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## INSOLVENCY SYSTEMS AND RISK MANAGEMENT IN ASIA

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**Risk Management, the Regulatory/Legal Environment and Insolvency  
Systems: Recent Trends and Developments in Pakistan**

by

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## **Risk Management, the Regulatory/Legal Environment and Insolvency Systems: Recent Trends and Developments in Pakistan**

### **Introduction:**

The linkage between risk management and insolvency systems is often imperfectly understood at the regulatory/main stake-holder level. In some cases, a decline in NPL levels owing to high economic growth rates and improvements in the regulatory environment causes enough complacency that efforts to create a modern insolvency regime is put onto the back burner. To amplify, an insolvency system's linkage with risk management is a bit like the concept of "derived demand" in economics. The need to improve insolvency systems is often felt as a consequence of a failure in the area of risk management, as evidenced by high NPL and/or a high growth rate in NPL. Therefore, in my formulation, a country can get away (in the short term) with a poor (or non-existent) insolvency system by making major improvements in risk management in particular and the overall regulatory environment in general. This, in a nutshell, is Pakistan's recent experience to a very considerable extent.

The country's NPL has neither evaporated nor has it disappeared. However, from a peak level of 26% of banking assets in 1999, and a fairly stagnant position in 2000 and 2001, the past three years have seen consistent downward trend – please see Annexure 1. Looking forward, this downward trajectory is expected to continue for another two years. The main factors responsible for this include a relatively good macroeconomic environment (leading to lower NPL flows), significant improvements in banking supervision/regulation, robust growth in banking sector profitability (leading to an increased ability to top up provisioning levels), and, last but not the least, the central bank's policy U-turn in October 2002 whereby write-off's were "decriminalized" and borrower-friendly settlements (at FSV – Fire Sale Value) were actively encouraged. All this is certainly very good news. However, the bad news is the important stake-holders within the Government appear to have lost their desire to implement a modern insolvency regime. It is hoped that the wake-up call will be internally generated and will not be in response to an NPL crisis in the future.

NOTE: Key indicators and financial statistics for the banking system are given in Annex 2.

### **Legal Developments.**

#### **The Current Position:**

The overall legal environment in Pakistan continues to be biased in favor of the lenders. In previous submissions to FAIR, I had discussed the Corporate Rehabilitation Act (CRA) in considerable detail. The CRA was an attempt to restore balance between debtors and creditors rights and to develop an institutional framework, thereby creating a modern insolvency system. CRA aims to adopt a more forgiving approach towards business failure, particularly where the failure was caused by issues external to the business itself – e.g., sudden change in duty structure, abrupt withdrawal of subsidy, governmental interference in terms of input costs and/or price control on the output side, etc. This draft law was prepared by the Banking Laws Review Commission (BLRC) in 2003 after nearly two years of deliberations. BLRC has adequate stake-holder representation from the relevant government departments (e.g., the State Bank of Pakistan, the Securities and Exchange Commission and the Ministries of Finance and Law). However, in spite of this it appears highly unlikely that the CRA will be presented to Parliament in the very near future. One of the "cultural" reasons for this ongoing delay is a widely shared belief that a person or entity that is unable to return a financial obligation is ipso facto part of the "axis of evil" and deserves neither sympathy nor any kind of relief. On occasions like these, one is reminded of the Strange Case of Dr. Jekyll and Mr. Hyde – i.e., because "loan forgiveness schemes" have become fairly regular part of the regulatory toolkit. There was one major scheme launched in 1997, followed by another one in 2002. Therefore, in the absence of the CRA, the legal framework relevant to this discussion consists of the following laws:-

