Regulatory Framework for NBFCs in Pakistan

The SME Lending Perspective

Non-Banking Finance Companies (NBFCs), as the name suggests, are financial institutions that provide selected financial services but do not hold a banking license. In most cases, NBFCs are not allowed to take demand deposits and unlike banks, cannot offer checking accounts. In Pakistan NBFCs are engaged in specialized financial services and are envisioned to play an important role in mobilizing finance to complement the outreach of the banking industry, especially in underserved segments such as the SME sector, housing and infrastructure development, leasing and discounting. Locally domiciled NBFCs are regulated and licensed by the Securities and Exchange Commission of Pakistan (SECP) and the Non-Banking Finance Companies (establishment and regulations) Rules, 2003 & the Non-Banking Finance Companies and Notified Entities Regulations, 2008 are the main set of guidelines around governance, operations and structure of NBFCs.

In 2015, the SECP introduced amendments to the Regulations that divided NBFCs into two categories: i) Lending NBFCs,[1] and ii) Asset Management NBFCs. Also included in the lending NBFC category were non-bank microfinance companies (NB-MFCs).[2] This essentially resulted in an existing specialized category of microfinance lenders being placed under the purview of the SECP under a uniform regulatory framework.[3] The different types of NBFCs operating in Pakistan are presented in **Exhibit 1** on the following page**.** They differ in terms of the services they offer, their clientele, minimum equity and licensing requirements.

In addition to the introduction and separation of categories, the 2015 amendments also introduced significant decreases in equity requirements for non-deposit taking NBFCs. For such non-deposit taking NBFCs that are engaged in leasing, discounting and housing finance the minimum equity requirement was revised down to PKR 50 million from PKR 700 million, while for Investment Finance Services (IFS) license holders the requirement was slashed to PKR 100 million from PKR 1,000 million. All in all, these amendments were intended to encourage establishment of more NBFCs with a specialized product focus, thereby expanding the level of credit provided by NBFCs.

Contextualizing Lending by NBFCs in Pakistan

Globally, NBFCs are increasingly recognized as a valuable alternative to bank financing, helping support economic activity and employment generation while enabling unbanked segments to access finance. As such, entities like the G20 and the Financial Stability Board (FSB)[4] have increasingly monitored trends in the NBFC segment while deliberating on the regulatory policies required to provide adequate and enabling oversight.

Despite the 2015 amendments to the NBFC Regulations in Pakistan, combined with other measures such as capacity building and awareness sessions through the SECP and NBFI and *Modaraba Association*, the establishment of new entities and the quantum of financing provided by the NBFC sector, especially through *Modarabas* and Leasing Companies, has been sluggish. The total advances of lending NBFCs (Investment Banks, Leasing Companies, *Modarabas*, and NB-MFCs) stood at PKR 151 billion as of March 2020, a miniscule ~1.88% of the total advances of the domestic banking sector (PKR 8.3 trillion).

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[1] Lending NBFCs are Leasing Companies, Housing Finance Companies, Investment Finance Companies, Non-Bank Microfinance Companies (NB-MFCs) and Discount Houses. The NBFC Rules grant permission to offer the services provided by the aforementioned company under one license with the exception of Microfinance.
[2] Fund Management NBFCs provide Asset Management Services, REIT Management, Pension Fund Management and Private Equity/Venture Capital Management Services.
[3] Until the NBMFC category was introduced, microfinance institutions (MFIs) functioned under a range of laws including the Trusts Act, Societies Act, Section 42 of the Companies' Ordinance, etc.
[4] The Financial Stability Board (FSB) is established to coordinate at the international level the work of national financial authorities and international standard-setting bodies in order to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies.

Exhibit 1: Types of NBFCs in Pakistan

Type of NBFC	Category	Description	Services Offered	Raising Investment/Deposits Externally
Modaraba	Lending	Islamic Finance Model with a clear distinction between management and investors	Trading in *halal* commodities, Investment in Stock Markets, Project Finance, *Sharia* Compliant Financial Products	Issuance of Certificate of *Modaraba* provided the company is listed on the stock exchange for trading purposes
Leasing Company	Lending	Lending for purchase of tangible assets on a rental or purchase model	Operating and Financial Leasing	Issuance of Certificate of Deposits provided the company is listed on the stock exchange *(among fulfilment of other criteria)*
Housing Finance Companies	Lending	Specialized home financing entity	Loans for purchase, construction or renovation of home, small builder loan	Issuance of Certificate of Deposits provided the company is listed on the stock exchange *(among fulfilment of other* criteria)
Investment Finance Company	Lending/ Advisory	Non-bank entity providing corporate finance services	Brokerage and Advisory, Project Financing, Underwriting, Portfolio Management, Capital Market Financing, etc.	Issuance of Certificate of Deposits provided the company is listed on the stock exchange *(among fulfilment of other criteria)*
Non-Bank Microfinance Companies (NB-MFCs)	Lending	Loans to small entrepreneurs and micro enterprises	Loans of up to PKR 500,000 for an individual, and up to PKR 1,500,000 for housing and microenterprise lending	**Cannot** mobilize deposits from clients
Discount House	Lending	An entity providing liquidity in capital markets	Discounting corporate receivables, short term money market instruments and financing against guarantees	Issuance of Certificate of Deposits provided the company is listed on the stock exchange *(among fulfilment of other criteria)*
Asset Management Company	Fund Management	Collective Investment Scheme in the form of a Mutual Fund and/or Pension Fund (subject to fulfilment of certain criteria)	Stand-alone or a combination of investments in money market, debt and equity	"Unit Holders" General Public and/or Institutional Investors
Private Equity/ Venture Capital Firm	Fund Management	Collective Investment Scheme	Portfolio of diversified investments in non-listed private companies with the objective of exiting after a certain time period	Institutional and/or High Net Worth Individuals (HNWI) General Public and/or Institutional Investors
Real Estate Investment Trust (REIT) Management Company	Fund Management	Collective Investment Scheme in real estate	Portfolio of Investments in real estate properties (bought or improved upon) that are sold or rented	Initial Public Offering (IPO)

