Guide on Minimum Quality Standards for Mortgage Lending in Pakistan

Conventional Mortgage Loans

PMRC

PAKISTAN MORTGAGE REFINANCE COMPANY LIMITED

Abbreviations

Abbreviation	Definition
BBFS	Borrower Basic Fact Sheet
CNIC	Computerized National Identity Card
FBR	Federal Bureau of Revenue
KIBOR	Karachi Interbank Offered Rate
KYC	Know Your Customer
LTV	Loan to Value
MRA	Master Refinance Agreement
MBS	Mortgage-Backed Securities
MQS	Minimum Quality Standards for Mortgage Lending
NADRA	National Database & Registration Authority
NTN	National Tax Number
OAEM	Other Assets Especially Mentioned
OTI	Overall Debt to Income Ratio
PFIs	Partner Financial Institutions
PMRC	Pakistan Mortgage Refinance Company
PTI	Payment to Income Ratio
SBP	State Bank of Pakistan
SPV	Special Purpose Vehicle

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This Guide on Minimum Quality Standards (MQS) for Mortgage Lending assists lenders in seeking to launch mortgage loan operations or restructure existing operations within their organizations. In addition to supporting the primary market, the application of these Guidelines should also ensure that the mortgage loans will meet requirements for the refinancing of mortgage loan portfolios by Pakistan Mortgage Refinance Company (PMRC) as well as the possible future issuance of mortgage covered bonds or mortgage-backed securities (MBS). For a mortgage portfolio to be considered suitable for inclusion in a bond issuance or a securitization, the lending institution must be aware of the prospective requirements of both credit rating agencies and investors.

The lender's decision to initiate mortgage lending operations is one requiring a careful market assessment, an objective review of its own capabilities, and, if the decision is positive, well-thought out marketing and organizational development plans to launch the new product. Due to the long-term nature of mortgage loans, offering such products will require greater sophistication in some risk management areas than other loan products. Similar to launching other products lines, specialized staff training and new information technology will be essential. In short, substantial resources will be required. All these factors argue for making the decision to enter the market on the basis of full, well-developed information.

We would like to thank the International Finance Corporation (IFC) for the preparation of this Guide. The overall editor and author of this Guide is Dr. Friedemann Roy from the IFC. Natalie Schoon, Consultant of the IFC, co-authored the chapter on Risk Management and provided careful and thoughtful review of the draft.

We would like to place on record our appreciation to the banks for their comments and suggestions and the Pakistan Banks Association for distributing the original version of this Guide to the banks and compiling their feedback to be included in the final version of the Guide.

We believe that this Guide is an important contribution to the creation of a viable and vibrant mortgage market in Pakistan

Management

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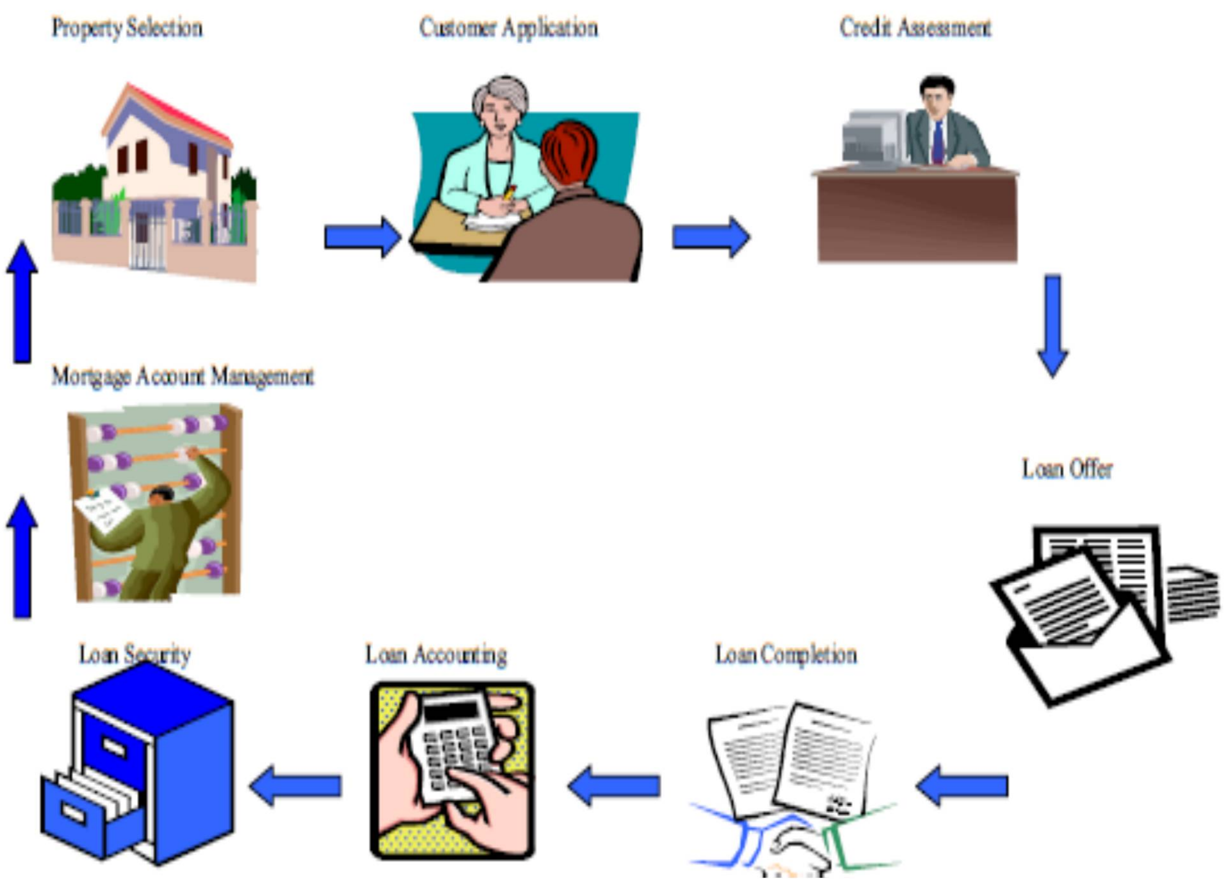
Introduction – Processing of conventional mortgage loans

This Guide on Minimum Quality Standards (MQS) for Mortgage Lending will provide recommendations to lenders on underwriting, servicing, and risk management of mortgage loan portfolios so that there is a common understanding among market participants on these standards in Pakistan. Standardization of mortgages allows for easy access to capital markets since it facilitates the risk analysis of investors, rating agencies and other parties. In addition, a minimum level of MQS is required in order to ensure the mortgages attracted by PMRC are comparable in quality and can be securitized.

The mortgage lending process of a financial institution can be depicted as follows (see **Chart 1**):

Chart 1. Illustration of the mortgage lending process

Source: EBRD



The MQS Guide has the following objectives:

- **Establishment of a sound and well-functioning primary mortgage market.** Within the primary mortgage market, origination of mortgages takes place. Lenders offering mortgages in this market include banks and other financial institutions. The primary market is a prerequisite for the existence of a secondary market where originators sell mortgages to investors via securitization (mortgage-backed securities) or the issuance of covered mortgage bonds. Investors are typically pension funds, insurance companies and hedge funds.

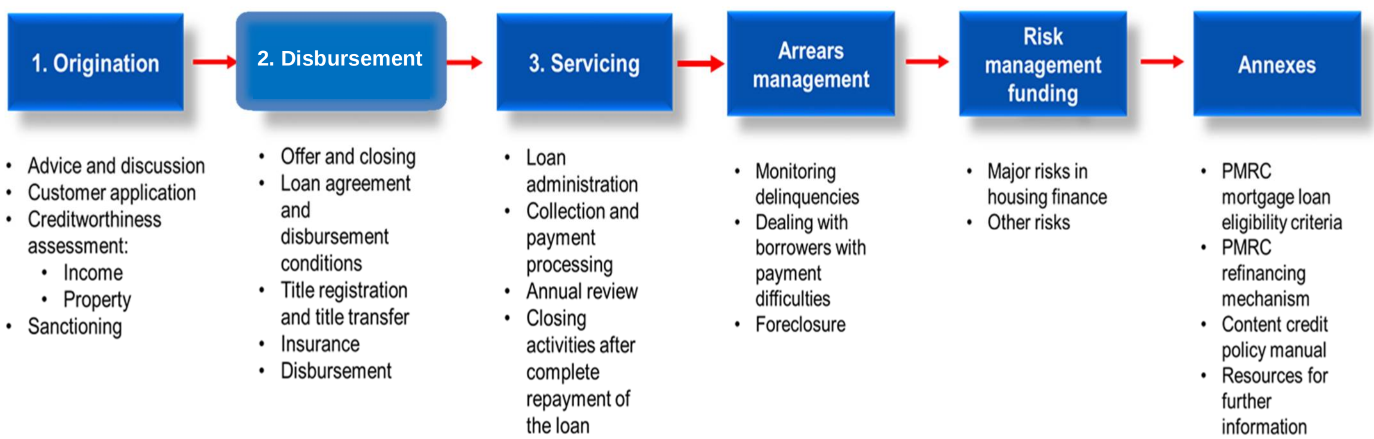
- **Standardization of mortgage lending practices**. Although the quality of the primary mortgage market depends on several elements, quality and consistency of the mortgage loan underwriting standards and the servicing after origination is the most important issue.

This Guide was developed by IFC and PMRC and benefitted from comments from the banking industry in Pakistan. In two discussion rounds organized by PMRC in April and August 2017, discussions focused on current lending practices and international standards. These discussions formed the basis for this Guide.

1.1 Organization of the Guide (MQS)

This Guide is modelled along the value chain of the mortgage lending process as illustrated in **Chart 2** below.

Chart 2. Value chain of the mortgage lending process



There are three main steps in processing of a mortgage loan: origination, disbursement, and servicing. These steps are further supported by (i) arrears management in case a borrower experiences payment difficulty; and (ii) risk management. The objective of the Risk Management Department is to ensure that all risks associated with mortgage lending are identified and managed. Key risks in mortgage lending are credit risk, interest rate risk and collateral risk. For further information about the mortgage lending process and housing finance, please see **Annex 5**. Further information – useful websites.

In the context of this Guide, the following definitions apply:

- Borrower, client, or mortgagee: the person(s) obtaining a mortgage
- Lender: the financial institution providing the mortgage
- Lending officer: employee of the financial institution processing the mortgage

Loan origination

The objective of the underwriting process is to identify creditworthy borrowers. Creditworthiness is determined by (i) ability to pay; and (ii) willingness to pay. Additionally, during the loan origination phase, the lender provides the borrower with information concerning mortgage financing: the process; the requirements; and the risks and obligations of the borrower. In addition, the lender obtains information from the borrower to determine the stability of the borrower's employment, formal and informal sources of income and the value of the property offered by the borrower as collateral.

1.2 Discussion with prospective borrower

The objective of the initial contact with the applicant is to provide him/her with the information about the terms and conditions of the loan whilst at the same time collecting as much information as possible about the applicant's creditworthiness. Another important objective is to ensure the borrower understands the features of the product offered including the risks.

1. Applicant approaches the lender. The initial stages of the loan application process and first contact with the potential borrower are critical to assist the lender in its initial decision-making process. The initial decision to grant the loan is based on an assessment of the acceptability of the level of risk for the lender. The first contact will usually be made in person at the lender's premises by the borrower.

2. Interaction between loan officer and applicant. During the initial interview, the objective of the loan officer is to provide the potential borrower with information on the lender's loan products, loan criteria, loan granting and servicing procedures. In addition, the loan officer will obtain basic information on the borrower's financial condition and personal circumstances so that obviously ineligible customers can be screened out at this initial stage.

The lender preferably provides an information leaflet to the prospective borrower outlining the mortgage loan process and related actions such as creation of the mortgage on the property which will be offered as collateral by the borrower, calculation of required amount of mortgage loan and term, obligations of the borrower and lender. The lender may also provide the borrower with a letter of understanding.

The information leaflet should provide the following information to the borrower:

- Permissible use of funds;
- Collateral and guarantees;
- Indication of the cost of a typical home loan for a borrower (e.g. insurance cost, legal cost, appraisal cost etc.);
- Options available for redeeming the loan to the lender (including the number, frequency, amount of redemption payments, etc.);
- How to calculate the appropriate loan amount and redemption payments in relation to income and the property to be financed;
- Sample repayment schedule, possibilities of early repayments, whether a valuation of the property is necessary and, if so, by whom it must be carried out.

3. Product selection. At this stage, the customer will choose the product of his/her interest from the products offered to him/her. The loan officer will inform the borrower about the eligibility criteria, documents required, terms and conditions of the loan and all basic and advanced requirements of the different housing loans offered by lender.

During the interview, the loan officer will use a standardized loan application form to collect detailed information about the customer. The borrower shall be advised that the collection of this data and the initial calculations of the loan amount and repayments are for information purposes only at this stage and do not commit the lender to granting a loan nor the borrower to accepting one.

1.3 Customer application

SBP Regulation HF-1 (4) does not specify which types of documents are required for a mortgage application, but instead delegates the responsibility for ensuring accuracy and completeness of documentation to individual financial institutions[1]. The requirements outlined in the remaining of this section represent the minimum, on top of which each lender may collect additional information to meet its operating requirements. Most of this information required will already be collected as part of the Board approved policies of each of the banks. In addition, some of the information outlined below may be replaced by information contained in the electronic Credit Information Bureau (e-CIB).

Borrowers who have informal income sources are to be required to provide additional documentation on their incomes. This list provided below takes this scenario in consideration.