- Companies Ordinance, 1984: Essentially based on English law of that period. Not designed for complex corporate reorganization. Used mainly for liquidation/winding-up, and occasionally, for voluntary reorganizations/mergers. CRA (once enacted) will replace a significant portion of the Companies Ordinance.
- Recovery of Finances Act, 2001: This law is an “improved” (for lenders) version of a debt recovery law enacted in 1997. Aimed at accelerating debt recovery for banks and other financial institutions. Has the same conceptual flaw that existed in the 1997 law – i.e., decrees are awarded allowing accrual of interest/cost of funds. A law to deal with non-accrual loans with decrees being awarded on an accrual basis is yet another legal innovation for our pioneering law-makers – i.e., “to boldly go where no other law has gone before” (with my apologies to the authors of Star Trek)!!! The recovery law is implemented through special Banking Courts, which have been in operation since 1997. The quality and level of expertise of the “specialized” judges is very uneven, to put it mildly.
- The National Accountability Bureau (NAB): This draconian law was enacted in 1999 (just after the military take-over) with a very broad scope. On the financial side, it contained whimsical terms like “willful default”, which became a criminal offence punishable by imprisonment. NAB could pick up a simple banking document (e.g., a loan restructuring agreement) and declare that the transaction was “against the public interest” without assigning any reasons whatsoever. Slightly more cerebral concepts like “cash generation”, “debt repayment capacity” and “sustainable debt levels” had, obviously, no place in the enabling law that created NAB. NAB has had some success in talking corruption using plea bargaining as a favored tool. With respect to the financial sector, it has been a resounding failure. Major reasons for failure include a poorly conceived (and badly drafted) enabling law, an inability to develop appropriate expertise/skills within NAB and an implementation pattern that reveals that the under-lying priorities keep changing at regular intervals. In addition to causing a major dip in the investment climate for at least 3 years, the NAB law also had a negative impact on the banking system. For example, in the very important area of write-off’s (i.e., balance sheet cleansing), decisions were either deferred, or simply avoided/not taken – please see Annexure 3. Logic would dictate that the NAB law is either repealed or drastically modified in terms of scaling down its mandate. However, practically speaking, it is difficult to see how such a large “white elephant” with its tentacles in each province (Regional Accountability Bureau’s) and “specialized” Accountability Courts will be cut down to size in the foreseeable future.

The current list of financial sector laws are either in draft form or are in the pre-draft stage are as follows:-

- State Bank of Pakistan (SBP) Act: A revamped and modernized version of the SBP Act of 1956 (amended in 2002). This law defines the functions, powers and objectives of the central bank.
- Banking Companies Ordinance (BCO): Currently being deliberated at by the BLRC. This law is intended to replace the existing BCO of 1962 (amended in 2001). The need for a new law is clearly felt by all market participants and stake-holders. It is felt that there have been major changes in the banking industry during the past four decades – i.e., in terms of new products, a major change in modes of delivery, the emergence (and complexity) of modern asset and liability offerings, etc. Some of the issues that are likely to be debated vigorously include the adoption of universal banking concepts and the merits (and/or disadvantages) of unified financial sector supervision (e.g., like the FSA in the UK). At present, the country has two regulatory bodies for the financial system – i.e., the State Bank of Pakistan (SBP) and the Securities and Exchange Commission of Pakistan (SECP).
- Corporate Rehabilitation Act (CRA): The drafting stage was completed nearly two years ago. CRA is with the government, awaiting presentation to Parliament. Discussed in much greater detail during previous FAIR conferences, as well as in a previous section of this paper.

## **Institutional Developments**

### **Structure:**

There have been no significant changes in terms of the legal framework in the recent past. The four basic layers of judiciary are as follows:-

- Civil Courts.
- District and Sessions Courts.
- High Courts.
- The Supreme Court.

In addition, there are also specialized courts, tribunals, etc., some of which are as follows:-

- Accountability Courts.
- Banking Courts.
- Federal Shariat Courts.
- Labour Courts.
- Taxation Tribunals.
- Federal Ombudsman (and 4 Regional Ombudsmen).

### **Appointment (and Removal) Procedures:**

High Court (HC) and Supreme Court (SC) judges are constitutional appointments. Appointments are made by the Chief Justice of Pakistan for the SC and the Chief Justice of the province for the HC. The Chief Justice of the HC of each province has administrative control over members of the subordinate judiciary in his province.

Removal of superior court judges is very rare. In theory, the Supreme Judicial Council is entrusted with this responsibility. In practice, it has never been used to remove a judge. The most recent test case was in 2001 when the Pakistan People's Party released transcripts of highly incriminating taped conversations between the then Chief Justice of the Lahore High Court (LHC), Justice Malik Qayyum (LHC) and various key characters in the Nawaz Sharif government, including the Federal Law Minister (Mr. Khalid Anwar). In addition to these embarrassing revelations relating to the use of political pressure, it was quite well known in relevant circles that the families of both the judges owned substantial amounts of defaulted loans (NPL) to a major public sector bank (Habib Bank Limited). The Supreme Judicial Council did not act. However, public pressure with a press playing a leading role finally resulted in a situation in which judges sought early retirement, which was immediately granted.