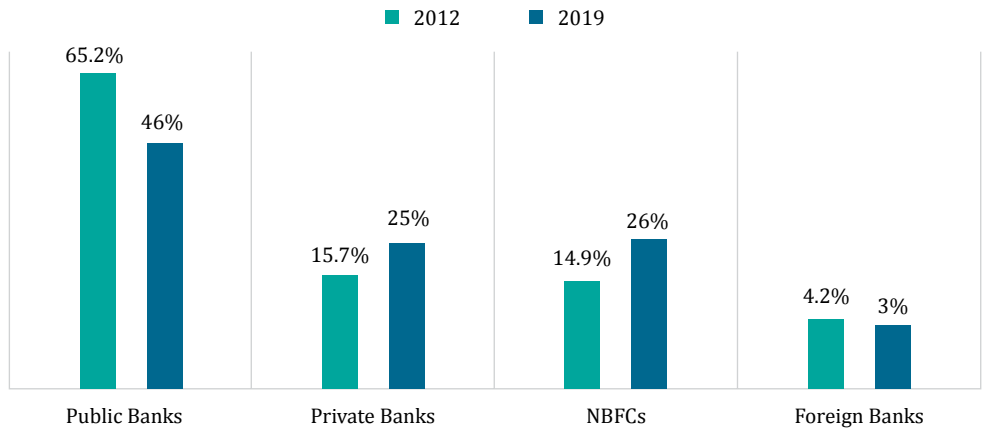
Note: 1) An NBFC license for Investment Finance Services is valid for undertaking Discounting, Leasing and House Financing Services; 2) Lending Companies can only issue Certificates of Investment (COI) with the permission of SECP and subject to the fulfilment of certain criteria

Exhibit 2: Total Assets & Advances of Lending NBFCs (March 2020)[5]

Type of Lending NBFC	No. of Entities	Total Assets (PKR Billion)	Loans, Advances & Leases (PKR Billion)
Leasing Companies	7	11	8
Investment Banks	12	65	45
Modarabas	28	53	20
NB-MFCs	25	122	78
Total	**72**	**251**	**151**

The share of NBFCs in total credit is also strikingly low when compared to neighboring India, which has a thriving NBFC segment. NBFC loans in India have grown steadily; by FY 2019 lending by NBFCs constituted more than 25% of overall credit, up from approximately 15% in 2012.[6]

Exhibit 3: Share of Financial Institutions in Total Credit – India (2012, 2019)



Source: (i). Reserve Bank of India (RBI). Financial Stability Report (FY19). (ii). OECD Economic Surveys: India 2019

Amendments to the NBFC and Notified Entities Regulations 2008

To support the domestic NBFC segment and remove ambiguities in the current regulatory regime, in December 2019 SECP released a set of draft amendments to the Non-Banking Finance Companies and Notified Entities Regulations, 2008 for comments and feedback from all relevant stakeholders. Some of the proposed amendments were notified by the Commission via SRO 279(I)/2020. This research brief takes a closer look at the amendements most relevant to SME financing.

The amendements (already notified and otherwise) are reviewed within the context of the prevalent regulatory regime for domestic NBFCs and also compared to the Prudential Regulations for SME Financing formulated by the State Bank of Pakistan (SBP). This exercise was undertaken with the view that it is crucial to aligning the two regulatory regimes governing the supply side of the SME finance ecosystem for improved performance and providing a level playing field.

[5] Securities and Exchange Commission of Pakistan (SECP). Monthly Sector Report – Mar 2020. https://www.secp.gov.pk/document/nbfi-sector-summary-march-2020/?wpdmdl=39316&refresh=5ee8757903ac41592292729

[6] Reserve Bank of India, Financial Stability Report (FY19)

Box 1: The Case of India[1]

Over the last five years the share of advances by NBFCs in total credit deployment has increased significantly: 13% in 2015 to 26% in 2019.[2] According to a PwC report, most of the growth has been recorded in the areas of retail and micro, small and medium enterprise (MSME) financing with total credit outstanding of INR 7.5 trillion as of FY18. NBFCs have offered these segments equipment financing, hire purchase and leasing, housing finance and gold loans in addition to consumer durable financing.