Documents required from the borrower

The borrower should present the following documents to the lender during the mortgage loan application process:

1. Details on the applicant[2]
 	
1a) Applicant's identity
	• Copy of applicant's Computerized National Identity Card (CNIC)
	• 2 recent passport-sized color photographs of applicant
	• Proof of address:
	    • Copy of most recent paid utility bills (electricity/gas/telephone)
	    • Copy of recent credit card bills and any other credit facilities (if applicable)

1b) Income details	*If employed:* • Employment certificate including, date of joining and present designation • Original or certified salary slip of last three months

[1] See SBP, Housing Finance Prudential Regulations, updated on April 18, 2017, Article 4 (Development of Financing Documentation)

[2] The same documents must be presented by any co-borrower.

	• Previous employment proof (if required) • Current account bank statement for the most recent 6 months • Evidence of any secondary income that is to be taken into account *If self-employed:*[3] • 3 years' proof of business (for example: tax return, bank certificate, certified audited accounts, or income and expense accounts) • Copy of partnership deed (In-case of partnership) • Professional association membership certificate / practice licence (if applicable) • Bank account statements • Lender references (if applicable) • Tax returns verified via FBR systems (optional) In both instances, alternative ways of income verification such as bank statement calculations or income estimations obtain through an agency may be applied.
1c) Details on credit history and relationship(s) with (any) other lender(s)	Where possible credit history will be verified using eCIB, Datacheck, Loan Application form or Borrower's Basic Fact Sheet (BBFS), and form CF-1. In the event this is not available, or insufficient, the following will be required: *Previous credit history:* • Details of any credit transactions over last three years, including loan and collateral agreements • Confirmation that any existing loan agreements are currently up to date *Existing relationship with any other lender(s)*: • Details and turnover of any existing accounts (of all types), for example average monthly balance, average monthly credits and debits • Information about assets with other lenders (e.g., securities, savings, etc.)
2. Property documents	*Original title documents relating to the property to be mortgaged (complete chain of documents).* If title already registered in name of borrower: • Extract from the land records authority certifying ownership of the borrower; and

[3] Some banks use industry surveys to determine profit margin in industries. Such business margin is applied on the statement of accounts to determine estimated annual income. If a bank uses this method, the in-house income estimation methods should periodically be evaluated for their relevance and predictability power.

	• Detailed property information from the land records authority – Aks-Shajra, Fard Malkiat. Kharsa, survey; and
	• Title document, being *inter alia* one of:
	    • Certificate of right of inheritance, issued by responsible public authority
	    • Conveyance or sale deed
	• Photos of the property
	• Construction permit (if applicable)
	• Approved Building Plan
	• Completion certificate
	• E&S Exclusion List
	If title not currently registered in name of borrower:
	• Sale-purchase, investment or other agreements on acquisition of the relevant property.

3. Others	• Consent of borrower for access to e-CIB and the verification of other information. A request for consent should be incorporated into the application form. • Information about other mandatory expenses.

Information required on the application form

The information contained in the Table below represents the minimum level of information required to be collected on the application form. Lender should require the borrower to provide the following information in the application form:

1. Details on applicant (and co-borrower(s) if applicable)	• All information included in the BBFS including:
	    • Name and address of borrower and co-borrower (if applicable), marital status, name of dependents in the property of the borrower
	    • Other contact details
	    • Age and sex of applicant and co-borrower (if applicable)
	    • Employment details (position, name and address of employer)
	    • Income of the borrower/co-borrower

2. Details on property to be mortgaged	Basic description of property being mortgaged:

	• Address • Type of property (e.g. apartment, single family house, etc.) • Details of property (e. size and other relevant details) • Year of construction (if available) • Cost of acquisition (if applicable): sale price, other cost related to purchase (e.g. property tax, notary cost, etc.)
3. Details on financing	• Information about mortgage loan (type, purpose of loan, term, interest rate, repayment amounts, number of instalments) • Down payment percentage and amount • Calculation of affordability to repay including regular payments related to the property and the mortgage loan (e.g. taxes, property insurance, electricity and water charges etc.) • List of borrower's total assets and liabilities excluding the current mortgage loan application (e.g. other properties, investments, funds). This information may be available in BBFS.
4. Other information provided in the application form	• Tentative repayment schedule • Information about the mortgage loan (description of product, interest rate basis (e.g. KIBOR plus specified mark-up or fixed rates for pre-determined period), terms, loan repayment calculation, interest calculation) • Other information about non-recurring cost (e.g. up-front fees) and recurring cost (e.g. building insurance), pre-payment (cost and procedure)

The above-mentioned information is gathered during the Know-Your-Customer (KYC) process and may include additional information and requirements such as:

- Capacity to pay (see **Section 1.4.1** below);
- Savings behavior history;
- Minimum period during which the customer has maintained a formal bank account with any financial institution;
- Additional security;
- Verification of identity in NADRA's Verisys;
- Borrowing history; and
- Any other information the lender may require.

The KYC process applies to all customers, irrespective of their income or financing requirements.

1.4 Creditworthiness assessment – income assessment and property valuation

The creditworthiness assessment consists of two elements: (i) assessment of the capacity to repay as evidenced by the applicant's income and (ii) appraisal of the value of the property offered as collateral.

1.4.1 Assessment of the capacity to repay

The ability to pay is generally determined based on salary slips or other documents providing evidence of income. The lender's methodology for the calculation of the borrower's ability to repay needs to include:

1. Total monthly amortization payments for the mortgage loan under consideration plus the repayment obligations of the borrower against all other consumer financing may not exceed fifty per cent (50%) of the net disposable income of the borrower.[4]
2. The minimum down-payment shall not be lower than 15 % of the property value, resulting in a maximum LTV ratio of 85 %.

When calculating debt-to-income ratios, the lender should take into consideration any payments made for life and building insurance. In addition, lenders should check whether the customer has met his regular obligations using e-CIB. If the information is not available or insufficient, the previous 3 months of obligations need to be checked (electricity bills, rents etc.).

If the lender takes into consideration income of co-borrower(s) for the calculation of the debt to income ratios, these persons must co-sign the loan agreement. Co-borrower(s) do not have to be co-owners of the property to be mortgaged.

All lenders shall refer to the Credit Bureau to obtain any information about defaulted loans.

One of the common methods to assess ability to pay is the residual income analysis which assesses the excess income after rent/mortgage and living expenses. An example of a residual income analysis is provided below. Residual analysis applies irrespective of the type of income (formal and/or informal) or the level of income (low/medium/high). In order to gain better understanding of appraisal methodology; an example of GRUH Finance Limited has been given in **Box 1**.

[4] Net disposable income is the income after taxes, all deductions and contributions paid.

Residual Income Analysis – Example

A household consisting of 2 adults and 3 children has a monthly income of Rs 90,000. Average living expenses per person per month are Rs 9,000, the monthly rent is Rs 33,000 and utility bills are Rs. 4,500. The family has one debt with a remaining maturity of 1 year, interest rate of 15% and monthly payment of Rs. 3,000.

RESIDUAL INCOME ANALYSIS (IN RS)

INCOME	90,000
RENT	33,000
UTILITIES	4,500
LIVING EXPENSES	45,000
DEBT	3,000
RESIDUAL INCOME	**4,500**

On the assumption that the family will no longer have to pay rent once they have purchased the property they can afford to service a mortgage of up to Rs 37,500 per month.

Considering informal income streams in creditworthiness assessment. Often, applicants have informal incomes or a combination of formal and informal income sources. As the existence of informal income streams is difficult to evaluate, the lender needs to make additional assessments to ensure the applicant's capacity to repay in relation to the loan amount requested.

Please refer to **Section 1.5.** *Underwriting applicants with informal income sources* for more information.

1.4.2 Collateral requirement and property valuation.

The following Guidelines identify the minimum requirements in terms of general mortgage and collateral requirements. The lender can add additional requirements to meet its operating regulations. The property offered by the borrower as security for the mortgage loan needs to meet the statutory requirements specified by PMRC which are included in **Annex 1.** Mortgage Loan Eligibility Standards of PMRC. In summary, the lender needs to ensure:

a) The Mortgage Security Document creates a valid, existing and enforceable exclusive and first mortgage on the Mortgage Property.

b) A substantially clean legal opinion has been obtained in respect of the Mortgagor's title to the Mortgage Property and creation and perfection of valid mortgage.
c) There is no provision in the Mortgage Loan Agreement and/or Mortgage Security Agreement that restricts the Customer from assigning or transferring all its rights, interests and benefits.
d) The Mortgage Property is:
    a. not subject to any bankruptcy proceeding or foreclosure proceeding;
    b. in the lawful possession of the Mortgagor;
    c. materially in compliance with all applicable laws and regulations;
    d. insured against loss by fire, hazards of extended coverage and such other hazards commonly occur in the area where the Mortgage Property is located. Insurance should be in line with regulatory requirements in force and will need to be reviewed periodically to ensure they remain compliant.

In addition to these requirements, the lender needs to ensure that the property is professionally appraised either by an external or in-house valuer registered with SBP. The appraisal should assess the following:

- Sale price is fair for the current market
- Current restoration and reconstruction value of the property for insurance purposes
- Suitability of communal services arrangements
- Any defects of the property
- Construction is in compliance with the applicable laws governing the vicinity.

To ensure that the property to be mortgaged meets these requirements, a structured appraisal should be undertaken covering the items outlined in the Table below.

Selection and approval of appraisers	• Appraiser registered with the Pakistan Banks Association (PBA); appraiser may be in-house or external • Appraisal conforms with current regulatory and legal requirements in effect in Pakistan
Minimum content of the appraisal[5]	• Description of property including address, year of construction (if available), type of property (apartment or single/double family house), building method (traditional/prefabricated/others), condition and state of repair (good/average/moderate/bad), equipment (good/average/simple), state of refurbishment (fully/partially/not refurbished), possibility of owner occupation, number of housing units in development • In case of apartment, condition of common areas of apartment building

5 The content of the Appraisal Report should comply with the standards and legal regulations in Pakistan

	• In case of apartment, how the building is managed • Size of land in square metres. In the case of apartment, the share of land owned by the borrower • Number of parking spaces or garage units • Special renovation risks such as planning permissions • Existing land contamination • Available services (gas/electricity/water) • Number of floors and whether there is a lift • Common entrance - is there a coded lock, concierge, etc. • Access to building and apartment • Location, including characteristics of general location (including access to communal facilities), similar properties for sale, demand, local infrastructure and amenities, condition of house in the neighbourhood • Recent repairs / works • Calculation of value • Insurance / re-instatement value for insurance purposes • Market value - an assessment that the sale price is fair for the current market • Forced sale value - the recovery value of the property if disposed of through repossession or enforced sale with no consideration for speculative elements • Negative areas • Deviations and violations

1.5 Underwriting applicants with informal income sources

Applicants with informal incomes undertake various activities. Typically, they are micro-entrepreneurs, small shop-owners or workers with a combination of formal and informal income. It is also possible that within a household there is a combination of one formally-employed member of the household and another member with an informal income source.

The property title documents offered as collateral may be formal but are more commonly semi-formal in nature; validity and enforceability may be difficult to ascertain.

To offer loans to households with informal income sources, the lender should have the capabilities to estimate the applicant's income beyond what can be evidenced by formal documentation. Knowledge of the local economic environment, customs and culture are of the utmost importance in this respect. Enhanced Know Your Customer (KYC) and credit checking may be required. In addition, lenders have restrictions in place regarding the limits on the recognition of informal income streams. Prudent lending practice would include informal income only up to 50% and only if it has a relative level of certainty attached to it.

1.5.1 Organizational requirements

The lender is recommended to make the following adjustments within its lending operations to allow for the inclusion of borrowers with informal income sources:

1. In-depth knowledge of local markets and close relationships with customers. Relationship managers and credit officers need to have an in-depth knowledge of the local economy, markets, culture and customs, to aid them with their assessment of the client, their willingness and ability to repay, and the strength of their collateral. Personal contact is important in this aspect which can be facilitated by a branch network. A close relationship with the client will assist with the collection of KYC information.

The typical outreach area of a branch is about 50 km. Credit officer should have local knowledge of the market where they work to have an appropriate knowledge of neighborhoods and locations which comply with the lender's standards for properties acceptable as collateral.

2. Staff capacity. The lender needs to employ sufficient numbers of staff particularly in relationship management and credit to ensure they can undertake the necessary verifications, KYC and any additional background checks.

3. Data storage and processing capacities. The systems and controls infrastructure need to be designed in such a way that they provide the capability to establish and maintain information on income levels per job type and level, fluctuations in income, levels and stickiness of informal income and other common income sources and validity and enforceability of collateral.

As part of the overall IT infrastructure and data storage requirements, banks should consider the following elements to be in place either automated or manual:

- Establishment of a comparable database of different income levels of different professions according to location;
- Fraud detection mechanisms to ensure compliance with the lender's credit policy during the whole loan cycle;
- Document loan approval discussions and post disbursement follow-up.

4. Credit policies and procedures. Credit policies and procedures must be clearly defined, easy to understand, and clearly indicate roles and responsibilities. They need to include requirements for KYC, estimation of living costs, establish history of savings, credit checks, collateral and any potential additional security requirements as well as verification procedures and follow-up activities during the loan underwriting and servicing process.

1.5.2 Procedures to determine the capacity to repay from informal income sources

Formal income is always considered primary income since it can be evidenced by salary slips or bank payments. The borrower's employment qualifications and professional experience indicators to assess whether the borrower is likely to be steadily employed receiving a primary income, thus being able to repay the loan on schedule.[6]

All other income such as rental income, interest income, remittances, and other informal income sources are secondary and need to be carefully considered when including them in the assessment of the ability to pay. Secondary income is typically not guaranteed and can often not be traced.