### **Funding and the Problem of Pendency:**

A recent report (by Bhandari and Naqvi) found that the number of judges (on a per capita basis) is actually quite small. On a regional basis, the figure for Pakistan (114,812 persons per judge) is slightly better than India (148,263). The position in Bangladesh (97,310) and Sri Lanka (60,586) is significantly better. Figures for certain other countries/jurisdictions for comparative purposes are: Canada (15,369), the USA (8,966), Belgium (7,000) and Germany (3,899).

The same report highlights the issue of growing caseload and increasing pendency. With respect to the Lahore High Court (LHC) it states "that while the total number of pending cases per year has increased almost 1450% since 1929 (i.e., from 4,078 to 64,427) the number of judges has only increased by 156% (i.e., from 16 to 41)". As of October 31, 2004, there are only 32 sitting judges at the LHC against a sanctioned strength of 50.

The funding position of the judiciary (at all levels) is far from satisfactory. A very poor remuneration structure has resulted in a situation where corruption is endemic at lower levels. The major load for funding the

judiciary falls on the provinces. Expenditure on the judiciary as a percentage of overall (provincial) expenditure is given below (all figures are for 2001):-

Punjab	0.69%
Baluchistan	0.59%
Sindh	0.51%
NWFP	0.47%

### **Judicial Infrastructure and Training:**

At the level of the superior courts, the quality of premises is adequate. However, the quality of premises at the subordinate courts level is grossly inadequate. The level of automation is uniformly poor.

Training (particularly for members of the subordinate judiciary) is an acute necessity, particularly for judges who are assigned to specialized courts (e.g., Banking Courts). The Federal Judicial Academy is essentially a large building with hardly any staff. The author conducted training courses at this Academy for judges of all the Banking Courts (in Pakistan) in 2002. Only 2 judges (out of 48 judges) answered “Yes” when the following question was posed to them: “Have you ever seen or read a balance sheet or annual report of any company in your life?”!!!

### **Judicial Independence:**

In theory, the judiciary is independent. In practice, notwithstanding occasional bouts of independent behavior, the judiciary has learnt to cooperate with whatever government happened to be in power. The executive utilizes subtle methods to ensure that the judiciary remains compliant. Bhandari and Naqvi’s report on judicial independence notes that “General Musharraf followed in the footsteps of General Zia by requiring all judges to swear fresh oaths of loyalty to him and his coup, and disposed of potential troublemakers by not inviting them to take oath. The then Chief Justice, Justice Saeed-uz-Zaman Siddiqui was not asked to take oath and to make sure that he got the message, a tank was parked in his driveway. Five other judges of the Supreme Court, to their eternal credit, refused to take oath. The new-look Supreme Court, much to everyone’s surprise, then validated the imposition of military rule in a 400 page judgment. The end result as noted by Makhdoom Ali Khan, one of Pakistan’s foremost constitutional experts, was further erosion in the rule of law and the stature of the judiciary:

The imposition of Emergency, the ouster of a political government, the military takeover, the Oath of Office (Judges) Order 2000, and its aftermath have caused considerable damage to the rule of law and the image of judicial independence. If our judicial pronouncements are to have any credibility, this image must be revamped. Executive interference with judicial proceedings must stop. The tenure of the judges must rest on foundations a bit more solid than the goodwill of the Chief Executive. They must be allowed to rule on executive orders and legislative measures without having to worry about yet another oaths order.” (The Question of Extradition, Makhdoom Ali Khan, Dawn, August 30, 2000).