Growth of India's NBFC sector can be characterized as follows:

- Deep understanding of the different customer segments;
- Customized product offering by adopting non-standard pricing models for product lines, in-line with customer profile and inherent risk of lending;
- Wide and effective reach through building a connected channel experience with 24/7 sales and service;
- Leveraging technology advances for improved efficiency and enhanced experience. Select NBFCs are also investing in data analytics and artificial intelligence (AI) to build robust relationships with their target customer segments;
- Co-lending arrangements by tying up with multiple alternative lenders with digital platforms and commercial banks. This has helped add to the NBFC sector's customer base; and
- Robust risk management models given the focus on lending to the sub-prime customer segment.

Wide ranging regulatory changes and amendments have been introduced by the Reserve Bank of India (RBI) in a bid to enhance the role of NBFCs in the financial landscape of the country. These have included mandatory registration with RBI, maintenance of a proportion of deposits in liquid assets, creation of a reserve fund, changes in capital requirements for registrations, rotation of audit partners, criteria for directors, credit/investment concentration norms, and classification of NBFCs into systemically important NBFCs and non-systemically important NBFCs based on asset size, among others.

The RBI also released a regulatory framework in 2016 allowing for account aggregator NBFCs. These entities are envisioned to perform the function of consolidating all financial information of a person across banks, insurance companies, mutual funds, etc. in a standardized format.[3]

[1] PWC Pvt. Ltd. Building the NBFC of the Future – A Scalable and Profitable Model. 2018
[2] Reserve Bank of India (RBI). Financial Stability Report (FY19)
[3] PWC Pvt. Ltd. Non-Banking Finance Companies: The Changing Landscape. 2016

1. Definition for Small and Medium Enterprise

Pre-Amendment Regulatory Regime for NBFCs

Prior to the amendments notified via SRO 279(I)/2020, the regulations for NBFCs did not specifically define 'Small' and 'Medium' enterprises. Accordingly, entities had to rely on the Companies Act, 2017 to arrive at a classification of such entities. As per the Companies Act, a 'Small Enterprise' is defined as a private company with a paid-up capital of up to PKR 10 million, turnover not exceeding PKR 100 million, and no more than 250 employees. The Act divides 'Medium Enterprises' into two sub-categories i.e., non-listed public company, and private company. A non-listed public company is categorized as medium if it meets certain criteria i.e., paid-up capital of less than PKR 200 million, turnover of less than PKR 1 billion, and between 250 - 750 employees. In the case of a private company, the criteria were somewhat similar but with a floor on thresholds i.e., paid-up capital of more than PKR 10 million but not exceeding PKR 200 million, turnover greater than PKR 100 million but not exceeding PKR 1 billion, and more than 250 but less than 750 employees.

SBP Prudential Regulations for SME Financing

The SBP has clearly defined criteria for Small and Medium enterprises in the Prudential Regulations for SME Financing (see **Exhibit 4** on following page).

Exhibit 4: SBP Criteria for Categorizing SMEs

Feature	Small Enterprises (SE)	Medium Enterprises (ME)
Number of Employees	Up to 50 *(including contractual employees)*	Between 51-250 for Manufacturing & Service entities; Between 51-100 for Trading entities *(including contractual employees)*
Annual Sales Turnover	Up to PKR 150 Million	Above PKR 150 million and up to PKR 800 million (all types of Medium Enterprises i.e. trading, services and manufacturing)
Overlapping Factors	In cases where an entity fulfils one of the criteria for Small Eenterprises (SE) and its second parameter falls within the range prescribed for Medium Enterprises (ME) or above the upper limit prescribed for ME, then the subject entity shall be classified as ME or as a Commercial/Corporate entity.	In cases where an entity fulfills one of the criteria for MEs and its second parameter is above the upper limit prescribed for ME, then the subject entity shall be categorized as a Commercial/ Corporate entity.

Post Amendment Regulatory Regime for NBFCs

With the recently notified amendments, SECP has included the definition for Small and Medium enterprises within the NBFC regulations. The definition included in the NBFC Regulations follows two-factor criteria i.e., Number of Employees and Annual Sales Turnover, with the lower thresholds being similar to those of the SBP's.

Exhibit 5: SECP's Revised Criteria for Categorizing SMEs

Feature	Small Enterprises (SE)	Medium Enterprises (ME)
Number of Employees	A business entity (not a public limited company) that has up to 50 employees *(including contractual employees)*	A business entity that has between 51-250 employees (Manufacturing & Service), or 51-100 employing (Trading) *(including contractual employees)*
Annual Sales Turnover	Up to PKR 150 Million	Above PKR 150 million and up to PKR 800 million *(all types of Medium Enterprises i.e., trading, services and manufacturing)*

This amendment will have positive implications for comparability of data across regulators and institutional peer groups, providing a more accurate picture of SME lending to policy makers, regulators, financial service providers, donors and other stakeholders.