In the event the primary income is not deemed sufficient for the servicing of the loan, the lender should first explore the possibility for the client to increase the down payment or may request additional security.

A lender may choose to include secondary income (such as overtime, remittances etc) in the ability to pay calculations if they are certain the income has a highly stable character. However, no more than 50% of the secondary income may be included in the ability to pay calculation. Where possible, the applicant should prove secondary income with relevant documents. It is up to the loan officer to determine the size of this type of income. His evaluation will be described in the loan application assessment in a manner that can easily be understood by third parties.

6 For self-employed people, a minimum of 18 to 24 months of self-employment in the same business is considered a good indicator for viability of the business.

Box 1: Appraisal methodology of GRUH Finance Limited, India

The Company's appraisal methodology of applicants consists of the following elements:

1. Willingness to pay

The most critical aspect to be ascertained at credit appraisal stage is the willingness to pay. This may be verified by the following process:

- ✓ Past one years' records of Rent, Electricity, Telephone etc. should be collected and the actual dates of payment must be verified against the due dates.
- ✓ Recurring Deposit, if any, should be checked to see whether the amount is being deposited regularly as per contract.
- ✓ In case of earlier loans, the account statement should be checked to see whether instalments were paid on time.
- ✓ Type of borrowings to see if customer is in the habit of rolling over his debts. A customer might be borrowing and using the funds to repay other borrowings and thus having perpetual borrowings at the same or higher level.

2. Ability to Pay

An appraisal of ability to pay is a challenge for this segment since formal income proofs may not be readily available and a calculation will require to be carried out. Hence income appraisal is done based on an extensive field visit.

The factors to be considered while appraising ability to pay would be:

- ✓ Source of Income.
- ✓ Stability of Income.
- ✓ Appraise average monthly cash flows from each source.
- ✓ Appraise Expenses and Liabilities.
- ✓ Family size and obligations.
- ✓ Check as to how well an individual is organized in terms of record keepings and files, whether rough or proper records are being maintained to keep a track/log of customer details, stock registers, cost and expenses accounting, details of material purchases, cash collection etc.
- ✓ Probe as to how cash profit is being utilized.
- ✓ Economics of the activity/business should be understood so as to calculate the income.

3. Stability of Income

- ✓ The stability of income needs to be established while verifying with the source and data available.

A probing mind is required to ask varying questions in assessing the volume of activity being done, unit price etc. to arrive at level of income and regularity of income.

4. Appraised Income

In case of self-employed individual, the economics of the business need to be understood to calculate the appraised income. e.g. Tailor/Carpenter - Verify cost price of each item based on cost of materials used and sale price. Depending on average sales per item, the income per month can be worked out.

5. Other factors to be considered

Besides the willingness to pay and ability to pay, the following also should be noted:

- ✓ Reason for purchase of house. Many a times a loan is taken for a house but the same is not likely to be occupied but could be let out.
- ✓ Educational qualifications to determine the mobility in case of vulnerability of activity / business.
- ✓ Number of dependents.
- ✓ Savings track record and accumulation of Savings / Assets.
- ✓ Medical history and spending habits.
- ✓ Source of margin money (down payment).

It is good industry practice to analyze the borrower's assets (e.g., other properties and assets) as part of the KYC. It supports the assessment of the ability to pay and may highlight irregularities. For example, a substantial deposit made in the two months prior to the loan application may indicate that the funds have been borrowed.

A residual income analysis can be used to assess the amount of income an individual has after all personal debts and expenses have been paid. If the residual income is sufficient for the servicing of the mortgage payment the loan will be granted. This calculation is typically undertaken on a monthly basis. Since borrowers find it challenging to assess their expenditure, the lender may apply an average cost per person for living expenses. An example of residual income analysis is given below.

Residual income analysis – example

A household consisting of 2 adults and 1 child has income of Rs.250,000 from the husband's job, with occasional overtime payments of approximately Rs.50,000 per month. In addition, the wife is running a small home-based business with income varying between Rs.20,000 and Rs.100,000 per month. Monthly rent is Rs.150,000 and living expenses are Rs.105,000.

RESIDUAL INCOME ANALYSIS

INCOME	Rs.250,000
INFORMAL INCOME	Rs.70,000-150,000
RENT	Rs.150,000
LIVING EXPENSES	Rs.105,000
RESIDUAL INCOME	**Between a shortfall of Rs.5,000 and excess of Rs.145,000**

In this case, the residual income depends on the informal income of the family. In months where there is no informal income, the family is having a shortfall of Rs. 5,000. The monthly mortgage amount the family can afford is Rs. 145,000. However, the bank may consider taking part of the informal income into consideration when determining the mortgage. Typically, this will need to depend based on the certainty of the informal income stream, whether it can be evidenced, and the persistence of the income. No more than 50% of informal income with high certainty may be taken into consideration.

Conceptual framework for mortgage loan pricing

To provide an acceptable return on investment, mortgage investments must be priced at a spread over the cost of the marginal source of funds. This spread must account for the expected costs of investing in a portfolio of mortgages and a targeted return on investment for the bank's owners.

The expected costs include premiums for the risks of mortgage lending and the operational costs of raising funds and making loans. Specifically, these factors include:

- Credit Risk - Potential loss due to borrower default;
- Interest Rate Risk - Potential loss deriving from mismatched funding (e.g., if loan rates adjust less frequently than funding rates in a rising interest rate environment);
- Options Risk - Reinvestment loss due to early redemption of fixed-rate mortgages (prepayment risk) and funding loss associated with locking a rate to a borrower prior to loan closing (commitment risk);
- Spread or Basis Risk - Potential loss deriving from change in funding margin (relative to a reference rate) if lending with a fixed margin (relative to a reference rate);
- Liquidity (Marketability) Risk - Cost of maintaining reserves or lines of credit, or losses associated with the sale of assets to raise cash;
- Administrative Cost - Marginal cost of raising funds, originating mortgages and servicing mortgages;
- Profit Spread - The targeted return on shareholder investment, net of expected losses and costs, necessary to compensate investors for the uncertainty of cost and loss estimates (e.g, through increased volatility in interest rates) and the opportunity cost of their investment.

A bank's actual expenses over the life of a pool of mortgages will depend on numerous factors, including expenses that the institution incurs in pursuing potential borrowers who never apply for a mortgage or whose applications are rejected; prepayment patterns; the frequency and timing of loan defaults, and the expenses that are incurred for each default; the amount of capital that the lender holds against its mortgages; and, its general management and administrative expenses.

Banks often find it useful to prepare estimates for each cost factor independently and then combine them in a spreadsheet that allows the institution to simulate what its expenses will be under different assumptions – for example, if its capital requirements rise, or if the frequency of defaults increases. Performing such a sensitivity analysis allows a lender to determine what break-even mortgage spread and fee structure will be necessary to cover its costs under a variety of circumstances.

Funding of Mortgage Loans

In general, the funding instruments available to mortgage lenders are as follows:

Deposits

Bank deposits consist of money placed into banks for safekeeping. These deposits are made to deposit accounts such as savings accounts, checking accounts and term deposit accounts. The account holder has the right to withdraw deposited funds, as set forth in the terms and conditions governing the account agreement. Savings play only a limited role in financing mortgage loan portfolios. Typically, maturity does not exceed one year, which restricts their use for long-term mortgages.

In many emerging markets, deposits are used to finance mortgage loan portfolios. However, as deposits are usually short term, it exposes banks to substantial interest rate and liquidity risk. Core deposits may allow the bank to manage these risks to some extent. Core deposits is the percentage of deposits which depositors automatically roll over despite their callable feature. However, banks should not rely only on core deposits to fund the mortgages. They should also use other avenues such as obtaining medium to long-term fixed rate funds from a liquidity facility to mitigate the interest rate and liquidity risks.

Covered Mortgage Bonds

A covered mortgage bond is a debt instrument which is secured against a dynamic pool of specifically identified and eligible mortgages. The fundamental concept of this security is its reliance on the collateral (mortgage) as the primary source of credit quality, which significantly reduces the risk to the bondholder. Mortgage bonds are issued by a bank and usually remain on its balance sheet (on-balance sheet financing). The credit quality of the bonds is assured through conservative underwriting standards and strict regulation of loans and lending institutions, as well as strict valuation rules.

Typically, covered mortgage bonds have a fixed coupon and a bullet payment at maturity and are collateralized by underlying mortgage loans. There is no implicit or explicit government guarantee of covered mortgage bonds; their market acceptability depends completely on the quality of the underlying loan pool and the legal structure ensuring the security of the bonds, even in the case of bankruptcy of the issuer.

Typically, specific laws govern the issuance of covered mortgage bonds to ensure the safety of the debt instrument and to establish a benchmark or brand for investors. Regulation requires that each issuance must meet the following criteria:

- Principle of coverage. Covered mortgage bonds (principal and interest) are covered at all times by loans (principal and interest) at least equal to the nominal value of all outstanding issues and yielding at least an equal interest return. Mortgages in the cover pool must be high-quality assets secured by real estate.
- Conservative lending limits. Only loans up to a certain loan to value ratio can be included in the cover pool. In Germany, for example, the regulation of covered mortgage bonds states a maximum LTV ratio of 60 %. Additionally, valuation rules for mortgaged real estate are strictly regulated.
- Comprehensive regulation. The German legislation on covered mortgage bonds requires a trustee which is nominated by the German supervisory authority and oversees the characteristics of the mortgage collateral. The central bank regularly monitors the coverage of mortgage bonds. Mortgages included in the cover pool may be changed (as loans are paid off, for example), but any substitutions must meet the same requirements.
- Protection of investors. In the event of bankruptcy of the lender, the bondholders have priority to access to the cover pool. Under this preferential right, in the case of a mortgage bank's insolvency, creditors of the German covered mortgage bond ("Pfandbriefe") do not participate in the insolvency proceedings. Instead, their claims are satisfied on schedule in accordance with the terms of the respective issue out of the cover assets, provided these are sound. If the claims in terms of coupon payments and redemptions cannot be satisfied

on time, because the assets in the cover pool are inadequate, separate insolvency proceedings would be opened with respect to the affected pool.

These strict criteria have earned covered mortgage bonds a reputation as solid and safe investments. As a result, their spreads usually deviate only slightly from Government bonds. For example, the Pfandbriefe have become a high-grade investment product, while they also pay a yield premium comparable with German government bonds. As high-grade credit, the Pfandbriefe competes with other agency issues, e.g. from issuers like KfW or other AAA tranches of securitisations. Given their outstanding credit quality and liquidity, Pfandbriefe have increasingly drawn the attention of international institutional investors.

The attractiveness of covered mortgage bonds depends on strict and clear regulations and investors' appetite for mortgage-related securities. By requiring specific standards, it creates the confidence that potential investors look for. If the covered mortgage bonds offer attractive risk-adjusted returns, demand may appear. Covered mortgage bonds help overcome liquidity and long-term capital constraints as well as improving cash flow risk management.

Liquidity Facilities to Support Secondary Market Development.

A liquidity facility is an institution that provides medium to long-term liquidity to mortgage lenders by issuing bonds to raise medium to long-term funds. It acts as an intermediary between mortgage lenders and the capital market. The liquidity facility can either purchase or refinance loans with recourse to the lending institutions. The use of short term funding instruments such as deposits expose the mortgage lenders to maturity mismatch and liquidity risk, A liquidity facility helps the mortgage lenders to mitigate the maturity mismatch and liquidity risk by providing them with medium to long-term funds.

Furthermore, since the liquidity facility can issue fixed rate bonds, the lenders and the borrowers will benefit by obtaining fixed rate medium to long-term funds from the liquidity facility. Fixed rate mortgage loans to borrowers will reduce the incidence of defaults (due to increase in general interest rate) as well as the non-performing loans of the banks.

PMRC has been established as a liquidity facility. For guidance on its model and mechanics, please refer to **Annex 4** of this Guide. Further information can be found on PMRC's website (www.pmrc.com.pk).

Sanctioning

Once all relevant information has been collected, the application will be submitted to the responsible department which will evaluate the proposal and, if required, prepare a recommendation to the Credit Committee or equivalent. Other divisions of the lender (if applicable), such as the Credit Department, Credit Administration Department and Legal Department may be involved in this process by providing their conclusions and recommendations.

The underwriting process shall include the following steps:

1. Carry out background checks on the information provided relating to income, loan history and other financial aspects of the borrower.

2. Carry out on-site visits to the property offered as collateral for the mortgage loan (as applicable).
3. Carry out checks on personal documents to prevent identity fraud using CNIC / NADRA Verisys.
4. Evaluate the borrower's consumer history and creditworthiness (ability to repay).
5. Establish that the borrower has sufficient funds available to cover the down payment and all other costs involved in the transaction.
6. Confirm the validity of the collateral title documents and chain of documents (by legal team).
7. Evaluate the adequacy and suitability of the collateral based on the Appraiser's Report.
8. Confirm the amount of the loan and the repayment terms and conditions.
9. Provide a written evaluation and recommendation to the Credit Committee (or equivalent).

If the loan underwriter at this stage reaches a conclusion that the loan cannot be granted to the borrower, the borrower shall be informed of the decision in writing where possible stating the reasons for rejection.

If the loan underwriter reaches a positive decision, the application will be submitted to the relevant Credit Committee (or equivalent) which will reach a decision based on the analysis and recommendations.

The documented decision of the Credit Committee (or equivalent) shall indicate any one of the following:

- That the loan application shall be rejected, indicating the reasons for this.
- That the loan will be granted with standard terms and conditions.
- That the loan be granted but with enhanced risk mitigation criteria applied (e.g., requiring an increased down payment from the borrower).

The borrower shall be informed in writing of the decision. In the event the application is rejected, the reasons for rejection will be included in the notification where possible.