### **Role of Professionals:**

There is no institutionalized insolvency profession in Pakistan. There are significant pools of individual expertise in relevant professions (e.g., accountants, the financial sector and lawyers), but there are no self-regulating organizations (like the Institute of Chartered Accountants – ICAP) and/or licensing bodies. The same holds true for vital functions like auctioneers, receivers, administrators, evaluators, etc. The CRA includes provisions for both the institutionalization and the regulation of such professionals, but it is still a draft law. The case of evaluators is of particular interest as the SBP has (unwittingly??) given them two very critical roles. For example, evaluators determine the amount of provisions that banks need to take – i.e., banks are allowed to deduct the “realizable value of assets” from the mandatory amount of provisions (100%) for NPL in the “Loss” category. More importantly, under broad-based guidelines issued in 2002, the central bank encouraged (in fact, “directed” would be more appropriate) the banking system to undertake cash settlements of NPL with borrowers on the basis of FSV (Fire Sale Value) of the mortgaged asset(s). The determination of

FSV was to be done by evaluators. NPL amounting to over Rs. 52 billion (comprising around 50,000 individual borrowers) has been settled under these guidelines. Preliminary data suggests that evaluators have assisted borrowers (as well as themselves) by taking a deeply pessimistic view regarding the FSV of industrial assets!!! The draft CRA provides for creating self-regulating organizations, professional bodies and licensing agencies for these professions.

### **Banking Ombudsman:**

A Banking Ombudsman was appointed a few months ago, under the provisions of a law enacted in 1997. A senior (retired) banker was been selected and appointed. He will have at best a marginal role in dispute resolution in case of debt restructuring and/or insolvency issues. His mandate is limited to handling complaints relating to banking malpractices, inordinate delays, corruption, maladministration, etc. The rationale for the creation of this structure is the reality that the SBP receives a huge volume of complaints on a daily basis. The central bank presently has a whole cell/department dealing with these matters. The public perception is that the central bank is slow and is partial (to the banks). Hence, this is an attempt creating an image of impartiality and to enhance transparency. Customers of banks will have recourse to this “window” within a few months. However, there is a large segment of the financial system that is regulated by the SECP. Unfortunately, the enabling law does not permit the Ombudsman to handle complaints relating to the NBFIs sectors, which comprises, leasing companies, investment banks, mutual funds, insurance companies, etc.

### **Corporate and Industrial Restructuring Corporation (CIRC):**

CIRC is the country’s first AMC. It was established in 2001, with a limited mandate, both in terms of scope of activities and time. The mandate was to acquire NPA’s (non-performing assets) from the public sector banks, thereby expediting the privatization process in the financial sector. While CIRC’s performance has been very uneven, privatization has proceeded at a reasonable pace. During the past three years, three major banks (Habib Bank Limited, United Bank Limited and Allied Bank Limited) have been successfully sold to private sector buyers.

The performance of CIRC has been the subject of considerable criticism. The main focus of criticism stems from the very narrow way that CIRC interpreted its mandate. They failed to develop any appetite and/or capacity for debt restructuring, and chose to act purely as an auction house. Senior bankers have been complaining that CIRC’s performance has been poor and that those (private sector) banks that did not surrender their NPA’s to CIRC have been obtaining better results in terms of both speed and value. A World Bank report (2003) on the functioning of CIRC noted that “CIRC has had a very limited success in cleaning up the balance sheets of the financial institutions.” In terms of numbers, during the past four years it has acquired 233 NPA’s involving NPL of Rs. 34 billion at an acquisition price of Rs. 6 billion. So far, it has managed to sell/auction only 87 units/NPA’s for slightly less than Rs. 3 billion. CIRC’s mandated “shelf life” is due to expire in less than two years. With well over 80% of the assets in the banking system now in the private sector, any extension in its mandated “expiry date” would defy common sense and logic.

The draft CRA has provisions designed to facilitate the creation of private sector AMC’s/vulture funds. It is hoped that the incremental flow of NPL would be managed by such (private sector) entities in the future.

