Criteria
1	LIQUIDITY	Historical	Current Ratio
		Forecast	Quick Ratio
			Cash Ratio
			Net Working Capital / Total Assets
2	Profitability	Historical	EBITDA / Sales
		Forecast	EBITDA / Assets (ROA)
3	Operating	Historical	Sales / Total Assets
			Sales / Fixed Assets
4	Repayment Capacity / Coverage	Forecast	EBITDA / I
			DSCR
5	Leverage	Historical	Interest Bearing Debt / Total Assets
		Forecast	Long Term Interest Bearing Debt / Total Assets
6	Financial Reporting / Transparency	Current	Auditors (State Bank assigned category)
			Listed
7	Owners	Current	Sponsors strength
			Ownership Structure
8	Management	Current	Management Quality
9	Industry	Forecast	Strength / Rating
10	Within Industry	Current	Market Share Ratio
11	Security	Current	Type of Charge
			Superiority of Charge
			FSV / Outstanding Loan
12	Covenants	Current	

The research team of NAFA Funds is carrying analysis of all the companies for fixed income department. The above defined ratios will be calculated on the actual numbers from financial statements of the company and forecasted financial statements as calculated by the research team.

4. **Company specific events**

Company specific events will be continually monitored by the Fund Manager and/ or Research team. These will be factored in while applying and reversing the excess provisioning. The main factors that will be looked upon in this regard include most importantly any restructuring developments. These factors are:

- Restructuring developments; whether restructuring plan is submitted by company, restructuring plan is approved by majority of stakeholders, default suit filed by stakeholders
- Merger, or take-over deal by an outside acquirer are also very significant.
- Any significant changes in Management, Board of Directors,
- Company's product lines, area and scope of business, coverage, reputation, brand image etc.

5. **Collateral**

The specific collateral / security behind the non-performing debt security will be given weight in the Investment Committee's decision regarding applying provisioning against the security. The natures of assets and marketability/ liquidity of these assets will be considered. The type of charge created on these assets will also be very important input in the Investment Committee's decision.

6. **Restructuring**

The investment committee can decide to reverse the excess provisioning on the occurrence of following events

- Restructuring Term Sheet received from the Issuer
- Restructuring Terms and condition agreed by the investors/lenders
- Signed supplementary Trust Deed received by the Funds

Securities and Exchange Commission of Pakistan
Specialized Companies Division
NBFC Department

No.NBFCD/MF/CIRCULAR/2009-31

January 6, 2009

CIRCULAR NO: 01 of 2009

SUBJECT: **VALUATION OF DEBT SECURITIES AND PROVISIONING CRITERIA FOR NON-PERFORMING DEBT SECURITIES**

1. This circular is applicable only to the debt securities held by Collective Investment Schemes for determining daily Net Asset Value (NAV).

2. For the purpose of this circular, debt security means any security issued by a company or a body corporate for the purpose of raising funds in the form of redeemable capital and includes Term Finance Certificates (TFCs), bonds, debentures, Sukuks, and commercial papers etc.

3. Dormant debt securities market coupled with recent liquidity crunch significantly dried out trading of debt securities held by Collective Investment Schemes. Owing to this, fair valuation of debt securities based on market traded data became unviable. Therefore the pricing mechanism entrusted with Mutual Fund Association of Pakistan (MUFAP) for determining and declaring the fair value of debt securities based on quotation of three brokers in terms of traded volume had become ineffective.

4. In order to derive the fair valuation of debt securities held by Collective Investment Schemes the MUFAP after thorough review of international best practices submitted a methodology for valuation of debt securities and provisioning criteria for non-performing debt securities to the Commission for its consideration. The Commission held various consultative meetings with the MUFAP in order to finalize these.

5. Now, in exercise of its powers conferred under section 282B (3) of the Companies Ordinance, 1984 read with Regulation 66 (b) of Non-Banking Finance Companies and Notified Entities ("NBFC") Regulations, 2008, the SECP hereby directs all the Asset Management Companies (AMCs) to apply the enclosed methodology in true letter and sprit to arrive at fair valuation of debt securities and provisioning thereon for determining true and fair daily NAVs. Adoption of the said methodology is aimed at bringing consistency across the mutual fund industry and is expected to lead to fair price discovery of debt securities. Methodology for Valuation of Debt Securities and Provisioning criteria for Non-Performing Debt Securities are enclosed at **Annexure 'I' and Annexure 'II'** respectively.

6. The value of debt securities based on methodology for valuation of debt securities shall be determined and announced by MUFAP on the fortnightly basis for the next eight (8) weeks from effective date of this circular. However, in case of any significant event (like changes in discount rate, KIBOR, etc), fresh valuation of debt securities shall be carried out by MUFAP immediately. After expiry of eight (8) weeks, the valuation of debt securities shall be determined and announced by MUFAP on daily basis. MUFAP shall announce these valuation on its website and shall maintain all the relevant data and working for at least 18 months.

7. In order to ensure consistent application of the methodology for valuation of debt securities, the MUFAP, in consultation with the Commission, shall appoint an accounting firm for conducting audit on a regular basis.