1.6 Completion

1.6.1 Loan offer and closing

The loan and mortgage Agreements shall be finalized according to the lender’s standard procedures for concluding these Agreements in conformance with the requirements of legislation in Pakistan. The following Guidelines identify the minimum requirements for terms and conditions to be included in the loan and mortgage Agreements. Other terms and conditions shall be included to satisfy the lender’s normal requirements for such Agreements.

Contents of the Loan Agreement

The Loan Agreement shall include the information outlined below:

1. Lender's details (name, address and CNIC).
2. Borrower and co-borrower's details, if applicable (surname, first name, patronymic, permanent residence address and CNIC).
3. Size of loan amount, currency, interest rate, term and maturity date.
4. Purpose of loan.
5. Declaration of the borrower that he/she has full legal capacity and capability (e.g. is mature and sane).
6. Schedule of repayments to be made by borrower, including commencement date and frequency.
7. Collateral details (collateral must be in favor of the lender).
8. Conditions of default under which lender will enforce the mortgage.
9. Definition of early repayment terms and penalties.
10. Definition of late payment terms and other penalties.
11. Lender must be able to assign its rights under the Loan Agreement to another party without the borrower's consent.
12. Lender must be expressly permitted under the Loan Agreement to disclose Customer's data to an assignee or potential assignee.
13. List of disbursement conditions (as applicable)

Contents of the Mortgage Agreement

The mortgage contract shall contain the following information and provisions:

1. Mortgagee details (name, address and CNIC).
2. Mortgagor details (surname, first name, patronymic, permanent residence address and CNIC).
3. Declaration of the mortgagor that he/she has full legal capacity and capability (e.g. is mature and sane and legally permitted to mortgage the property).
4. Description of the property and/or the registration data for the property (if land is included, a description of the land must also be included).
5. If the mortgaged property is jointly owned, the Agreement shall stipulate that it is mortgaged with the consent of all joint owners.
6. Confirmation from mortgagor that:
    a. Mortgaged property is not subject to any liabilities or other contractual obligations, pledges or legal claims.
    b. No restrictions on mortgagor to alienate mortgaged property.
    c. No restrictions on resale of property.

d. Property not subject to outstanding possession and sale procedures.

7. The mortgagor to be prohibited from alienating the mortgaged property in any other way, including by the issuance of mortgage deeds, without the consent of the mortgagee.
8. The Mortgage Agreement shall allow the mortgagee to assign the rights thereunder to another party without the mortgagor's consent to do so.
9. In case of breach of the Loan Agreement or provisions of the Mortgage Agreement by the mortgagor, the mortgagee shall have the right to enforce the mortgage as specified in the Pakistan laws.
10. The mortgagor, members of his family and other occupants of the property shall sign waivers recognizing that their right to remain in the property ceases upon default by the mortgagee.
11. The mortgagor and all other occupants shall vacate the property within 30 days of notice from mortgagee to mortgagor that mortgagee intends to enforce the mortgage.
12. After the property has been seized, mortgagee shall be permitted to sell the property in any manner allowed by Pakistani law in effect at the time of the sale.
13. The mortgagor has to maintain the property in good condition.
14. The mortgagor has to insure the property as required by the mortgagee.
15. The mortgagor has to inform mortgagee of any material changes to the property or its condition (proposed or actual), or changes in the usage of the property and to seek the lender's consent to these.

1.1.1 Insurance required

Lenders shall require property insurance to be taken out by the borrower. Additionally, the lender may require life insurance.

The lender shall develop a list of acceptable insurance companies to provide property and life insurance cover. Both insurances shall be concluded with reputable insurers and must be pledged in favor of the lender.

1.7 Disbursement

The borrower may need to meet other requirements before disbursement. These are specified in the conditions of disbursement and may include:

- Conclusion of the insurances required;
- Presentation of documents which the borrower could not obtain in time before the sanctioning of the loan request.

The disbursement is the last step in the loan underwriting process. It completes the loan offer: once the customer has met all the conditions of disbursement and all documents required have been reviewed and cleared, the lending officer initiates the disbursement of the loan amount. Instead of disbursing the funds into the borrower's own account, the lender may prefer to transfer the loan proceeds directly to the seller or the construction company.

Servicing

The main goal of servicing is to ensure efficient management and monitoring of the mortgage loan account and the relationship with the client from disbursement to redemption of the mortgage loan. It also provides quick access to information about the individual mortgage loan and the whole mortgage loan portfolio. A highly-automated processing system will lead to lower cost and a better tracking of missing payments and documents. Finally, servicing focuses on improving the ability of the lender to provide customer service, handle requests and maintain customer satisfaction and retention.

1.8 Loan administration

Besides the physical administration of the mortgage loan files, lenders will have systems and controls in place for the processing of mortgage loans including appropriate data storage. In addition, repayment schedules, maturity profiles, geographical distribution, arrears profile, etc., will be produced to comply with the reporting standards of the lender.

Ideally, mortgage loans should be serviced and monitored by loan officers who are not directly involved in the initial sales process (i.e. back office personnel). The responsibilities of these loan officers must include:

1. Set up and maintain mortgage loan files in which all important documents provided by the borrower are stored.
2. Ensure all disbursement conditions have been met.
3. Ensure all required documents are present.
4. Ensure payments for mortgage loans.
5. Process early (pre-term) payments on mortgage loans and, where appropriate, recalculating loan repayment schedules.
6. Carry out procedures for overdue mortgage loan accounts, including reminders to borrowers, calculation of penalties and initiation of the bad loans process for recovery of the debt.
7. Review the collateral, property insurance and the borrower's financial position on a regular basis.
8. Carry out final closing processes upon maturity of the loan.

1.9 File building

Once a loan officer has determined that a client would be likely to qualify for a mortgage, he or she will begin creating a file for the prospective loan.

A mortgage loan file is a compilation of all the documents and information that is gathered in relation to a customer’s loan at every stage of the origination and servicing process. A complete, accurate and well-organized loan file is a vital tool for a lender in ascertaining and managing the risk that any mortgage represents.

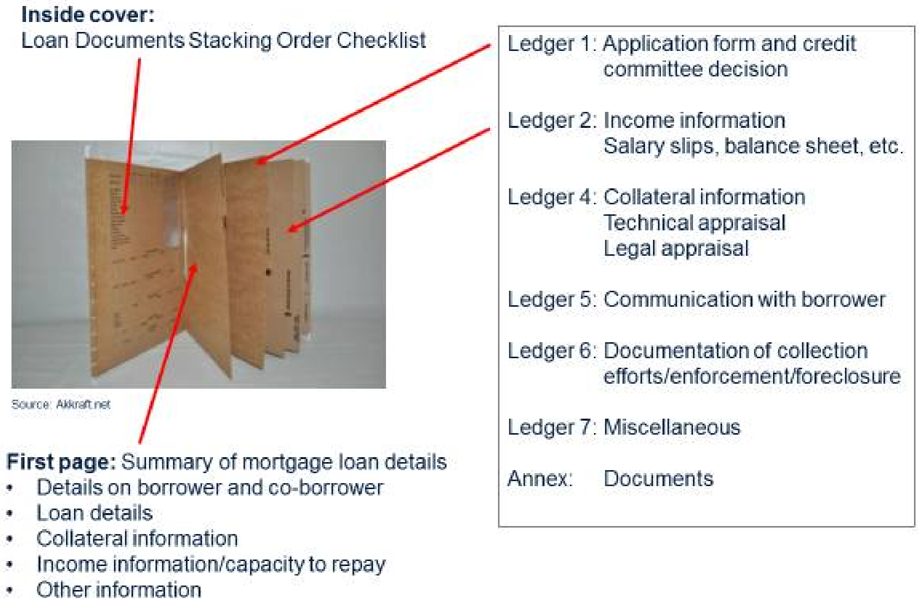
1.9.1 Building a loan file

In creating each loan file, the loan officer will adhere to the rigors of a Loan Documents Stacking Order Checklist, which specifies what documents must be included in a file at each stage in the origination and servicing process, as well as the order in which the documents must appear. Chart 3 provides an overview about the different ledgers of a loan file, and the document checklist is included in **Annex 3:** Loan Documents Stacking Order Checklist. This list should be attached to the inside cover of the loan file so that the loan officer has a full control on all the documents collected and available and to still to be collected.

The loan officer – and each staff member who manages the loan at any subsequent stage of the process – must register on the checklist and deposit in the file every document related to the customer, even if it is not part of the standard checklist form. Every document should be included in the file in the same order as it appears on the checklist, and each item in the file should be numbered to permit each staff member who is authorized to have access to the file to efficiently locate each piece of information.

To begin a loan file, the loan officer should attach the document and information checklist to the file and organize a separate working file. All documents must be placed in the loan file. It is important that all documentation that the loan officer collects, including his/her personal notes, are kept in the file and registered in the checklist. This makes it easier for an underwriter or other authorized staff to subsequently review the file; it assures that all pertinent information about a loan is available to all staff; and it promotes strong internal controls. If a loan officer's "personal" notes are not properly filed, other staff may lack critical information if they need to fill in for a loan officer who is temporarily absent or who leaves the institution.

Chart 3. Ledgers of a loan file



1.10 Collection and payment processing

Direct debit should be the preferred form of mortgage payment collection since it is the quickest and cheapest form to process loan repayments as well as to identify delinquent borrowers.

Borrowers are typically required to hold their current account with the lender that grants the mortgage loan. This close link should allow the lender to utilize direct debiting software tools. For salaried employees it is highly recommended that the date of repayment coincides with the date the borrower receives his salary.

1.11 Annual review

Each mortgage loan will need to be reviewed at least once a year, or more often if necessary. The periodic review comprises an assessment of the borrower’s current ability to repay and includes an evaluation of the employment situation, relationship with other lenders and financial status since the conclusion of the mortgage loan agreement. Furthermore, the loan officer shall check life and property insurance on adequacy and continuation of cover.

Borrowers shall be obliged to present an income statement and any other information which the lender considers crucial to the review (e.g. insurance or tax payments etc.). For home construction loans the property itself needs to be reviewed once a year.

Based on the findings of the annual review, the loan officer may decide to change the review periodicity (for example from annually to 6-monthly).

1.12 Customer service

A well-functioning servicing of mortgage loans is a prerequisite for dedicated customer orientation and servicing quality. It also assists lenders in reaching a competitive edge. It is recommended that the following information be provided to the borrower:

1. Written confirmation of the key terms of the mortgage loan prior to signing the mortgage.
2. Annual statements regarding the mortgage loan detailing the principal outstanding, the interest payments made during the year and any penalty interest or other penalty charges.
3. The lender's policy or equivalent internal regulations in the case of arrears and/or possession.
4. The lender will inform the borrower at least on an annual basis of any changes in the fee structure, e.g. redemption penalties, statement fees, re-mortgage fees (if applicable), etc.

1.13 Closing activities after complete repayment of the loan

Once the borrower has completed the repayment of the loan, the lender officer executes the following steps:

- Closing of the loan account (in case no further loan requests have been made).
- Notifying the borrower of the loan completion.
- Returning all property related documents to the borrower.
- Cancelling the lien on the title.
- Moving the loan file to archives.

Arrears management

1.14 Standard procedures to deal with payment arrears

Monitoring repayments shall ensure that the borrower makes her/his loan payments on time. To reduce the possibility of late payments, the following measures are recommended to be taken into consideration:

- For salaried employees the date of redemption payment should coincide with the date when the borrower receives his regular salary.
- Remind the borrower 2 – 3 days prior to the payment date that a payment is due.
- All communication with the borrower should be maintained in a manner that is accessible for other bank staff as well.
- The lender could charge a fee for late payments. This could be either a fixed amount or a higher interest rate on the overdue debt and serves as a deterrent for late payment.

In line with international best practices, a lender must deal fairly with any customer with either a payment shortfall or who is otherwise in breach of the mortgage. Lender needs to have written policies and procedures in place to ensure the lender makes reasonable efforts to reach an agreement with the customer regarding the repayment method and the timeframe over which the shortfall is to be repaid. The lender should honor requests by the client for a change in payment date or the method by which the payment is made, unless the lender has a good reason to refuse. The lender may only repossess the property once all other reasonable attempts to resolve the position have failed.[7]

A well-designed arrears management process aims to bring the account back on track. The quicker an actual or potential delinquency can be resolved, the more likely that both the customer and the credit institution will have success. Conversely, the longer the account is delinquent, the greater the likelihood of foreclosure and repossession.

Each missing payment needs to immediately be reported to the loan officer, who will perform several steps before initiating the foreclosure procedures. The loan officer (or collections unit) will need to receive a delinquency report that lists accounts aged by 30, 60, 90, 180 days, 1 and 2 years in arrears. The lender must have procedures in place to start contacting the borrower for payment as soon as a payment has been missed.

Typically, the delinquent borrower is contacted at several intervals, for example in line with the following schedule:

1. The day after the first late payment, the loan officer shall contact the borrower, by telephone or in person, if possible, to;

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[7] Mortgage Conduct of Business Sourcebook (MCOB), Chapter 13 Arrears, Payment Shortfalls, and Repossessions. Financial Conduct Authority - https://www.handbook.fca.org.uk/handbook/MCOB/13/?view=chapter

- Find out the reasons for default.
- Remind the borrower of the penalties that the lender may impose.
- Advise of the consequences of such penalties for the borrower.

If necessary and appropriate, loan officer takes remedial actions (e.g. amendment of repayment rate, grace period etc.).

2. If the payment becomes 14 days overdue the loan officer shall send the borrower a registered letter / courier to:
   - Require an immediate payment of the overdue amount.
   - Warn of the potential consequences of continued non-payment.