### **New Developments: The Financial System, the Regulatory Environment and Secured Lending Procedures.**

#### **Recent Developments (2002-2004):**

The past two years have seen several major changes in the financial system as well as a significant (positive) shift in the overall regulatory atmosphere. Some of the more important developments are as follows:-

- Consolidation: The 1990's saw a mushroom growth in the banking sector, with a huge increase in the number of banks, quite a few of which had low capitalization, inadequate/inappropriate staffing, poor risk management practices and very marginal portfolio quality. The central bank has been nudging the banking system into consolidation by successively raising the minimum (paid-up) capital requirements in a phased manner. The minimum requirement was Rs. 1 billion for 2003, it is Rs. 1.5 billion for 2004 and is set at RS. 2 billion for 2005. There have been 17 mergers and acquisitions during the past two years, and several are in the pipeline. In all 17 cases, the acquiring bank was itself not a large bank. Two up-sides have been achieved – i.e., weak entities have been eliminated and concentration has not been enhanced. The average capital base (of a commercial bank) has risen from Rs. 1.8 billion (2000) to Rs. 3.7 billion (2003).
- Privatization: Three major banks (Habib Bank Limited, United Bank Limited and Allied Bank Limited) have been successfully sold to private sector buyers. Well over 80% of the total assets of the banking system are now privately managed.
- Two Regulators: This has been a slightly controversial move. Regulatory oversight for a sizeable chunk of the financial system (comprising leasing companies, modarabas, investment banks, mutual funds, and insurance companies) has been moved to the Securities and Exchange Commission (SECP). While this was done in a planned manner around two years ago, SECP failed to build capacity in a timely manner in order to handle this inflow. In fact, even now, the SECP lacks on-site inspection capability.
- Universal Banking: While some of the main stake-holders are uncomfortable with this paradigm, market forces may dictate adoption. The SBP has become more permissive in this respect. Banks are now allowed to form separate subsidiaries to function as mutual funds, asset management companies, venture capital, foreign exchange companies, etc.
- Consumer Banking: Encouraged by a low interest rate environment as well as excess liquidity, the banking system has (finally) expanded its lending operations to middle and lower income groups. A large range of consumer asset products (credit cards, car loans, clean installment loans, housing finance, etc.) are being marketed aggressively. A leasing company has recently started financing golf club and country club memberships!!! On the other hand, liability products lack imagination. This could be because of excess liquidity and very low inter-bank rates. NPL from the consumer sector is significantly lower than the corporate sector. Likewise, SME financing has also become part of the lending toolkit. However, several (conservative) banks are staying away from this sector, on the grounds of relatively high risk perception.
- Automation: ATM coverage is relatively low and on-line banking is only offered by a few banks. However, owing to competitive pressure there is rapid progress on both fronts. The central bank itself has been making significant progress. For example, till recently data checking (credit history of borrowers) from the Central Information Bureau (CIB) of the SBP took roughly one week – i.e., written request followed by data sent by mail to the bank. CIB data is now available on-line. Similarly, on-line data is available from the credit rating agencies.
- Prudential Regulations: The central bank has been slowly but steadily moving away from its tradition of intrusive regulation and directed lending. In general, a much more permissive (regulatory) atmosphere prevails. The SBP has recently modernized and revised Prudential Regulations for Corporate and Commercial Banking, SME Financing, Microfinance Institutions and Consumer Financing. Draft guidelines for private sector participation in infrastructure project financing have been released (for debate) recently.
- Banking Audit and Supervision: This is an area of on-going risk management where “real” progress has been noticed by all market participants. SBP's compliance with Basle Core Principles is generally high. SBP now conducts comprehensive on-site inspections using a standardized CAMELSS (Capital, Assets, Management, Earnings, Liquidity, Sensitivity to Market Risk, Systems) framework for rating the overall condition of a bank. Earlier attempts at developing early

warning systems were crude and somewhat “cosmetic”. It appears that they have been re-tooling their regulatory radar and have recently developed an early warning system called IRAF (Institutional Risk Assessment Framework). As stated earlier, the other financial system regulator, the SECP has still not developed on-site inspection capability. The need for capacity building at the SECP is considered to be very urgent.

