SECP

SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN
Specialized Companies Division
Policy, Regulation and Development Department

No. PRDD/MF/317/2012 October 24, 2012

CIRCULAR NO. 33 2012

Subject: Replacement of Annexure I and II of Circular No. 1 of 2009

The Securities and Exchange Commission of Pakistan ("the Commission") vide Circular No.1 of 2009 dated January 06, 2009 along with Annexure I and II, had prescribed the valuation methodology and provisioning criteria for debt securities held by Collective Investment Schemes (CIS). Subsequently, certain clarifications in respect of Annexure I and Annexure II of Circular No.1 of 2009 were issued on March 06, 2009 and January 20, 2010 vide Circular No. 6 of 2009 and Circular No.3 of 2010, respectively.

Considering the issues faced by Asset Management Companies (AMCs), the Mutual Funds Association of Pakistan ("MUFAP") proposed certain amendments in the above said Circulars for consideration of the Commission. The amendments suggested by MUFAP, have been reviewed by the Commission and in exercise of the powers of the Commission conferred under Section 282 B (3) of the Companies Ordinance, 1984 read with Regulation 66(b) of the Non-Banking Finance Companies and Notified Entities Regulations, 2008, Annexure I and Annexure II of Circular No. 1 of 2009 shall stand replaced with the revised Annexure I and II as enclosed with this Circular. Further, Circular No. 6 of 2009 and Circular No. 3 of 2010 dated March 06, 2009, and January 20, 2010, respectively, stand repealed.

All other requirements stipulated under the Circular No. 1 of 2009 shall remain unchanged.

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

This Circular shall come into force with immediate effect.

(Muhammad Ali)
Commissioner (SCD)

Distribution:

1. Chief Executives, Asset Management Companies
2. Mutual Funds Association of Pakistan
3. Trustees of Collective Investment Schemes.

NIC Building, Jinnah Avenue, Blue Area, Islamabad.
PABX: 051-111-117-327, Direct: 051-9214006 Fax. No. 051- 9218590

ANNEXURE-I

METHODOLOGY FOR VALUATION OF DEBT SECURITIES

CHAPTER 1

1A.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.15 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.15 million but equal to or more than Rs.1 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

2A. 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.

2B. 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.

CHAPTER 3

3A.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.15 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:
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    - 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	+200/-100 bps	+50 bps
Duration over 2 years	+150/-50 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.

Mark up of yield of performing debt securities

In addition to the above discretion, an AMC shall not provide for against a performing debt security. However, MUFAP shall have the discretion to apply maximum mark-up of upto 500bps to the calculated yield of any specific debt security after taking into account the potential credit risk of any particular performing debt security or considering any unusual factor/event associated with the issuer, issue or sector in order to ensure consistent and transparent valuations for entire mutual fund industry. Such factors/events may include following:

- Issuer of the performing debt security has defaulted on its other financial obligations.
- Rating of the performing security has been significantly downgraded in a short time span.
- Breach of covenants relating to the performing debt security.
- Deteriorating operating, financial and cash flow position of the issuer.
- Unfavorable conditions or weak outlook of the specific sector.

Such factors/events shall be duly documented/ noted in the decision taken by MUFAP while adjusting valuation of such securities.

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

3B. REVIEW OF SPREAD

The maturity spreads (across tenors) and credit spreads (across rating grades) used in the model shall be reviewed and updated quarterly by MUFAP based on a review of 3 month, 6 month and 1 year spreads.

3C.CAPPING OF PRICES

In case, if price of a debt security increases solely due to reason of movement from traded to non-traded category, MUFAP shall cap it at its last traded price.

ANNEXURE-II

PROVISIONING CRITERIA FOR NON-PERFORMING DEBT SECURITIES

A. 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 from the due date.

B. 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.
- 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.

C. 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
90^{th} day	20%	20%
180^{th} day	10%	30%
270^{th} day	10%	40%
365^{th} day	10%	50%
455^{th} day	10%	60%
545^{th} day	10%	70%
635^{th} day	10%	80%
725^{th} day	10%	90%
815^{th} day	10%	100%

- In the process of arriving at minimum provisioning against non-performing debt securities as per the timeline given above an AMC may exercise discretion with respect to the timing for creating the requisite provision such as immediately on the day of classification as non-performing or spreading it over the number of days, as deemed appropriate in the best interest of unit holders. However, the minimum provision on effective day shall be in accordance with the schedule given above.

- Where a debt security immediately preceding its classification as non-performing is valued at a discount to its outstanding principal amount, such discount may be accounted for while arriving at the minimum provision. However, if any such discount exceeds the requisite provisioning, the excessive discount shall not be written back and debt security shall be carried at the existing value upon classification as non-performing.

- 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, half yearly and annual accounts.

D. RECLASSIFICATION OF NON PERFORMING DEBT SECURITIES

- 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.

- In case of non-performing debt securities which have been rescheduled/restructured, the debt security shall only be re-classified as performing if all the following conditions are met:
    i. The terms and conditions of rescheduled/restructured debt security are fully met for a period of at least one year; and

    ii. All the arrears (till the date of restructuring) have been received in cash;

    iii. An amount equivalent to two installments (excluding grace period, if any) as per original repayment term (before rescheduling) are paid in cash

However, during rescheduling/restructuring period the AMC may stop creating additional provisioning against restructured/rescheduled debt security. If the debt security subsequently did not perform as per rescheduling/restructuring agreement the debt security shall be treated as non-performing from date of its original default

E. REVERSAL OF PROVISIONS

- The unrealized interest/mark-up amount reversed shall be written back to income upto the extent it is received in cash.
- The provision made for principal amount shall be written back to the extent it is received in cash and the remaining provision shall cover the minimum provision required. The full provision shall be reversed when the debt security is reclassified as performing.