2. Maximum Exposure Limits

Pre-Amendment Regulatory Regime for NBFCs

The regulations, prior to the recent amendments, did state per party and group level exposure limits, however specific exposure limits for SMEs were not part of the framework. In terms of per party limits, the pre-amendment regulatory regime states that a total outstanding exposure (fund based and non-fund based) by an NBFC to any party/person shall not, at any time, exceed 20% of the equity of an NBFC; this ceiling for fund based exposure is set at 15% of equity. For an NBFC engaged exclusively in the business of issuing guarantees to enhance the quality of debt instruments to finance infrastructure projects in Pakistan, the total outstanding exposure (fund based and non-fund based) to any party/person shall not exceed 40% of its equity. This relaxation is applicable for the first five years of the entity's operations.

The regulations also require that an NBFC, while taking exposure, shall not provide finance if the total exposure availed by the borrower from financial institutions (FIs) exceeds 10 times its equity (as disclosed in the financial statements of the borrower). For fund based exposure the limit is set at 4 times the borrower's equity. In instances where the equity of the borrower is negative and the borrower has injected fresh equity during its current accounting year, it will be eligible to obtain financing of up to 4 times of the freshly injected equity, subject to the condition that the borrower shall plough back at least 80% of the net profit annually until such time that it is able to borrow without this relaxation.

In terms of group limits, total outstanding exposure (fund based and non-fund based) by an NBFC to any group is not bound to exceed 25% of the equity of the NBFC while the group level fund based exposure has been capped at 20% of equity. These limits, however, are not applicable to exposures taken by an NBFC in its own subsidiaries out of its surplus equity. For an NBFC engaged exclusively in the business of issuance of guarantees for infrastructure projects, group limit for total outstanding exposure (fund based and non-fund based) is 50% of its equity.

SBP Prudential Regulations for SME Financing

Under the prudential regulations, an SE can avail exposure of up to PKR 25 million from a single bank/DFI or from all banks and DFIs, while MEs can avail financing (including leased assets) of up to PKR 200 million from a single bank/ DFI or from all banks and DFIs. This prescribed restriction is actually on the ultimate client, whether it uses a single FI or multiple institutions, for a maximum amount (cap) that may be borrowed.

Post Amendment Regulatory Regime for NBFCs

While retaining the prevalent clauses on exposure limits (discussed above), the SECP has now added a provision on per party and group limits for institutions involved in wholesale financing. Accordingly, the Infrastructure Finance Company,[7] and a non-deposit taking NBFC that is not involved in retail lending and provides wholesale finance to other NBFCs or financial institutions, are allowed to exceed the earlier defined per party and group limits by up to 5% and 10%, respectively, of its equity. The amendments also restrict the applicability of Article 17 "Maximum Exposure of NBFC to a single person, or Group" to an NBFC that has access to public funds in Pakistan.[8]

While the aforementioned amendments have been notified, the SECP had also included SME specific per party and group level limits. The proposed limits followed a similar structure as mentioned in the SBP's Prudential Regulations for SMEs: it was proposed that SEs and MEs can avail maximum financing of up to PKR 25 million and PKR 200 million, respectively, from a single NBFC, bank or DFI, or from all NBFCs, banks or DFIs. However, the amendments that have been subsequently notified exclude this proposal. Had this amendment been approved, it would have provided a clear and tiered structure for domestic NBFCs to follow, based on the ultimate risk profile and nature of their respective clientele. Client specific exposure limits could have paved the way for unambiguous lending rules, while comparable thresholds would have provided a level playing field for all bank and non-bank lenders to SMEs.

3. Unsecured Finance

Pre-Amendment Regulatory Regime for NBFCs

NBFCs were allowed to provide unsecured finance of up to PKR 200,000 to a single borrower with a limit on aggregated portfolio of unsecured financing, which was bound to not exceed the total equity of an NBFC. The Regulations were even more restrictive in the case of deposit taking NBFCs, where total unsecured financing was stipulated to not, at any time, exceed 50% of their equity. It should be noted that these limits cater to the type of financing rather than the nature of clients.

SBP Prudential Regulations for SME Financing

As per the SME Prudential Regulations, banks and DFIs can take clean exposure (facilities secured solely against personal guarantees) on an SME borrower of up to PKR 5 million i.e., 25 times the limit allowed to NBFCs.

Post Amendment Regulatory Regime for NBFCs

The SECP has retained its mechanism of defining limits with respect to the type of financing rather than the nature of clients. In the notified amendment it has retained the existing limit on unsecured financing of PKR 200,000 (to a single borrower) for deposit taking NBFCs. However, in the case of non-deposit taking NBFCs this limit is now set at 10% of an NBFCs equity (for single borrowers or a group). The SECP has also retained its guidelines on the aggregated amount of unsecured finances.