   A copy of the letter shall be placed in the loan file.
3. If the payment becomes 30 days overdue the loan officer shall send another notification to the borrower and shall visit the borrower and the mortgage property.
4. If the payment becomes 60 days overdue, the loan officer shall send another notification to the borrower and shall visit the borrower and the mortgage property.
5. If the payment becomes 90 days overdue, the lender will send a default notice to the client and classifies the mortgage as OAEM.

As for the classification and provision rules, please refer to SBP's website for Housing Finance Prudential regulations for the most recent regulations.

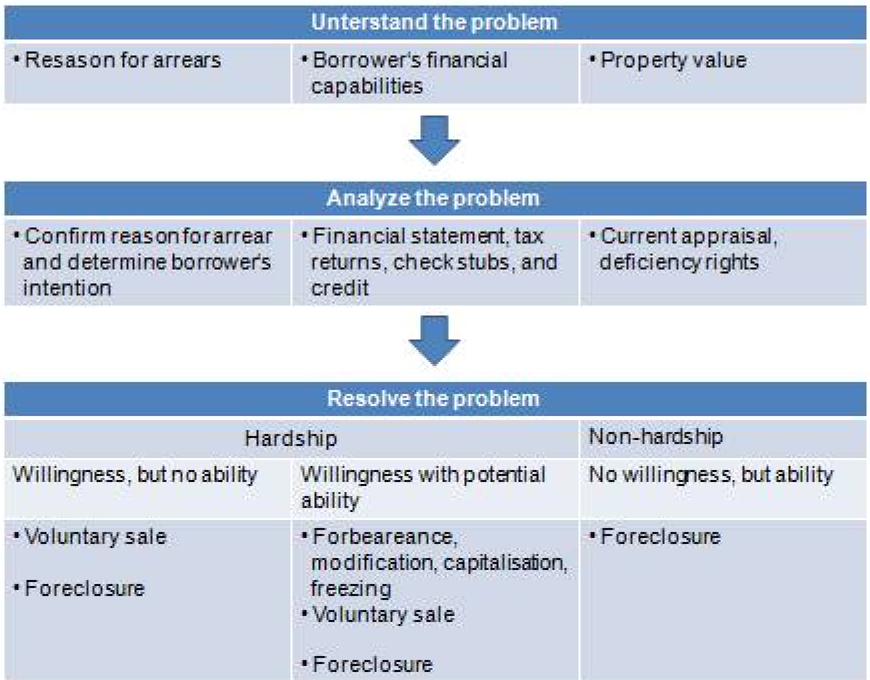
In all cases, foreclosure should be the action of last resort as it is a costly and time-consuming process in which lenders often fail to recover the full loan amount. Typically, delinquent loans should be processed by a separate department.

The foreclosure process is a very fraught situation for the lender. It is probable that the relationship with the borrower has totally broken down. If the business decision is to repossess the home, it is critical that the security is absolutely in order.

1.15 Specific procedures for loan restructuring

Chart 4 provides an overview of a potential restructuring process. The objective of an organized restructuring process is to find a solution for a borrower who is in trouble to meet his/her mortgage repayments short of the foreclosure process.

Chart 4. Illustrative mortgage loan restructuring process decision tree



Source: Mortgage Guaranty Insurance Corporation

1.The lender should contact the borrower as soon it becomes aware of any arrears and initiate discussions on mortgage payment problems. Early discussions offer both the borrower and the lenders an opportunity to reach a quick solution. The lender and the borrower or their authorized representatives need to discuss the cause of the arrears, the borrower's financial position and proposals for repayment of the arrears (for example, the parties should consider whether the causes of the arrears are temporary or long term and whether the borrower will be able to pay back the arrears in a reasonable time).

2. Following initial contact to discuss payment difficulties, the lender should provide the borrower with a clear overview of his mortgage account. During the discussion on the present payment arrears, the lender will provide the borrower with detailed information about the mortgage contract payments, including at least the following information:

1. the total amount of the arrears;
2. the total outstanding of the mortgage loan; and
3. whether late-payment interests or a contractual penalty will be added, and if so and where appropriate, details or an estimate of the late-payment interest or penalty that he/she may be expected to pay.

3. Loan restructuring is a concession of the lender, not a right of the borrower. It is up to the lender to decide on a loan restructuring. A workout is a voluntary agreement on both.

An informal workout should only be commenced if the circumstances of a financially-troubled borrower appear to offer the possibility to resolve the financial difficulties and establish a payment schedule which is both affordable and sustainable.

4. Clear communication and documentation. The lender should document any communication, and certainly if there is agreement on any changes to the payment schedule or other aspects of the loan repayments, this should be formally documented in a letter to the borrower.

The borrower is required to provide the lender with all necessary information in a timely and accurate way to allow for a proper evaluation of her/his financial position. This should include information relating to earnings and other financial assets.

The most critical issue in developing a loan restructuring strategy for a troubled borrower is to determine whether the situation is truly one of economic hardship. To enable this, the borrower shall provide the lender with all necessary information data on regular income and other sources of financing (savings accounts, investments etc.), current employment circumstances, sources of household income, future employment prospects etc., to allow for a proper evaluation of his/her financial position. As necessary, he/she should also inform the lender about any other regular payment obligations or loans.

5. All possible restructuring solutions should be considered and discussed prior to any steps to foreclose the property.

1. The lender will consider and discuss all possible loan restructuring solutions prior to any foreclosure activities (enforcement of the collateral).
2. The lender will not start a foreclosure procedure whilst a settlement is still actively being explored by both parties.
3. The lender and the borrower will discuss possible solutions to resolve arrears, in particular the alteration of the terms and conditions of the mortgage loan. The lender can refer to the following options. The final loan restructuring plan will be agreed upon on a case-by-case basis. The lender may offer other variants to the borrower.
    - Agree on a forbearance plan. The borrower is permitted to make reduced monthly payments during a defined period of time, but he/she will be expected to make increased payments to compensate for the delinquency by the end of the forbearance period. This restructuring option can be used for borrowers facing a temporary reduction in income who have good long-term prospects for increases in income that could sustain the mortgage obligation.
    - Altering the terms and conditions of the mortgage loan (loan modifications). Loan modifications typically encompass interest rate reductions and/or term extensions. Candidates for loan modifications are borrowers with long-term income reductions, but who can maintain payment for their home with smaller mortgage payments.
    - Term extensions should only be made in cases where the borrower would remain under 65 years of age at the final payment date. The interest rate type for the loan could be altered where this may provide a reduction in the monthly payment. Where appropriate the lender may consider reducing the interest rate level in an effort to improve affordability of the loan.
    - Capitalizing interest or arrears. Capitalizing interest may be used for a limited time period where the lender deems that the borrower's payment difficulties are temporary in nature or

where the borrower has a good prospect of redressing his/her situation at some future point. Capitalizing the arrears is another option where a new loan amount can be negotiated and the arrears capitalized as part of a new loan balance. This would avoid incurring charges or penalty interest rates.

- Freezing a portion of the loan. As part of a temporary solution, the lender may consider a temporary freeze on a portion of the loan where principal payments would be suspended and the interest rate set to 0%.
- Allowing a voluntary sale to take place. If a borrower can demonstrate that reasonable steps have been or will be taken to market the property at an appropriate price in accordance with reasonable professional advice, the lender may consider postponing starting foreclosure action. The borrower must continue to take all reasonable steps to actively market the property where the lender has agreed on a postponement to start foreclosure actions.

6. Prompt response to any proposal by the borrower. The lender will respond promptly to any written proposal for payment made by the borrower. If the lender does not agree with such a proposal, he should give reasons in writing to the borrower within 10 business days from the date of receipt of the proposal.

7. Allow for a reflection period for any new proposal. The lender will give the borrower a time period of not less than 5 business days to consider the proposal for a new payment schedule and to give the borrower the opportunity to get advice and discuss the proposal. The lender should set out the proposal in a clear and unambiguous way to enable the borrower to understand the implications of the proposal.

8. Realistic and achievable restructuring of loans. The loan restructuring proposal should be based on an achievable and reasonable payment schedule, where the loan servicing payments do not exceed 50% of the borrower's income.

9. The lender will not initiate any court proceedings whilst the borrower is complying with the terms agreed for the loan restructuring. The lender will not initiate any court proceedings to foreclose the property if the borrower and lender agreed on a loan restructuring proposal and the borrower complies with all the terms of the loan restructuring.

10. Respect for confidentiality. The lender will respect the confidentiality of the borrower and, unless there is agreement from the borrower, will not disclose any details or information about the borrower's circumstances to a third party.

Risk management

Lenders shall be capable of proving that capital and shareholder's funds are being prudently managed and that appropriate risk management controls are in place. Risk management policies should ensure that mortgage loans are underwritten prudently, arrears management policies are appropriate and portfolio funding risks are being monitored. Mortgage designs and pricing shall reflect the risks which are associated with mortgage lending. In housing finance, lenders are exposed to several risks as outlined below:

Categories of Risk		
Financial Risks	Operational Risks	Strategic Risks
Credit Risk	Transaction Risk	Governance Risk
Liquidity Risk	Fraud or Integrity Risk	Reputation Risk
Interest Rate Risk	Legal / Compliance Risk	External Business Risk
Portfolio Risk		Event Risk

1.16 Financial risks

Credit risk refers to the chance that a borrower will fail to repay his/her loan, or that the collateral property will not be worth enough to cover the remaining principal balance of the mortgage. The credit risk associated with each mortgage is a function of three factors: (1) the probability that the borrower will default on his/her obligation; (2) the credit exposure, or how large the outstanding balance will be at the time of default; and (3) the recovery rate, or what share of the institution's exposure the lender expects to recoup through a foreclosure and sale of the collateral property, or through other means. A lender typically mitigates credit risk principally through a combination of prudent underwriting and active servicing after the loan is closed. They are documented in the lender's Credit Policy Manual. **Annex 2**: Recommended content of a home loan credit policy shows the minimum documentation required.

Liquidity risk refers to the possibility that the lender will not be able to access funds in order to meet loan obligations that it has made. Liquidity risk must be balanced against the alternative risk of an institution having more cash on hand than it can profitably employ. Liquidity management represents the ongoing effort to balance these two outcomes. Effective liquidity management entails preparing regularly updated estimates of projected cash inflows and outflows, while maintaining both access to funds when they are needed and the means to profitably deploy cash. Liquidity risk can be mitigated by obtaining long-term funds from PMRC.

Interest rate risk refers to losses that an institution might suffer due to changes in the financial markets in which it operates, including changes in interest rates or shifts in foreign exchange rates. Adverse interest rate fluctuations could reduce the spread between the rate that the institution pays for the funds it uses to finance its mortgage loans and the interest it earns on those loans or could result in a negative spread – whereby a lender pays more for the funds it lends than what it earns on the loans. Foreign exchange risk arises principally when an institution maintains a mix of assets and liabilities that are denominated in different currencies – exposing the organization to losses that result from changes in the relative value of the different currencies.

Mortgage lending can present particularly pronounced interest-rate risk, because mortgages are typically written for extended periods of time, during which interest rates can be certain to fluctuate. The principal strategy that lenders employ to manage this risk is to match the interest rate structure of their mortgages with the interest rate structure of the funds with which they finance those loans. For example, if a lender is funding mortgages primarily through deposits on which interest rates are re-set every six months, it should endeavor to structure the mortgages so the rate that the borrower pays will be adjusted on the same schedule.

> *A lender should not offer a mortgage with an interest rate that is fixed for an extended period unless either: (1) the institution has access to funding where the interest rate is fixed for the same period; or (2) the originating lender can be certain of being able to sell its mortgages (or pass-through mortgage backed securities) to an investor who will take on the entire long-term interest rate risk.*

Obtaining funding from PMRC is a way to manage liquidity and interest rate risk. **Annex 4:** Mode of Operations with PMRC , details PMRC's process. For information about terms and conditions, please contact PMRC directly. Contact data are to be found on PMRC's website: http://pmrc.com.pk/

Portfolio risk refers to an institution's vulnerability to losses that could result when its assets are inappropriately concentrated in a limited number of categories. In the mortgage lending context, undue concentration can occur if an institution lends only to people who live in a small number of geographic areas, or only to people who work in a limited number of industries. Such a concentration can leave a lender vulnerable to drops in the economic fortunes of some parts of the country or of some sectors of the economy. Institutions typically mitigate portfolio risk either by directing their lending to a range of borrowers and locales or by selling some share of their assets if their overall pool of loans becomes unacceptably concentrated.

1.17 Operational risks

Transaction risk entails the potential for losses that result from errors that an institution makes in executing the operations that it undertakes in conducting business. Such errors can arise if an institution employs processing rules that do not provide staff with sufficient direction, if staff misapplies rules, if staff is insufficiently trained, or if actions are inadequately documented. Institutions address these risks by adopting detailed processing rules and by ensuring that staff are adequately trained on how to apply the rules. The use of information technology systems can also play a critical role in mitigating transaction risk by ensuring that decision rules are applied accurately and by capturing and storing the data that are needed to support transactional decisions and to monitor assets over their lives.

Fraud or integrity risk involves losses that occur as a result of deliberate deception either by an institution's business partners or by its staff, to secure unfair or unlawful gain. A common form of fraud in mortgage lending occurs when an applicant misrepresents his or her income or assets and liabilities in order to qualify for a loan. These or other forms of misrepresentation can be abetted if the lender's employees collaborate with the applicant to fraudulently confirm inaccurate information. Institutions can help guard against fraud through such practices as requiring written documentation from third parties to confirm the accuracy of critical data that are used to qualify applicants for a loan; training staff to recognize likely signs of misrepresentation; and auditing a share of all transactions to provide an additional check on the honesty of both outside parties and the institution's staff.