- Corporate Governance: Both the SBP and the SECP have issued Codes of Corporate Governance. However, these are still “wish lists”. Corporate disclosure standards have improved – e.g., all banks and public limited companies have to publish quarterly accounts. However, the fact remains, that the quality of financial statements (in certain industrial/segments) continues to be marginal. Too many companies “cook” their books and fudge their profits!!! However, in all fairness, this is an area of regulatory reform where the prime regulator (the SECP) cannot succeed unless there is meaningful reform of the taxation structure and the tax collecting institutions (at both the provincial and federal levels).
- Out-of-court workouts (informal): Well over two-thirds of the stock of NPL involves a single lender. These cases are relatively easier to resolve, now that most of the banking system is privately owned. In fact, the country’s NPL would have starting declining in the late 1990’s had privatization taken place half a decade earlier. In the public sector, working on resolving NPL issues was fraught with hurdles, both internal and external. These included pressures from influential borrowers (“the protected species”) often exerted through the government, an intrusive regulatory environment and a working culture whereby anyone who took meaningful decisions was considered to be a suicidal maniac. Standard tools of risk management/damage control like settlements could not be undertaken owing to an archaic tax regime. For example, till recently the tax authorities would not allow a bank to write off any amount (i.e., any deduction from taxable income) till the bank could “prove that it had exhausted all possible remedies” – i.e., two to three decades was considered to be fast track!!! For multi-lateral cases (involving more than one bank), informal creditor committees are created on a case-to-case basis. Decision-making can be reasonably fast and coherent provided that there is no public sector bank in the committee.
- Out-of-court workouts (formal): There is a (national) committee that was created to revive sick projects. The Committee for the Revival of Sick Industrial Units (CIRSU) has broad-based representation – i.e., business, bankers, etc. CIRSU does not under “deep” revival – i.e., the project is never visited, nor are the characteristics of the under-lying industry ever analyzed. The issue of whether the sickness is “worthy of revival” is not considered. CIRSU’s methods are somewhat “cosmetic”. They rely entirely on financial data obtained from the lenders/banks. CIRSU’s style is like a Panchayat/Jirga (informal dispute resolution mechanism in the rural areas), whereby they mediate between the two contestants (i.e., the debtor and the creditor). “Revival” is declared if the mediation is successful and financial restructuring is done. Conversely, if the mediation fails it is flagged as “not revived”. CIRSU claims that it has revived 172 industrial units involving an outstanding NPL of RS. 46 billion. It is very difficult to comment on this claim as CIRSU does not maintain any record with respect to the post-revival status of these industrial units. The World Bank undertook an assessment of CIRSU last year, the conclusions of which were that “in the absence of operational analysis, there would generally appear to be little increment in the value of the project. Future viability and renewed distress of these projects are of concern. No track is kept of financial or operational details of the projects after revival”.
- SBP’s Settlement Guidelines: In 2002, response to growing NPL and the combined failure of CIRC, NAB and CIRSU, the SBP issued guidelines whereby banks were actively encouraged to settle NPL with borrowers at the FSV (fire sale value) of the under-lying collateral. While the desperation of the regulator is understandable, it is generally felt that the freebee was too generous. Instead of being based on a mere piece of paper (i.e., a valuation certificate), it could have been based on a more quantitative methodology (e.g., sustainable debt levels). In fact, such methodologies exist – e.g., a debt recovery program called EDR (Excess Debt Recovery) using sustainable cash generation as a key yardstick was presented to the SBP in 1998. EDR had a write off efficiency ratio of 5:1 – i.e., for each Rs. of provisions used/written off it would generate a cash

recovery of Rs. 5. Unfortunately, EDR was never adopted. Under these guidelines (using FSV), Rs. 52 billion of NPL has been settled at the cost of unnecessarily large write off's (around Rs. 35 billion – initial/rough estimate), a fairly poor write off efficiency ratio. However, on a more general note, periodic recourse to these (so-called “one-time”) “amnesty” and “incentive” schemes is a de facto admission that in the areas of insolvency, corporate restructuring/reorganization, etc., the legal system has effectively collapsed. The Governor of the SBP admitted in a recent speech (October 14, 2004) that “the legal system is still too time consuming and costly for ordinary market participants”.