Accordingly, the aggregate unsecured financing by a non-deposit taking NBFC shall not exceed its equity. In the case of deposit taking NBFCs, aggregate unsecured financing shall not, at any time,

[7] Infrastructure Finance Company is an NBFC which deploys at least 70% of its total assets in infrastructure finance and is compliant with minimum equity and CAR requirement defined in the regulations.
[8] "Public Funds" include public deposits, inter-corporate deposits, bank finance and all funds received whether directly or indirectly from outside sources such as funds raised by issue of debentures, commercial papers etc. "indirect receipt of public funds" means funds received through associates and group entities which have access to public funds

exceed 50% of their equity. In addition, the regulations now also require NBFCs to determine their internal prudential limits, restrictions and requirements for unsecured exposure as per the credit and risk management policies duly approved by their Board, and to submit reports to the Commission on a quarterly basis regarding such policies and the unsecured finance provided.

Earlier, the SECP had proposed that an NBFC may be allowed to provide unsecured finance of up to PKR 500,000 to a single borrower. In addition, the proposals also included the allowance to NBFCs to provide unsecured finance of up to PKR 2 million to an SME, subject to: Ii). Obtaining personal guarantees of its owners, partners or directors, as the case may be, and (ii). Obtaining an undertaking from the SME that its aggregate unsecured exposure does not exceed this limit. However, these proposals have not been notified by the Commission.

The limit on unsecured lending prescribed for deposit taking NBFCs (PKR 200,000), when viewed in light of: (i). the clean lending limit prescribed for banks (up to PKR 5 million), (ii). the regulatory space provided to microfinance banks (MFBs), which can lend up to PKR 1 million and in the case of NBMFCs, PKR 0.5 million to individuals and PKR 1.5 million to micro entrepreneurs, and (iii). the inability of the majority of SMEs to provide collateral in the form of land and property.[9] Raising the limit on unsecured lending would have been a promising move, especially in light of the increasing uptake of technology and the introduction of AI-powered credit scoring models. In the long run this allowance could incentivize more NBFCs to enroll for a deposit taking on IFS licenses, resulting in greater diversification to their funding sources and higher lending.

4. Requirement for Audited Financial Statements

Pre-Amendment Regulatory Regime for NBFCs

SECP has defined a tiered structure of documentary requirements for NBFCs extending financing to its retail clients. The requirements are defined based on exposure limits. As per the pre-amendment regime, a borrower was required to submit audited accounts if the loan request exceeds PKR 5 million. Loans of less than PKR 5 million could be sanctioned and approved based on less stringent documentary requirements.

Exhibit 6: Documentary Requirements by Exposure Limit

Exposure Limit	Documentary Evidence and Audit Requirements
Exposure up to PKR 1 million	Documentary evidence of net worth of the Borrower
Exposure more than PKR 1 million but not exceeding PKR 2 million	Accounts duly signed by the Borrower
Exposure more than PKR 2 million but not exceeding PKR 5 million	Accounts duly signed by the Borrower and counter signed by: (i) a chartered accountant; or (ii) a practicing cost and management accountant
Exposure more than PKR 5 million	Accounts duly audited by: (i) a practicing-chartered accountant; or (ii) a practicing cost and management

SBP Prudential Regulations for SME Financing

In the case of SEs, banks and DFIs are not required to obtain a copy of audited accounts for exposure up to PKR 15 million. However, in such cases, banks and DFIs may ask the borrower to submit financial accounts in some form, signed by the borrower, to assess SEs' cashflows and conduct due diligence. If the loan to a SEs exceeds PKR 15 million, banks and DFIs are required to obtain a copy of financial statements duly audited by a practicing chartered accountant. In the case of MEs, banks and DFIs are required to obtain audited financial statements if the exposure of the bank/DFI exceeds PKR 10 million.

Post Amendment Regulatory Regime for NBFCs

In its recent amendments, SECP has relaxed the requirement of obtaining audited financials for SEs, making it mandatory only for loan amounts exceeding PKR 15 million (currently above PKR 5 Million).

[9] HaidermotaBNR & Co. Financial Inclusion and Secured Transactions: Expanding Access to Credit in Pakistan's MSME Sector. "Most SMES in Pakistan are in trade and services (51% and 35%, respectively) and their assets mostly comprise of moveable property, such as inventory and receivables."

If the borrower is classified as a public company or a private company, which is a subsidiary of a public company, or a private company with paid up capital of PKR 3 million or more, the NBFC is required to obtain a copy of its financial statements duly audited by a practicing chartered accountant, while in case of any other company, copy of financial statements audited by a practicing chartered accountant or a practicing cost and management accountant can suffice.

The lower end of the SE segment is generally considered to be less structured with limited formal reporting protocols in place, in addition to a general unwillingness/inability to incur hefty compliance and audit costs. This modification will not only align the provisions for SME lending with SBP's Prudential Regulations, but will also address the limitations and fears of borrowers, making the regime more market and client friendly.