Legal or compliance risk refers to losses that can arise when an institution's business practices do not adhere to governing statutes, or when the institution's regulator determines that the organization is in violation of some requirement or is operating in a manner that could put its financial standing at risk. Institutions mitigate legal risks by subjecting all their activities to review by legal counsel to identify and correct any potential inconsistencies with governing laws and regulations. Codifying transactions by using model documents that have been found to be enforceable in courts of law is another means of controlling legal risks. Addressing compliance risk requires carefully adhering to all requirements that the institution's regulator imposes, and maintaining the sort of professional relationship with one's regulator that allows potential issues to be addressed before they advance to the point of becoming formal adverse findings.

1.18 Strategic risks

Governance risk occurs if the senior management of an institution, including its board of directors, fails to exercise appropriate oversight for the organization – either by not putting in place sound procedures to direct how business is to be conducted, or by not following through to ensure that policies are being followed. At the Board level, institutions can mitigate governance risk by ensuring that the board includes people who have a range of skills and backgrounds, by including people who do not hold full-time management positions within the organization, and by creating mechanisms that ensure that the Board is directly involved in setting and overseeing risk management policies.

Reputation risk refers to acts or circumstances that damage an institution's standing among its stakeholders. Damage to an institution's reputation can make customers or partners unwilling to do business with the organization, can diminish the institution's ability to attract capital, or can invite more intense scrutiny, and eventually restrictions, from the institution's regulator. Damage to an institution's reputation most often occurs when organization acts – or even appears to act – in a dishonest manner, or with disregard for the interests of others. An institution's senior managers can diminish the chance that such an event occurs by building a culture of integrity, whereby all staff members adhere to principles of honesty and fair treatment of others.

External business risk – also sometimes referred to as counter-party risk – occurs when the parties with which an institution does business are unwilling or unable to satisfy the obligations that they take on. In the context of mortgage lending, counter-party risk could occur, for example, if a company that is providing hazard insurance for properties that serve as collateral for an institution's loans is unable to pay claims. Other counter parties in the mortgage lending business can present risks as well, including closing or settlement agents, property appraisers, or construction firms. A financial institution can mitigate counter-party risk by establishing minimum standards that any business partner must satisfy, and by monitoring compliance with such guidelines.

Event risk refers to the chance that an institution suffers losses as a result of any number of occurrences that are beyond its control. An unlimited range of events could adversely affect an institution – form a natural disaster in the area in which it does business, to political instability, to the death of a key executive.

The challenge for the institution is to identify those events that are most likely to occur or that could most seriously affect the organization – then put in place policies to mitigate the impact of such events. For example, having a disaster recovery plan can provide a lender with immediate access to back-up facilities and to mission-critical information in the event that these are destroyed or become inaccessible. Similarly, a succession plan can help an institution recover from the loss of a key staff member.

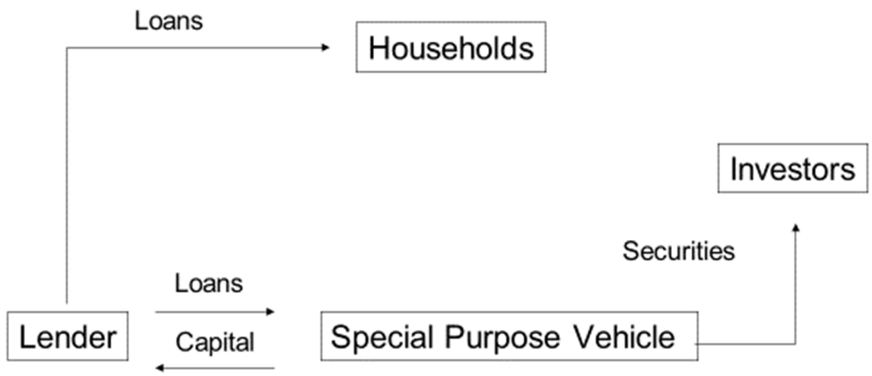
1.19 Stress testing to mitigate risk

All banks in Pakistan are subject to SBP regulations of stress testing and the Internal Capital Adequacy Assessment Process (ICAAP). Mortgages are included in the stress tests against SBP guidelines. Scenarios need to specifically assess changes in the economic environment, labour market changes and extreme fluctuations in KIBOR. Analysis of the stress test results will allow the risk management function of the lender to assess the risk on the portfolio and adjust lending limits and practices as required to remain within the risk appetite of the firm.

Securitization

Securitization is the financial practice of pooling mortgage loans and selling their related cash-flows to third party investors as mortgage- backed securities (MBS). The lender sells the mortgages to a special purpose vehicle (SPV) which issues the MBS. **Chart 5** provides an illustration of this process.

Chart 5. Typical securitization structure



The establishment of a viable and functioning market for securitization depends on various elements:

1. Enabling market readiness. The enabling environment includes all elements which are conducive to the development of efficient housing and housing finance markets:

- Macroeconomic stability. An important prerequisite for housing finance development. Often linked to the inflation rate as the most important determinant of interest rate.
- Appropriate laws and regulations and functioning enforcement. A workable system of land records and basic banking laws for foreclosure and other procedures.
- Proper institutional framework. Important elements include a working and reliable credit bureau and clearly defined appraisal standards for property evaluations.
- Financial development (banking sector reform and banking law reforms) Characterized by financial depth measured as the ratio of out-standing bank credit to GDP, and the ratio of broad money (M2) to GDP.
- Effective housing policy to support mortgage market development. This criterion covers the legal and regulatory framework and government intervention to influence the supply of mortgage finance.

2. Primary market readiness. A functioning primary market allows for the access to mortgage loans at reasonable cost. These are, for example low interest rates and long tenors:

- Efficient property markets ensure the supply of affordable housing. They include a functioning infrastructure for land development and property development. A suitable indicator is the structure of the building and construction industry as well as an existing database of listings and sales transactions.

- Functioning housing market. It includes a competitive offer of housing finance products and services (e.g. different products for particular target groups, distribution channels, etc.), clear lending standards in underwriting, documentation, servicing, collection and disclosure as well as access to different funding channels and appropriate risk management techniques.

3. Capital market readiness. The long-term sustainability of a primary market depends on its integration into the capital market to ensure continuous access to long-term funds. To raise funding through securitization, additional requirements need to be met:

3.1. Lender preparedness. The originator's organization must be prepared for securitization, especially departments in charge of Underwriting, Servicing, Information Management and Treasury.

- The lender may be capital constrained (at least on the margin). In such circumstances, the all-in costs of wholesale funding (through asset sale) may be less than retail funding considering the cost of equity capital.
- The lender may have cash flow risk management needs. Securitization may allow the lender to manage interest and liquidity risk. Deposits are usually short- term (up to 1 year) and can often be withdrawn at short notice.

3.2. Investor demand. Various factors influence investor demand for MBS. These include the performance of the mortgage loan pools, liquidity in the market and availability of a benchmark or yield curve.

- Mortgage securities must offer attractive risk-adjusted returns. Typically, investors compare the return on a MBS issue to that of government bonds which they view as the risk-free alternative investment to the MBS issue. To compensate for the higher risk of a MBS issue, they expect an attractive risk-adjusted return.
- Investors must have a capacity for mortgage-related securities. In markets in which Governments are excessively issuing debt, the capacity of institutional investors to purchase mortgage securities may be limited or non-existent (i.e., the Government may crowd out other issuers). Capacity may also be related to the liability mix of the investors. If investors have short duration liabilities, they will seek short duration assets as a match. Investors may prefer short duration assets in volatile environments to minimize the price risk in their portfolios.
- Investors must be able to invest in mortgage-related securities. This is an infrastructure development issue. Investors must have the legislative and regulatory authority to invest in such assets, and the regulatory treatment (e.g., for capital adequacy, liquidity and asset allocation purposes, eligibility to technical reserves) must be well- defined.
- Adequate legal, tax and accounting framework for securitization. Securitization must be supported by basic security laws, e.g. clear and reasonable off-balance sheet guidelines for securitized assets and the guarantee of the bankruptcy remoteness of SPV among others. Another requirement is the ability to transfer (assign) security interest: In the case of

securitization, there is a transfer of the lender's beneficial interest to the investor. The legal system must recognize and record the transfer and it should involve only a modest cost.

Annex 1. Mortgage Loan Eligibility Standards of PMRC

a. Mortgage Loan is for the purchase, balance transfer facility, renovation of a residential unit or construction of property, and is fully disbursed to or for the account of the Mortgagor and there is no obligation for the Customer to advance additional funds thereunder.

b. The Mortgagor is a natural person owning a verifiable source of income (verified by the Customer) and, to the best knowledge of the Customer, is not an undischarged bankrupt nor have any bankruptcy proceedings been commenced against the Mortgagor.

c. Total monthly amortization payments, including under the Mortgage Loan, and the repayment obligations of the Mortgagor against all other consumer financing does not exceed fifty per cent (50%) of the net disposable income of the Mortgagor.

d. The Mortgage Loan is in compliance with Applicable Laws, in particular, the Housing Finance Prudential Regulations issued by SBP.

e. As of the Requested Drawdown Date, repayment by the Mortgagor is up to date for the preceding month.

f. Weighted average of mark-up rate on the portfolio of Mortgage Loans is higher than the Applicable Rate on the Refinance Loan, provided that the criteria in respect of the mark-up rate on Performing Loans and Shortfall Mortgage Loans (as defined in the Assignment Deed) shall be as specified by PMRC from time to time.

g. Weighted average tenor of the portfolio of Mortgage Loans is longer than the tenor of the Refinance Loan, provided that the criteria in respect of the tenor of Performing Loans and Shortfall Mortgage Loans (as defined in the Assignment Deed) shall be as specified by PMRC from time to time.

h. The Mortgage Loan has not been satisfied, cancelled, subordinated or rescinded in whole or in part and the Mortgage Property has not been released from the first ranking mortgage created by the Mortgage Security Document, in whole or in part, nor has any instrument been executed that would affect any such satisfaction, cancellation, subordination, rescission or release.

i. There is no default, breach, violation or event of acceleration existing under the Mortgage Loan Documents and no event which, with the passage of time or with notice and the expiration of any grace or cure period, would constitute a default, breach, violation or event of acceleration, and the Mortgagor has not waived any default, breach, violation or event of acceleration;

j. The Mortgage Loan has not been prepaid in full and the Customer has not received any notification from the Mortgagor that a prepayment in full shall be made after the Requested Drawdown Date.

k. The Mortgage Loan Agreement and/or the Mortgage Security Agreement contains customary and enforceable provisions for enforcement of the Customer's rights and remedies against the Mortgage Property, including the right of the Customer to: (i) take possession of the Mortgage Property; (ii) sell/assign the Mortgage Property; (iii) commence foreclosure proceedings; and (iv) exercise any other enforcement procedure, right or remedy available under Applicable Laws.

l. The maximum loan to value ratio does not exceed eighty per cent (85%), provided that "value" shall be the lower of the price or appraised value of the Mortgage Property.

m. The Mortgage Security Document creates a valid, existing and enforceable exclusive and first mortgage (legal or equitable) on the Mortgage Property, including all improvements on the Mortgage Property, in favour of the Customer and such mortgage is duly perfected, in the case of a legal mortgage, through registration with the land registrar/sub-registrar, and in the case of an equitable mortgage, through actual possession of the Title Deeds.

n. A substantially clean legal opinion has been obtained in respect of the Mortgagor's title to, and Security Interests (if any) on, the Mortgage Property and creation and perfection of valid mortgage.

o. There is no provision in the Mortgage Loan Agreement and/or Mortgage Security Agreement that restricts the Customer from assigning or transferring all its rights, interests and benefits thereunder to any person with or without the Mortgagors consent.

p. The Mortgage Property is not subject to any bankruptcy proceeding or foreclosure proceeding or any other enforcement proceedings and the Mortgagor has not filed for protection under applicable bankruptcy laws.

q. The Mortgage Property is in the lawful possession of the Mortgagor, and all inspections, licenses and certificates required to be made or issued with respect to the Mortgage Property and, with respect to the use and occupancy of the same, if any, have been made or obtained from the concerned Authorities.

r. To the best of knowledge of the Customer, the Mortgagor and the Mortgage Property is in material compliance with all Applicable Environmental and Social Requirements.

s. The Mortgage Property is insured against loss by fire, hazards of extended coverage and such other hazards as are customary in the area where the Mortgage Property is located. All such insurance policies contain a standard mortgagee clause naming the Customer, its successors and assigns as first loss payee and all premiums thereon have been paid. The Mortgage Security Document obligates the Mortgagor thereunder to maintain all such insurance at the Mortgagor's cost and expense, and on the Mortgagor's failure to do so, authorizes the Customer to maintain such insurance at the Mortgagor's cost and expense and to seek reimbursement therefor from the Mortgagor.

Annex 2: Recommended content of a home loan credit policy guide

The credit policy of the lender shall be set out in a manual. A manual is considered a tool to facilitate the taking of acceptable risks by setting parameters within which a lender structures, approves and manages credit facilities and credit relationships. It does not only give clear guidance and direction to staff but also demonstrates to potential investors and rating agencies the type and style of risk management in place.

The manual shall detail the lending policy and the processes and procedures for the complete loan lifecycle. This shall comprise a written description and a flow chart showing the steps involved and shall include the following stages:

Origination	• Customer interview • Obtaining required documentation • Standard conditions for lending • Assessing ability to repay • Collateral valuation • Standardized loan and mortgage document preparation • Completion of loan application and mortgage documentation forms • Credit Committee decision process and documented authority levels • Underwriting the application
Servicing	• Standards in loans agreement and three-party contract • Loan and mortgage commencement process • File set up and document control • Legal process and registrations • Review procedures • Post completion monitoring
Risk management and funding	• Organization structure of the mortgage lending process and responsibilities of the individual departments • Reporting standards • Accounts management • Arrears management policy

The lender shall also have in place adequate controls and checks to ensure credit policies are properly applied.