### **Efficiency of Secured Lending Procedures:**

This is an area where there is need for urgent reform at many levels. I will attempt to briefly flag the main issues in this paper. Mr. Feisal Naqvi (delegate from Pakistan) will amplify any of these points, if so desired by the forum. The main issues that hamper the efficiency of secured lending procedures are as follows:-

- **No Record of Land Title:** Outside the main urban centers, land title is determined from the revenue record – i.e., the heroic assumption is that the person who is liable to pay taxes is the owner of the land. There is no central register of land title.
- **Inheritance Issues:** There is no concept of a will in Pakistan (Islamic laws of inheritance in which the share of each relative is specified). Execution (by a bank) on any mortgaged land/property can be thwarted by litigation from a female relative on the grounds that she had not received her due share in inheritance. Under current law, there is no statute of limitations on claims by women and their heirs. Hence, litigation can pop up at any time in the future!!!
- **Oral Gifts:** Ownership of land can be changed through an oral gift. Such a gift may or may not be reflected in the land revenue records.
- **Pre-emption Laws:** This mainly applies to the rural areas. While courts do not approve of pre-emption laws, they are still a method of harassment used by neighbors to blackmail sellers of land.
- **Benami Transactions:** These are transactions (typically for land) where the stated owner (i.e., the owner on paper) is a fictitious cover for the real owner. Typically used in the rural areas to own land beyond the permissible maximum land holding. Also used in the urban areas by tax dodgers and holders of “black” (i.e., undeclared) money to disguise their real wealth.
- **Rent Control Laws:** Originally enacted to protect tenants from harassment and/or eviction. The effect is an unmitigated disaster as the only exception is “for bona fide personal need” (i.e., of the owner of the property). Establishing this “personal need” can take well over a decade to settle in court.
- **Chaotic Property Tax (and Stamp Duty) Regime:** Property taxes (particularly in the Punjab, the largest province) are imposed in a highly whimsical manner. They need to be reduced and rationalized in order to encourage the development of real estate market. Rental income (as determined by local government) is the basis for calculation. Property tax can often exceed the annual rental from a property!!! Likewise, stamp duties are very high often resulting in sale transactions not being reported. They need to be reduced so the documentation of all land transactions is improved.

The cumulative effect of these laws and “social practices” is that banks are extremely reluctant to lend against real estate outside the main urban centers. Furthermore, even in the main cities, banks are (understandably) very cautious in approving housing finance transactions. The debt/equity ratio they often apply is around 50/50, as opposed to 80% debt financing, which is the norm in countries like the UK. Therefore, the removal of these impediments is crucial to the development as well as broadening of the banking sector in Pakistan.

## **Conclusion:**

Significant improvements across a wide spectrum of risk management and banking regulation have taken place in the recent past. The banking system is healthier and has a greater capacity to absorb (normal) shocks. NPL is declining on an annual basis. However, major concerns about the proper quantification of the country's NPL and gaps in data integrity persist – please see Note to Annexure 1 (Pages 23-25). The macroeconomic environment is supportive. New areas of lending are opening up rapidly. This “space” or “breathing room” should be used creatively by the main stake-holders to plug major deficiencies in the legal system (including the repeal of out-dated laws and practices), identified in several sections of this paper.

As highlighted in this paper, the country has opted for two regulators in the financial system. From a risk management perspective, this has created a unique problem – i.e., the problem of large groups and holding companies. Who regulates them from the point of view of contagion??? To amplify, in the on-going privatization process, large Pakistani (industrial) groups are picking up banks, insurance companies, etc. on a regular basis. To understand these newly emerging conglomerates a specialized (Large Groups Unit) regulatory cell needs to be created urgently either within the SBP or SECP.

With respect to the insolvency system, it is imperative that the draft CRA along with its institution-building components should be expedited. Implementation should be done in a multi-disciplinary manner. Both bankers and lawyers develop their own tunnel vision over time. An economic perspective (in an environment where resources are a scarce commodity) is crucial to fully articulate and implement the concept of “sickness worthy of revival”.

The past two or three years have been good, and looking forward there are more upsides than downsides. It is human nature to become complacent - I guess, the Government is human too. However, there is much work to be done, particularly in the area of legal reform. Time is of the essence, and the good times should be used to prepare strong institutions and procedures to handle any turbulence in the future.

“There will be time, there will be time  
To prepare a face to meet the faces that you will meet;  
There will be time to murder and create,  
And time for all the works and days of hands  
That lift and drop a question on your plate;  
Time for you and time for me,  
And time yet for a hundred indecisions,  
And for a hundred visions and revisions,  
Before the taking of a toast and tea.  
In the room women come and go  
Talking of Michelangelo.”

The Love Song of J. Alfred Prufrock – T.S. Eliot (1888-1965).