5. Deposit Taking Capacity of NBFCs

In addition to the above, while not directly related to the provision of SME financing, one other aspect critical to the operationalization of an NBFC is access to capital via deposits. Current regulations include a clear set of criteria for an NBFC to evolve from a non-deposit taking to a deposit taking entity. The criteria are listed below:

- The entity should have been operational as a lending NBFC for a minimum of three years, and posting profits for the last two years;
- The entity should be meeting Compliance with Minimum Equity requirements (depending on the type of license);
- The entity should be compliant with Capital Adequacy Ratio (CAR) requirements;
- The NBFC and its substantial owner (stake more than 10%) should not have defaulted or obtained a write-off on finance from any FI or investor in any of its redeemable capital instruments within the last five years;
- The NBFC and its substantial owner (with a stake of more than 10%) should not have defaulted on any obligation towards any of its depositors;
- The NBFC is listed on a stock exchange (provided that this requirement shall not extend to the NBFC that is owned directly by the federal and provincial governments); and
- The NBFC has been assigned a credit rating of minimum 'A-' (if the NBFC has been assigned with a rating of BBB; it may apply to the SECP to raise deposits from sources other than individuals, sole proprietors, provident/gratuity funds, trusts, charitable institutions, and section 42 companies).

It should be noted that NBFCs are considered to be higher risk vehicles in terms of deposit mobilization as the deposited funds are generally not insured (contrary to the arrangement available for SBP regulated entities through the Deposit Protection Corporation) and are costlier due to longer tenor (certificates of deposit), given that an NBFC cannot offer current checking accounts. Accordingly, the regulations place a cap on maximum deposits that an NBFC can raise.

Exhibit 7: Types and Share of Deposits Across Lending NBFCs (PKR millions)[10]

Category	Leasing Companies	*Modarabas*	Investment Banks	Total	Share %
Individuals	419	2,656	3,800	6,876	44%
Corporates	92	2,245	218	2,555	16%
Trusts	-	397	220	617	4%
Govt. Entities	-	-	-	-	0%
Financial Institutions	-	5,500	-	5,500	36%
Total Deposits	**512**	**10,798**	**4,238**	**15,548**	**100%**
Total Liabilities	**5,480**	**32,519**	**27,272**	**65,271**	**N/A**
Share of Deposits in Total Liabilities (%)	**9%**	**33%**	**16%**	**24%**	**N/A**

[10] Securities and Exchange Commission of Pakistan (SECP). Summary of NBFC, NEs and Modarabas Sector. Monthly Sector Report – Mar 2020.
https://www.secp.gov.pk/document/nbfi-sector-summary-march-2020/?wpdmdl=39316&refresh=5ee8757903ac41592292729

Exhibit 8: Caps on Deposit Taking NBFCs

Credit Rating	Total Deposits from all sources (including deposits from individuals, sole proprietors, provident/gratuity funds, trusts, charitable institutions, and section 42 companies)	Deposits from individuals, sole proprietors, provident/gratuity funds, trusts, charitable institutions, and section 42 companies
AA- and above	5 times of Equity	4 times of Equity
A- To A+	3 times of Equity	2 times of Equity
BBB to BBB+	2 times of Equity	-Nil-

Additional restrictions are as follows:

- The NBFCs can only raise deposits by way of issuing 'Certificates of Deposit' (CODs);
- The maturity period of deposits shall not be less than three months;
- The entity shall, at all times, maintain this minimum credit rating and the same shall be updated at least once every year; and
- Deposit taking NBFCs shall create a reserve fund wherein at least 20% of the after-tax profits of the NBFC shall be credited till the time that reserve funds equals the amount of paid-up capital; thereafter a sum of 5% of its after-tax profit shall be credited to the reserve fund.

At least 15% of the outstanding funds raised through deposits by the NBFC, excluding deposit held by financial institutions, shall be invested in government securities, or instruments or investments as notified/allowed by the SECP. This arrangement is similar to the Statutory Liquidity Requirements (SLR) of the SBP, where the apex regulator requires conventional banks to invest 19% of their total demand liabilities and time deposits with tenor of less than one year in Pakistan while for Islamic banks this requirement is 14% of their total demand liabilities and time deposits.

The proposed amendments included additional restrictions on deposit taking NBFCs. **Exhibit 9** summarizes the proposed requirements. It can be seen that for an NBFC to mobilize deposits from individuals, sole proprietors, provident/gratuity funds, trusts, charitable institutions, and section 42 companies, it was suggested to enhance the minimum credit rating criteria to 'A' (currently: 'A-'). However, this modification has been excluded from the notified amendments.

Exhibit 9: Proposed Requirements for Deposit Mobilization by NBFCs

Credit Rating	Total Deposits from all sources (including deposits from individuals, sole proprietors, provident/gratuity funds, trusts, charitable institutions, and section 42 companies)	Deposits from individuals, sole proprietors, provident/gratuity funds, trusts, charitable institutions, and section 42 companies
AA and above	5 times of Equity	3 times of Equity
A To AA-	3 times of Equity	Equal to Equity
BBB+ to A-	2 times of Equity	-Nil-

While we understand that the new limits were designed to safeguard depositors' interests, these would have increased reliance of domestic NBFCs on funding lines from commercial banks and other financial institutions[11], reduced their bargaining power, and squeezed margins, with a likely fallout on overall growth and sustainability, especially during periods of economic uncertainty and contraction.