A regular review of the credit policy is recommended so that amendments are taken into consideration to adapt to changing market conditions.

Annex 3: Loan Documents Stacking Order Checklist

It lists all the forms that should appear in a loan file – and the order in which they should appear – at various stages leading up to and including the closing and funding of the loan.

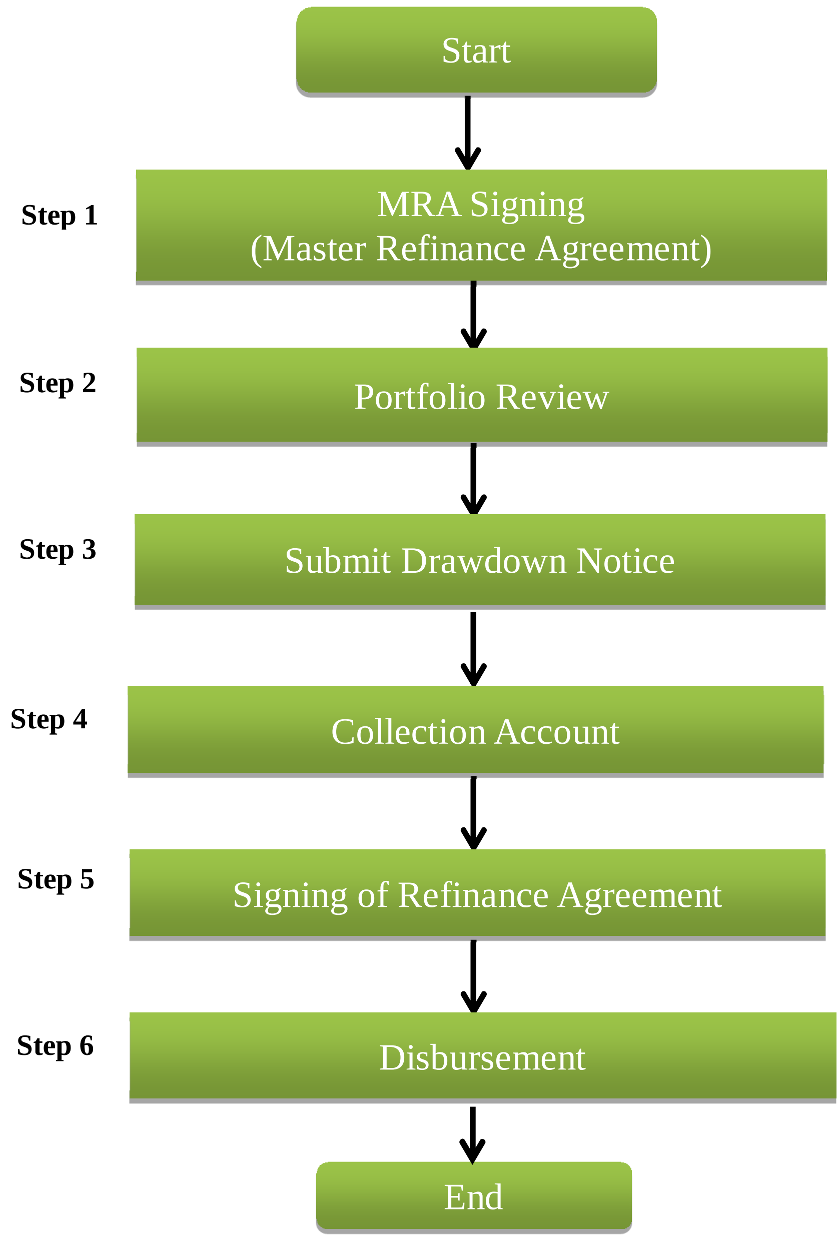
Borrower / Co-Borrower: Ali khan and Saba Ali
Subject Property Address: Street 38, Defence Phase 6, Karachi

Loan Officer: Adnan Ali   Loan Tracking Number: 2005-1

Item Sent	Item Received	
	15-4	Completed Loan Application
	27-4	Signed Borrower Disclosure Form
10-5	15-5	Completed Request for Verification of Deposit
3-5	18-5	Completed Request for Verification of Employment
1-5	12-5	Residential Appraisal Report
		Executed Appraisal Notice Requirement Not Applicable
		Credit Report for Borrower / Co-Borrower Not Applicable
		Credit Information Summary Form
	16-5	Completed Credit References
	10-5	Verification of Down payment / Cash-to-Close
	10-5	Verification of Gift Deed
		Paid Rent Receipts Not Applicable
		Verification of Rental Payments Not Applicable
	28-4	Current Pay Stubs
	3-5	Current Bank Statements
		Profit-and-Loss Statements for Business(es)
	13-5	Balance Sheets for Business(es)
	11-5	Individual Tax Return for Borrower / Co-Borrower
		Business Tax Return(s)
	20-6	Evidence of Hazard Insurance
	18-6	Verification of Property Tax Payments
		Title Report
		Survey Report
	6-6	Underwriting Summary
	7-6	Mortgage Proposal Review
	9-6	Summary for Loan Committee
	10-6	Loan Approval Form
	30-6	Closing Package Checklist
	1-7	Loan Disbursement Authorization
		Others ____________________

Annex 4: Mode of Operations with PMRC

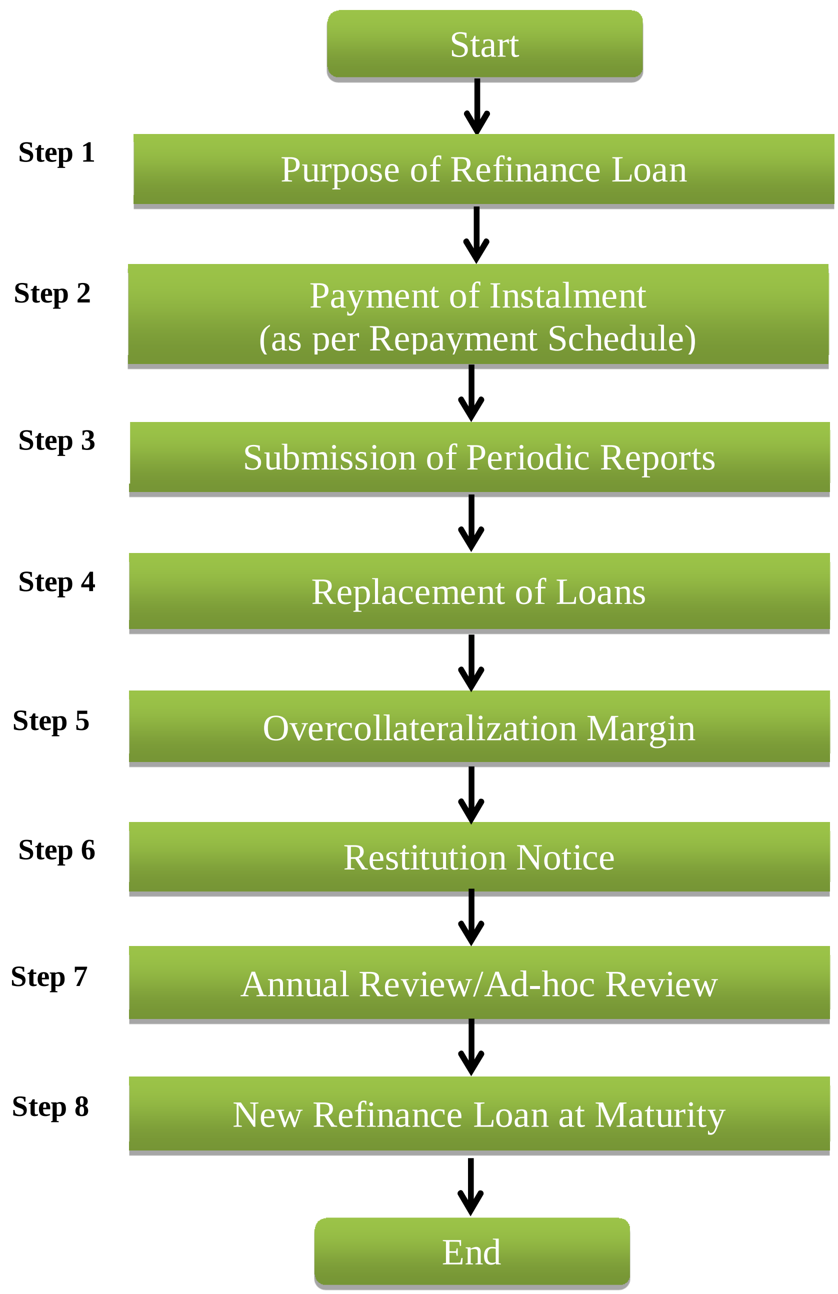
Workflow for Mode of Operations



Servicing of Refinance Loan from PMRC

Following flow chart showing the servicing obligations of Refinance Loan from PMRC.

Post Disbursement Activities



The Mode of Operations are as follows:

Signing of Master Refinance Agreement (MRA)

Customer shall meet the following criteria to qualify for signing the MRA:

PML's Qualification Criteria for signing MRA

A financial institution that:

- Is licensed and regulated by SBP and/or SECP and is engaged in the business of housing finance.
- Has a long-term credit rating of at least "A" issued by one or more recognized credit rating agencies licensed by SECP.
- Has unqualified audited Financial Statements for the most recent financial year, except for an emphasis of matter, paragraph in the Auditor's Report related to the Customer's minimum capital requirement as allowed by SBP.

Documents Required for Execution of MRA

PML shall provide PMRC the following documents prior to execution of the Master Refinance Agreement (MRA):

a) Certified copies of the constitutional documents of the Customer.

b) Certified copy of the resolution of the Board of Directors of the Customer authorising the Customer to avail the Refinance Facility and to create Security from time to time and the execution of the Principal Documents, from time to time, by authorized representatives.

c) Certified copy of Banking Licence/DFI Notification.

d) Latest credit rating report issued by one or more credit rating agencies licensed by SECP.

e) Copies of the most recent audited Financial Statements.

Portfolio Review

PML submits the Mortgage Loan Portfolio based on Mortgage Loan Eligibility Standards (refer to **Annex 1**) in the data format for Mortgage Loan Portfolio for review by PMRC.

Submission of Drawdown Notice

PML will ensure compliance with following Conditions Precedents for Drawdown Notice

Conditions Precedent to Delivery of Drawdown Notice

a. Details of the Mortgage Loan Portfolio in the form prescribed by PMRC from time to time.

b. Latest search report obtained from the SECP as evidence that the Mortgage Loan Portfolio is free from all Security Interests.

c. Amended and updated documents listed in Schedule A (*Documents on Execution of Agreement*), if any.

d. Environmental and Social Representation Form.

Environmental and Social Representation Form

Customer will be required to submit the following E&S form

A. Environmental and Social Management System

(i) Does [●] have an Environmental and Social Management System? (Y/N). If yes, please attach a copy, if no please provide plan to comply.

(ii) Does the ESMS incorporate Applicable Environmental and Social Requirements, as defined by PMRC in Mortgage Loan Eligibility Standards, in relation to Mortgage Loans? (Y/N)

(iii) Does [●] ESMS have an environmental and social screening process in relation to Mortgage Loans that integrates requirements of PMRC Environmental and Social Risk Management Policy? (Y/N)

(iv) Does [●] have a staff member/ unit/ department specifically responsible for management of environmental and social risks and implementation or the ESMS? (Y/N) If yes, please provide name and contact information.

B. Compliance of Mortgage Loan Portfolio with Applicable Environmental and Social Requirements

(i) Does the Refinance Mortgage Loan Portfolio, to the best of [●] knowledge, comply with Applicable Environmental and Social Requirements, including those set out in Mortgage Loan Eligibility Standards? (Y/N)

(ii) Is adequate documentation available for review by PMRC, its representatives in the Mortgage Loan Files? (Y/N)

For and on behalf of [●] through its authorised signatory

Name: Designation:

SIGNATURE

Footnote: i Check that documents stipulated in PMRC E&S procedures are available, such as ESIAs (to the extent applicable), lease completion certificate, approved building plan, site plan of the mortgage loan and surveyor report are available

Collection Account

The Collection Account required to be opened by the Customer

- Customer shall be required to establish and maintain a single Collection Account to deposit the Mortgage Loan Receivables in relation to each Refinance Loan.
- PMRC shall have a lien on the Collection Account to secure all obligations owed to PMRC under the Refinance Facility.
- PMRC will, on a case by case basis, determine whether the use of the funds by the Customer held in the Collection Account should be restricted or otherwise be permitted to be used in the ordinary course of business. This will be achieved through Utilization Consent issued by PMRC to the Customer.

Signing of Refinance Agreement

Customer will execute the following documents:

  - Refinance Agreement;
  - Lien Security and Control Agreement; and
  - Deed of Assignment

- Customer will arrange to stamp the above documents and return them to PMRC for execution.
- PMRC will execute the documents and return them to Customer.
- Customer will register the Deed of Assignment with SECP and intimates SBP.
- Customer will then return the original set of the above documents together with the acknowledgement of Registration with SECP.