8. Given the specialized nature of the methodology for valuation of debt securities the same shall be reviewed by MUFAP on an ongoing basis and at least quarterly. Any refinements that are deemed necessary shall be presented by MUFAP to the Commission immediately for its consideration.

9. In case of any clarification with respect to this circular, all the AMCs and MUFAP shall approach the Commission for this purpose.

10. This circular supersedes directive issued vide Circular No. 26/2008 dated the 5th November, 2008.

11. This circular shall come into force with effect from January 10, 2009.

Akif Saeed

(AKIF SAEED)
Executive Director (NBFCD)

Distribution:

(i) Mutual Fund Association of Pakistan
(ii) Chief Executive Officers, all Asset Management Companies
(iii) Managing Directors, KSE, LSE, ISE
(iv) Institute of Chartered Accountants of Pakistan

Annexure - I

METHODOLOGY FOR VALUATION OF DEBT SECURITIES

CHAPTER 1

CLASSIFICATION OF DEBT SECURITIES

The debt securities held by the Collective Investment Schemes shall be classified as per the following criteria:

1. **Traded Securities**
   - Debt securities that have a minimum traded volume of Rs.25 million during the 30 (calendar) days period before the valuation date.
2. **Thinly Traded Securities**
   - Debt securities that have a traded volume of less than Rs.25 million during the 30-day period before the valuation date.
3. **Non Traded Securities**
   - Debt securities that have a traded volume below Rs.1 million during the 30-day period before the valuation date.

Debt securities classified on the above basis, shall be further categorized as follows and valued accordingly:

(a) **Rated** – Debt security rating shall be used and where no such rating is available the rating of the issuing company or the body corporate shall be applicable. In case of more than one rating, the most conservative publicly available rating shall be used.

- **Investment Grade** (credit rating of BBB and above)
- **Non Investment Grade**
  - Performing Assets
  - Non Performing Assets (issuer delays an interest/principal payment)

(b) **Non-rated –** issue where neither the debt security nor the debt issuing company or the body corporate is rated shall be classified as non-rated

- An internal rating shall be assigned by MUFAP and such rating shall be a notch below the rating of a comparable issue/issuer rating in the same sector/industry.
- If a comparable issue/issuer is also not available, the issue shall be treated below investment grade and valued as elaborated in "valuation of non-investment grade debt securities" mentioned below in Chapter 2.

CHAPTER 2

1. VALUATION OF TRADED DEBT SECURITIES

All debt securities classified as traded securities shall be valued on the basis of their volume weighted average price during the fifteen (15) calendar days preceding their valuation date. In case of no trades during the last 15 days period, trades during the thirty (30) calendar days preceding the valuation date shall be used for the purpose of calculating the volume weighted average price.

2. VALUATION OF THINLY AND NON TRADED DEBT SECURITIES

i) INVESTMENT GRADE:

The performing investment grade debt securities shall be classified as under:

a) **Debt Securities with residual maturities of up to six months** – Such non traded and thinly traded debt securities shall be valued on the basis of amortization to its face value.

b) **Debt Securities with residual maturities of over six months** – Such non traded and thinly traded debt securities shall be valued in accordance with the yield matrix as explained in Chapter 3 below:

In case an investment grade debt security is classified as non-performing, the determined value shall be provided for in accordance with the Annexure II.

ii) NON INVESTMENT GRADE

- Non investment grade performing debt securities shall be valued at a discount of 25% to the face value

In case a non-investment grade debt security is classified as non-performing, the determined value (discount of 25% to face value) shall be provided for in accordance with the Annexure II.

<u>CHAPTER 3</u>

VALUATION PROCESS – YIELD MATRIX

STEP I: Establishment of a Benchmark:

A risk free benchmark yield shall be built, for which yields published by Reuters (PKRV) for the government securities shall be grouped into following seven tenor (maturity) buckets:

- 3 - 6 months
- 0.5 - 1 years
- 1 - 2 years
- 2 - 3 years
- 3 - 4 years
- 4 - 5 years
- 5 - 6 years or any longer period

In order to capture the interest rate risk, the debt securities shall be classified on the basis of coupon structure i.e. floating or fixed rate coupon. In case of a debt security structured on floating rate coupon, the relevant tenor bucket shall be applied based on the coupon rate resetting cycle (3months, 6months, one year, etc.). In case of a debt security structured on fixed rate coupon, the relevant tenor bucket shall be applied based on the residual time to maturity.

STEP II: Adding a Credit Spread:

A matrix of spreads (based on the credit risk) shall be built for marking up the benchmark yields. For this purpose following criteria shall be applied:

- Trades of debt securities of various ratings shall be used and all traded debt securities (with minimum traded value of Rs.25 million) during the fortnight under consideration shall be classified by their ratings and grouped into following rating buckets. Each rating bucket shall further be classified into the following sub buckets according to weighted average residual maturity (WARM).