From the supply side perspective, SBP and SECP are the two prime regulators governing extension of credit to the SME sector. With the recent amendments SECP has taken a step in the right direction to align the NBFCs' regulatory framework with that of SBP's Prudential Regulations for SME Financing. However, some key proposals relating to pre-defined exposure limits for SMEs and enhanced limits for unsecured financing have been left unaddressed. For NBFCs to successfully cater to the SME clientele, it is imperative to have clear, focused and less restrictive lending guidelines enabling these institutions to emerge as effective vehicles to address the overlooked financing needs of the domestic SME sector.

Additional Policy and Regulatory Considerations for SECP

In Pursuit of Digitization

It is a well-known fact that digitization of financial services and uptake of digital financial services have been on an upward trajectory. The Ministry of IT and Telecommunications (MoIT) is in the process of introducing the Personal Data Protection Act (PDPA) 2020. PDPA will impact regulators such as SBP, SECP and Pakistan Telecommunications Authority (PTA), among others. Due to the overriding effect of the PDPA on existing Acts it is advisable for SECP to carefully review the Bill to fully understand the provisions for itself and for NBFCs, especially with regard to the categorization of financial data (sensitive personal data, critical personal data), the role of third party data collectors and managers *vis a vis* data originators and data subjects, and last but not least, the utilization of cross-border and/or local cloud service which will have a direct bearing on the operating costs of FIs utilizing technology.

In addition, the SBP issued Regulations for Electronic Money Institutions (EMIs) in 2019. While some NBFCs (CreditFix, Finja Lending Services, etc.) are known to be utilizing technology to conduct and manage lending, the EMI Regulations may be assessed from the standpoint of SME lending by NBFCs (see **Box 2** for a case study on Finja Lending Services). With no access to payment systems and restrictions on offering checking accounts, NBFC are reliant on banks under agency arrangements for releasing liquidity to consumer. This has a direct bearing on an NBFC's ability to access client payment data, restricting their ability to design innovative financing solutions. Access to digital platforms to enable Big Data analysis can unlock several opportunities for NBFCs. While the EMI license itself does not make a license holder eligible to on-lend depositors' money, this license can provide a valuable access point into national payment systems while offering the opportunity to capture client data to develop lending algorithms.

At present, the effectiveness of this improvisation is restricted as the current regulation puts a cap on transaction amounts, limited utility for the SME segment. To facilitate SME lending and data aggregation and analysis, regulators can consider revisiting the transaction limits on the EMI license. Currently, the aggregated monthly load limit of an e-money payment instrument is set at PKR 50,000 on CNIC verification and PKR 200,000 on biometric verification, while in the case of merchant accounts the transaction limit is capped at PKR 500,000.[12] The cash withdrawal limit for e-money holders is set at PKR 10,000 per day, subject to biometric verification.[13] It can be deduced that the set limits are best suited to give lending leads to institutions engaged in microfinance.

Accordingly, regulators should consider enhancing the monthly/daily transaction limits under EMI regulations, to also capture Business to Business (B2B) payments. This would enhance the value and depth of transactional data captured via EMIs and can eventually help lending institutions to leverage payment data for lending solutions.

Access to SBP's Refinance Schemes

In addition to aspects of the digital ecosystem, it is also worth noting that NBFCs cannot provide widescale deposit services and they access significant funding from the banking sector. This means that NBFCs have a higher cost of finance, relative to banks, and they also face the risk of a financing crunch during periods of economic contraction.

The sector evidenced this during the 2007-08 financial crisis; the COVID-19 pandemic is likely to have a similar impact. Given that NBFCs are a source of funding for SMEs, it is worth exploring allowance by the SBP to access the multiple refinance schemes available under its umbrella—schemes for Women Entrepreneurs, Renewables Power Projects, Business Modernizations and the Agriculture sector. NBFCs by their very nature are finance providers with a specialized solution. Regulators should consider opening up access to these specialized refinancing schemes to the NBFC sector. This will not only enable NBFCs to access cheaper liquidity, but could also improve the uptake of these schemes.

[11] As of March 2020, total advances of the lending NBFCs (Investment Banks, Leasing Companies, Modarabas, and NBMFIs) stood at PKR 151 billion, while total credit (excluding investments) by the banking sector to NBFCs was reported at PKR 102 billion (~ 68% of lending NBFCs' advances). Orix Leasing Pakistan, the leading NBFC of Pakistan, reported Gross Loan Portfolio (GLP) of PKR 16 billion in March 2020, while the company's total borrowings stood at PKR 15 billion.

[12] State Bank of Pakistan (SBP). Rules for Digital On-boarding of Merchants. http://www.sbp.org.pk/psd/2019/C3-Annex.pdf

[13] State Bank of Pakistan (SBP). PSD Circular No. 1 of 2019 (April 2019) http://www.sbp.org.pk/psd/2019/C1.htm

Box 2: Finja Lending Services[1]

Finja is a financial services and lending platform focused on digitising payments, savings, investments, insurance and lending for MSMEs and associated salaried individuals in Pakistan. Finja has two subsidiaries: a digital payment platform (EMI license holder), and a lending NBFC (IFS license holder).