**ANNEX 1: Non-Performing Loans (NPL's) of the Banking System (Rs. in Billion – i.e., in Column 2).**

<u>Year</u>	<u>NPL's</u>	<u>NPL's to Loans</u>	<u>Provisions to NPL's</u>
1997	173.0	23.5%	46.6%
1998	183.0	23.1%	58.6%
1999	230.7	25.9%	48.6%
2000	240.1	23.5%	55.0%
2001	244.1	23.4%	54.7%
2002	231.5	21.8%	60.6%
2003	211.3	17.9%	63.7%
June 2004	207.8	14.5%	66.8%

Source: State Bank of Pakistan.

Note: Concerns Relating to Data Integrity in NPL – Conceptual and Methodology-related Issues:

As stated earlier in this paper and in prior submissions to FAIR, the country's NPL appears to be under-stated. The extent of this cannot be quantified on account of the following methodology-related problems, which need to be addressed on a priority basis:-

- Two regulators: The financial system has two regulators – i.e., the SBP and the SECP. The former monitors (and publishes) NPL data regularly and has on-site inspection capability. The SECP neither reports NPL data nor does it have any audit capability.
- Facility-based classification versus borrower-based classification methodologies: The SBP uses facility-based and time-based classification systems whereby a borrower (using multiple banking products) can be in different classification “boxes” depending upon his time-based (default) status in each individual facility. In line with global best practices, the entire debt of the borrower should be immediately transferred to the most adverse classification category. Obviously, very low risk facilities (e.g., where the lender holds 100% cash collateral) may be exempted from this treatment. In fact, the audit teams of the central bank use these conservative methodologies. Consequently, SBP's published NPL figures are based on NPL data derived from time-based methodologies. Adding up NPL from the audit reports of the SBP gives a totally different (and much higher) NPL figure!!! Two different sets of NPL figures within the same central bank cannot be a very coherent decision-making tool!!!
- The accounting implications of allowing court decrees with accrual clauses: As stated earlier in this paper, both the debt recovery laws enacted in the recent past (in 1997 and in 2001) contain accrual clauses – i.e., the money decree against the defaulting borrower is awarded with interest. This accrual (of interest) continues till the debt is entirely extinguished by the borrower. The NPL figure must, therefore, mirror and reflect legal reality. Consequently, the regulators need to devise appropriate accounting and/or monitoring systems to ensure that all the accruals floating around in the financial system (in hundreds of thousands of court decrees) are accurately reflected in NPL data. Likewise, if the court awards a decree that is less than the NPL (on the books of the lending institution), then the passing of a WOFUD (Write-off Of Finances Under Decree) accounting entry must be made mandatory.
- Stress on Net NPL is misleading: For the past few years, the central bank has been using the Net NPL figure (i.e., Gross NPL minus provisions held) in most of its publications. This is misleading, as provisions are actually share-holder's money which has been put to an unproductive use – i.e., to improve the solvency ratios of the financial institution. In fact, good bankers always target

recoveries above the Net NPL figure, so that surplus provisions can be returned to the bottom line – i.e., back to the share-holder. Therefore, in line with modern best practices, the emphasis should be on Gross NPL, both in terms of both decision-making as well as financial sector reporting.

**ANNEX 2: Financial Soundness Indicators of the Banking System - in percent (%)**

<u>Indicator</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>
Capital to							
Total Assets	3.5	5.3	4.8	4.5	3.8	4.8	5.4
Return on							
Assets	(1.2)	(0.1)	(0.2)	(0.2)	(0.5)	0.1	1.1
Return on							
Equity	(30.7)	(2.7)	(3.9)	(3.5)	(12.6)	3.2	20.5
Cost to							
Income	85.2	72.7	75.8	71.6	62.4	59.1	49.1
Advances							
To Deposits	57.6	56.6	62.0	66.2	61.7	54.9	56.5

NOTE: ROA and ROE are on a post-tax basis.

Source: State Bank of Pakistan.

**ANNEX 3: Financial Relief given to Borrower's (i.e., write-off's) by the Banking System (Rs. in million)**

<u>Year</u>	<u>Amount</u>
1996	4,030.27
1997	8,234.11
1998	8,326.94
1999	4,034.83
2000	2,679.34
2001	4,614.66
2002	9,807.66
2003	9,218.86