    - Less than One year
    - Between 1 and 3 years
    - Between 3 and 5 years
    - Over 5 years

Rating/WARM	Less than one year	1 to 3 years	3 to 5 years	Over 5 years
AAA				
AA+				
AA				
AA-				
A+				
A				
A-				
BBB+				
BBB				

- All trades during the fortnight prior to the valuation date shall be used in building the corporate Yield To Maturity (YTM) and spread matrices. The spreads so calculated shall be computed fortnightly and average volume weighted yield shall be computed.

- Employing the traded prices as well as primary issuances during the considered fortnight, average volume weighted yield for each rating shall be determined. In the absence of which, the information during the *30-day period* prior to the valuation date shall be considered.

- In the event of lack of trades in the secondary market and the primary market, the gaps in the matrix shall be filled by *extrapolation.* (i.e. if the yield for a particular rating cannot be determined, the average of the yields for a notch above and below shall be used for determining its yield). In case of extrapolation for sub-buckets i.e. weighted average residual maturity, an appropriate factor shall be applied and the same shall be disclosed with rationale.

- If extrapolation is not possible, the gaps in the matrix shall be filled by carrying the spreads from the last matrix.

- In case, the market determined yield curve is not smooth (i.e. the determined yield for a lower rating is lower than the determined yield of a higher rating, which theoretically is not possible), extrapolation (as described above) may be used to smoothen up the yield curve.

STEP III: Mark up/Mark down of Yield

- The yields calculated by MUFAP in accordance with the above steps may be marked-up/marked-down by applying discretionary discount by AMCs as per the following criteria:

- **Application of Discretionary Discount**
  - The asset manager shall have the discretion to apply a mark up/mark down (within the available limit as specified below) to yield of any specific debt security.
  - Discretionary mark up/mark down shall be applied to take into account the following aspects associated with a specific debt security:
    - Illiquidity risk,
    - Sector specific risk,
    - Issuer class risk.
  - Mark up/mark down shall be determined on the basis of whether the issue is rated or unrated as per table below.

	Rated	**Unrated**
Duration up to 2 years	**+100/-50 bps**	**+50 bps**
Duration over 2 years	**+75/-25 bps**	**+50 bps**

  - Application of discretionary mark up/mark down shall be approved by the Investment Committee (with proper written justification) and shall be reported on the same day to the Board of Directors (of AMC), MUFAP, SECP and the Trustees. The decision in relation to application of the discretionary mark up/mark down shall be ratified by the Board of the AMC in the next meeting

- Discretionary mark up/mark down , if applied, shall be reviewed fortnightly or on occurrence of any significant change in the financial markets by the Investment Committee

STEP IV: Valuation

- The risk adjusted yields so arrived shall be used to discount all future cash flows of a debt security to determine its value

Annexure - II

PROVISIONING CRITERIA FOR NON-PERFORMING DEBT SECURITIES

CLASSIFICATION AS A NON-PERFORMING ASSET (NPA)

- A debt security shall be classified as non-performing, if the interest and/or principal amount is past or overdue by 15 calendar days from the due date

SUSPENSION AND REVERSAL OF INTEREST/PROFIT

- The accrual of interest/profit shall be suspended from the first day the interest/profit payment falls due and is not received
- All interest/profit accrued and recognized in the books of Collective Investment Scheme shall be reversed immediately once a debt security is classified as non-performing.

MINIMUM PROVISIONING AGAINST THE PRINCIPAL AMOUNT

All non-performing debt securities whether secured or unsecured shall be provided for in accordance with the following criteria from the day of classification as non-performing:

Effective Day for Provisioning	Minimum Provision as % of book value (outstanding principal amount)	Cumulative Provision
90th day	20%	20%
180th day	10%	30%
270th day	15%	45%
365th day	15%	60%
455th day	balance	100%

- However, full provisioning shall be made immediately if the applicable rating of the debt security is down graded to 'D' (default).

- In addition to the minimum provision prescribed above, any installment of principal amount in arrears during the period of non-performance shall also be fully provided.

Note: The above criteria outlines the minimum provisioning requirements; however, the AMC has the discretion to provide for more than these requirements if the circumstances warrant such provision, subject to the approval of Board and disclosure in quarterly accounts.

RECLASSIFICATION OF NON PERFORMING DEBT SECURITIES

- In case a Collective Investment Scheme has received all the arrears of interest, the interest amount reversed shall be written back to the extent it is received.

- In case a Collective Investment Scheme has received all arrears of interest and the debt security has not been reclassified as performing, the suspension of interest shall continue.

- The debt security shall only be reclassified as performing once all the arrears have been received in cash and debt security is regular on all payments (interest as well as principal) for the next two installments. The provision made for the principal amount shall be written back in the following manner:-

    - Where provision of principal was made due to the interest defaults only, 100% of the debt security provided for in the books shall be written back upon reclassification of the debt security as performing.

    - Where both installments and interest were in default, 50% of the provision made in the books shall be written back at the receipt of the first payment (interest/principal) and 50% at the receipt of second payment and the asset shall be reclassified as performing.