With both licenses in place, the company envisions developing a direct channel with its customers, both by way of enhancing its brand visibility, and without having to enter into any agency relationship with banking institution. The EMI license has allowed Finja to offer business management tool that helps companies manage all kinds of payments, including employee salaries, payments to vendor, collections, government taxes with seamless interconnectivity to any bank account. Via this license, the Fintech has not only got direct access to the payment system but also to clients' payment data which is being used to provide insights on consumption patterns and credit worthiness of potential borrowers., vital in providing lending leads to its NBFC – Finja Lending Services.

The product suite of Finja Lending Services includes:

- Productive Loans – SMEs can obtain short term loans for Business Financing and Supply Chain Loans,
- Executive Loans – for high ranked professionals with loan amount of up to 1million and a tenure of 12 months,
- Term Advances – credit tenures ranging from 2-18 months, underwritten by employers using Finja Business Portal,
- Professional Line of Credit – Using Data warehouse of Rozee.pk and credit is offered to salaried segment not captured under Finja Business Portal,
- Payroll Loans/ Advances against Salary, and
- Equal Monthly Instalments – Users can make purchased on online marketplaces on equal monthly installments ranging from 3-12 months.

To strengthen partnerships in the domestic lending industry, Finja has also launched an innovative solution of creating a lending marketplace, where partner institutions can share their loan books on Finja's platform and outsource the loan management process. Finja, along with a risk sharing arrangement, can facilitate in identifying and connecting to an obligor that better suits the requirements of the partnering institutions. The platform runs on a credit engine that runs checks and perform Debt Burden Ratio (DBR) calculations using data from data partners, credit bureaus, Finja's Business Portal and Payment Platform. Finja has partnered with Rozee.pk, Unilever, PepsiCo, Reckitt Benckiser and NBP Funds to develop its obligor database.

So far, the company has processed PKR 43 billion worth of payment transactions pertaining to salaries, vendor payments and collections. On the lending side, 25,000 digital loans amounting to PKR 300 million have been disbursed. Under the supply chain financing module, Finja Lending Services has disbursed 2,900 loans totaling PKR 163 million. The current product offerings and loan ticket sizes depicts that Finja's products are tilted towards consumer financing. This can be attributed to the inherent limitation of the model that this Fintech has deployed. While EMI does give an opportunity to circumvent reliance on a banking institution to interact with clients, it has an overall limit on the amounts that can be processed directly through the payments system.

The approach of having both licenses (EMI and IFS) seems to provide an innovative and effective solution, but with the existing regulatory framework it is better suited to compliment micro financing and is therefore of restricted use in terms of enterprise lending. The regulators, SBP in consultation with SECP, may consider revisiting the transaction limits for EMIs with the express purpose to facilitate SME lending.

[1] Company presentation and Interview with FINJA management.

Access to Risk Sharing Schemes

Risk sharing is another key aspect for these entities to operate successfully. NBFCs' clientele is generally high risk and since these institutions specialize in a certain product/solution or value chain, low diversification can give rise to unsystematic risk that can have significant bearing during crisis situations. Pakistan Credit Guarantee Company (PCGC), an associated concern of the SBP, has been established and will be offering credit guarantee schemes to locally domiciled FIs. Access to such credit guarantee schemes is imperative for the NBFC sector to operate effectively and grow. Further, since these schemes are poised to limit portfolio risk, eligible NBFCs can acquire and maintain favorable credit ratings, which in turn enhance their deposit mobilizing capacity and access to market liquidity.

Conclusion

The notified amendments to the NBFC regulations provide long-awaited clarity with respect to the operational aspects of SME financing for these institutions. With limited avenues to raise finance, domestic SMEs are heavily reliant on commercial banks, which give low consideration to this high risk and low-ticket clientele. While these amendments are well placed to provide a direction and a push to domestic NBFCs to expand their SME lending solutions, additional modifications regarding SME specific exposure limits and relaxed structure for unsecured financing may also be considered.

Regulators should follow a coherent approach to minimize the operational bottlenecks for these institutions and provide them with a level playing field, so that they become an effective channel to serve underserved segments. Regulatory frameworks should follow a progressive approach, allowing use of modern-day technology not only limited to delivery channels but also include ways to capture consumer data as this shall help in shaping and evolution of the domestic financial industry and make the journey to a documented economy a lot easier and quicker.

About Karandaaz

KARANDAAZ PAKISTAN is a Section 42 company established in August 2014 and focuses on fostering economic growth and creating jobs through financial inclusion of unbanked individuals and unserved enterprises, with a special focus on women and youth. The company has four verticals:

Karandaaz Digital

Focuses on expanding the poor's access to digital financial services in Pakistan by working across the ecosystem with all stakeholders.

Karandaaz Capital

Provides wholesale structured credit and equity-linked direct capital investments to micro, small and mid-size enterprises (MSMEs) that demonstrate compelling prospects for sustainable business growth and employment generation in Pakistan.

Karandaaz Innovation

Manages the Innovation Challenge Fund and Women Entrepreneurship Challenge, providing risk capital and grants to partners with the aim to generate innovative solutions in areas of financial inclusion and entrepreneurship.

Knowledge Management and Communications

Supports the company's core financial inclusion goal by developing and disseminating evidence based insights and solutions.

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