Disbursement of Loan

PML will ensure compliance with following Conditions Precedents for Disbursement of Loan

a. the Customer has complied with Part A of this Schedule C (*Conditions Precedent to the Delivery of the Drawdown Notice*);

b. PMRC has received a duly completed Drawdown Notice signed by an authorized representative of the Customer;

c. the Requested Drawdown Date specified in the Drawdown Notice is a Business Day within the Availability Period;

d. PMRC is reasonably satisfied that the statements and certifications made in the Drawdown Notice are true and correct on Disbursement;

e. PMRC is reasonably satisfied that no Event of Default or Specified Event has occurred and is continuing and that the disbursement of the Refinance Amount will not result in the occurrence of an Event of Default or Specified Event;

f. PMRC is satisfied that all regulatory and corporate approvals relating to the Maximum Facility Amount and completion of all actions under the Principal Documents have been issued and are subsisting;

g. PMRC has received all satisfactory evidence for PMRC to determine that the Customer is a Qualified Financial Institution;

h. satisfactory completion of the Portfolio Review;

i. PMRC is reasonably satisfied that there is no law, directive, notification, order or decree of any Authority, the SBP or any Court in Pakistan, as the case may be, which prevents or restricts PMRC from Disbursement;

j. the representations and warranties set out in the Principal Documents shall as of the date of the Drawdown Request be true and correct and the Drawdown Request shall contain a statement to that effect;

k. no event or circumstance has occurred or exists which would have any Material Adverse Effect on the rights of PMRC under this Agreement;

l. PMRC is satisfied that the Disbursement of a Refinance Amount would not result in any of the Prudential Regulations being violated, or in the event it does, necessary waivers have been obtained by the Customer from the SBP and documentary evidence confirming the same has been provided to PMRC;

m. PMRC is reasonably satisfied that the Customer conducted an environmental and social due diligence on the Mortgage Loan Portfolio and has provided PMRC a confirmation of such due diligence in the form of an Environmental and Social Representation Form;

n. after Disbursement of a Refinance Amount, the Customer would not be in violation of:

   (i) its constitutional documents;

   (ii) any provision contained in any document to which the Customer is a party (including this Agreement) or by which the Customer is bound; or

   (iii) any Applicable Law, authorization or agreement or other document binding on the Customer directly or indirectly limiting or otherwise restricting the Customer's power to incur Financial Indebtedness.

o. A Refinance Agreement and Security Documents have been executed in relation to the Refinance Amount in the form provided in Schedules D and E of Master Refinance Agreement;

p. Security has been perfected in accordance with Applicable Laws, including registration/filing of the Security with: (a) the Companies Registration Office of SECP and a certificate of registration issued by SECP in respect of the same has been provided to PMRC; and (b) the SBP;

q. If required by PMRC, copies of the Mortgage Portfolio Documents have been delivered to PMRC before the requested Drawdown Date in the form and manner instructed by PMRC; and

r. The Collection Account required to be opened by the Customer in accordance with the terms of this Agreement has been opened to the satisfaction of PMRC.

Servicing of Refinance Loan from PMRC

The servicing obligations of Refinance Loan from PMRC are as follows:

Purpose of Refinance Loan

Customer will ensure that Refinance Loan provided by PMRC should be used for origination of new mortgages within a time span agreed between the Customer and PMRC.

Payment of Instalment

- The Customer shall receive Instalment Intimation email from PMRC prior to the due date and the Customer will acknowledge receipt of the email.
- The Customer shall transfer the Instalment Amount as per the Repayment Schedule to PMRC's account with SBP on the due dates through RTGS.
- The Customer shall inform PMRC via email of the amount of instalment credited to PMRC's account.

Submission of Periodic Reports

The Customer shall prepare and submit to PMRC the following quarterly reports:

Portfolio Monitoring Report

The Customer shall prepare and submit a quarterly "Portfolio Monitoring Report" to track payments and collateral coverage.

Defective Loan Report

The Customer shall submit a Defective Loan Report to PMRC on a quarterly basis setting out details of Defective Mortgage Loans which are to be replaced.

Statement of Collection Account

The Customer shall provide a certified Statement of Collection Account on a quarterly basis showing debits and credits of the Account during the statement period.

New Loans Disbursement Report

The Customer shall prepare and submit New Loans Disbursement Report on a quarterly basis, to show the generation of new mortgage loans from the refinance loan obtained from PMRC.

Financial Statements

The Customer shall send to PMRC a written notice confirming that its Financial Statements have been uploaded onto the Customer's official website.

Replacement of Loans

Following are steps for the replacement of loans:

- Within ten (10) business days of receiving a Replacement Direction, the Customer shall replace the Defective Mortgage Loan(s) identified in the Replacement Direction with another Mortgage Loan(s) that meets the Mortgage Loan Eligibility Standards to the satisfaction of PMRC.
- In the event that the Customer does not have sufficient eligible Mortgage Loans, it may offer alternative assets as substitute collaterals up to a limit of 20% of the pledged assets. Substitute collaterals can be:
- Government Securities i.e. PIBs or Treasury Bills. The Government Securities will be placed under pledge by transfer of securities to PMRC's SGLA Account with SBP. Government Securities will be accepted as collateral on market value or
- Deposits with another bank that will be kept in escrow for the benefit of PMRC. Deposits will be valued at their nominal value.

Overcollateralization Margin

The Customer will be required to maintain overcollateralization of 125%

- The overcollateralization for loans refinanced with PMRC shall be 125% or such other margin as may be determined by PMRC from time to time.
- In case the Customer does not have sufficient eligible mortgage loans for replacement, the Customer may offer alternative collaterals which may be in the form of PIBs, Treasury Bills or deposits as temporary collateral, pending the replacement of eligible mortgage loans.

- Based on the Portfolio Monitoring Report, in case Overcollateralization level goes below 125%, PMRC will send the Restitution Notice to the PML to top-up with eligible mortgage loans to meet the required overcollateralization margin.

Restitution Notice

Find below the process for Restitution of Loans:

- Within fifteen (15) Business Days (or such extended period as PMRC may specify in writing) of receiving a Restitution Notice, the Customer shall create additional Security Interests in favour of PMRC in accordance with the Security Documents.
- The Customer shall provide Mortgage Loan(s) that meets the Mortgage Loan Eligibility Standards to the satisfaction of PMRC.
- In the event that the Customer does not have sufficient eligible Mortgage Loans, it may offer alternative assets as substitute collaterals up to a limit of 20% of the pledged assets. Substitute collaterals can be:
- Government Securities i.e. PIBs or Treasury Bills. The Government Securities will be placed under pledge by transfer of securities to PMRC's SGLA Account with SBP. Government Securities will be accepted as collateral on market value or value of PIBs.
- Deposits with another bank that will be kept in escrow for the benefit of PMRC. Deposits will be valued at their nominal value.

Annual Review/Ad-hoc Review

PMRC or its appointed Reviewer shall conduct an annual review of the mortgage loans provided as security to ensure that the portfolio complies with the terms and conditions of the Master Refinance Agreement.

PMRC may also conduct an ad-hoc review if in the opinion of PMRC such an audit is necessary.

New Refinance Loan at Maturity

PMRC will have the option to offer a new Refinance Loan in place of the existing maturing Refinance Loan. In such instances, the Customer shall be required to make a formal request.

Steps for the new Refinance Loan will be as follows:

- Indicative Term Sheet will be communicated to Customer by PMRC one month prior to the maturity of the loan.

- Customer will confirm its commitment to avail the Refinance Loan based on the terms and conditions stipulated by PMRC.
- Drawdown Notice will be required.
- Signing of Refinance Agreement.
- Security requirement will be complied with before disbursement of Refinance Loan.
- Disbursement will be made in Customer’s Account at SBP.

Portfolio Review and Security Requirements

- Review of Portfolio will not be required (if same collateral in the maturing Agreement shall be used).
- Deed of Assignment will be re-registered with New Refinance Loan Number at SECP and intimation to SBP.

Annex 5: Further information – useful websites

The objective of this Annex is to provide the user with resources where he/she can access additional information to update or establish any credit policies, underwriting and servicing standards. Additionally, they provide information about mortgage markets of other countries.

5.1 Information about mortgage markets

1. Hofinet

http://hofinet.org/

HOFINET intends to consolidate global housing finance information and knowledge jointly with its international partners and to make it widely accessible.

2. International Monetary Fund (IMF) – Global Housing Watch

http://www.imf.org/external/research/housing/index.htm

The Global Housing Watch tracks developments in housing markets across the world on a quarterly basis. It provides current data on house prices as well as metrics used to assess valuation in housing markets, such as house price-to-rent and house-price-to-income ratios.

3. International Union for Housing Finance (IUHF)

http://www.housingfinance.org/

IUHF is a worldwide housing finance network organisation which enables its members to: (i) keep up-to-date with the latest developments in housing finance from around the world; and (ii) learn from each other's experience. The Union covers 46 different countries through its 104 members, which range from national banking associations or mortgage lending institutions to independent consultants, academics, government agencies and international institutions specialized in housing finance.

4. The World Bank Housing Finance Unit

http://www.worldbank.org/en/topic/financialsector/brief/housing-finance

Information about housing finance projects and different countries.

Information about regional/national housing finance markets

5. European Mortgage Federation (EMF)/European Covered Bond Council (ECBC)

https://hypo.org/

EMF is the voice of the European mortgage industry on the retail side of the business, representing the interests of mortgage lenders at European level.

ECBC is the platform that brings together covered bond market participants including covered bond issuers, analysts, investment bankers, rating agencies and a wide range of other interested stakeholders.

6. Mortgage Bankers Association (MBA)

https://www.mba.org/

As the leading advocate for the real estate finance industry in the United States, the MBA represents and serves its members through a comprehensive array of capabilities and tools that enable members to successfully deliver fair, sustainable and responsible real estate financing within ever-changing business environments.

7. Institute of Urban Economics (IUE), Russia

http://www.urbaneconomics.ru/en

IUE is a non-governmental and non-profit organization established in 1995 in Moscow. It was created to identify and analyze the social and economic problems of urban areas and promote solutions to these problems. Main goals of the Institute are: elaboration and introduction of new approaches to solving housing problems, financing of housing and urban infrastructure, municipal management, urban land use, social protection of the population, and other problems of the social and economic life of cities. All IUE researchers bring considerable experience in working with different governmental and municipal structures, scientific research and educational institutes, both state-sponsored and private, as well as international donor agencies, banks, small business enterprises and foreign companies.

8. Asia Pacific Union for Housing Finance (APUHF)

http://apuhf.info/

APUHF is a platform to act as a knowledge sharing and networking medium. The forum intends to promote coalition and coordination among the South Asia Countries in determining their housing and housing finance solutions. APUHF will also track the events and happenings in the housing markets globally. The forum focuses on initiatives taken by the different member countries in their own regional contexts. The users of the platform will include member country institutions engaged in housing and housing finance such as housing finance institutions, construction agencies such as builders, co-operatives, Government agencies, etc., policy and regulatory bodies, Central Banks, International Finance Institutions.

5.2 Information about liquidity facilities

1. Cagamas Berhad (Cagamas), Malaysia

http://www.cagamas.com.my/

Cagamas, the National Mortgage Corporation of Malaysia, was established in 1986 to promote the broader spread of house ownership and growth of the secondary mortgage market in Malaysia. It issues corporate bonds and sukuk to finance the purchase of housing loans and receivables from financial institutions, selected corporations and the public sector. The provision of liquidity at a reasonable cost to the primary lenders of housing loans encourages further financing of houses at an affordable cost.

2. National Mortgage Company (NMC), Armenia

http://www.nmc.am/en

NMC provides liquidity, stability and affordability to mortgage market in Armenia. It unites housing refinancing and capital market by means of mortgage bonds. That will contribute to the company's chartered mission to increase the amount of funds available in order to make home ownership more available and affordable.

3. Nigeria Mortgage Refinance Company (NMRC), Nigeria

http://nmrc.com.ng/

NMRC is a private sector-driven mortgage refinancing company with the public purpose of promoting home ownership for Nigerians while deepening the primary and secondary mortgage markets. Its vision is to be the dominant housing partner in Nigeria, with a mission to break down barriers to home ownership by providing liquidity, affordability, accessibility and stability to the housing market in Nigeria.

NMRC raises long- term funds from the capital market, to enhance access to affordable housing finance in Nigeria. NMRC was incorporated on 24th June 2013 and obtained its final operating licence from the Central Bank of Nigeria on 18th February 2015.

4. PT Sarana Multigriya Finansial (Persero) – SMF, Indonesia

http://smf-indonesia.co.id/en/corporation/company-profile/

The mission of the Company is to promote and develop secondary mortgage market that will increase medium to long-term fund availability for housing sector, which will provide home ownership to be affordable for every Indonesian family.

5. Jordan Mortgage Refinance Company (JMRC), Jordan

http://www.jmrc.com.jo/jmrc/homepage.aspx?lng=1

JMRC aims at giving the Jordanian citizens the opportunity to borrow from Jordanian banks and financial institutions operating in the Kingdom of Jordan to enable them to own a suitable housing units at reasonable terms through providing medium and long-term finance to these institutions to enable them to expand their business in housing finance.

5.3 Information in Pakistan

1. Pakistan Mortgage Refinance Company (PMRC)

http://pmrc.com.pk/

PMRC was set up as a mortgage Liquidity Facility by the State Bank of Pakistan to address the long-term funding constraint in the banking sector, which was hindering the growth of the primary mortgage market. PMRC will serve as a secure source of long-term funding at attractive rates and at the same time ensuring sound lending habits amongst the primary mortgage lenders (PMLs). Its thrust is three-fold: help reduce maturity mismatch risk for PMLs, increase the availability of fixed rate mortgages and increase the maturity structure of the mortgage loans. This in turn would not only help improve the affordability of mortgages but also increase the number of qualifying borrowers. With these initiatives, PMRC envisions an expansion of the primary mortgage market, which in turn will lead to the ultimate goal – a more widespread home ownership.

2. State Bank of Pakistan (SBP)

http://www.sbp.org.pk/

Data on financial sector, including housing finance.