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Value Maximization of Non-Performing Loans (NPL) and Distressed Assets – Pakistan's Experience (October 1999 – October 2003)

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The composition and inherent characteristics of NPL can vary significantly between (and, indeed, within) countries and cultures. These variations include which economic segments and sub-segments are most affected (real estate, manufacturing, services, etc.), what are the key geographical concentrations, competitive characteristics, obsolescence issues, management quality, the regulatory environment, labour and employment sensitivities, etc. Therefore, it is important to look at Pakistan's NPL in terms of such characteristics and issues prior to making a determination/judgement as to whether the country's value maximization efforts were successful or not. The traditional yard-stick of measuring success (or failure) in terms of how many cents out of each dollar was "recovered" is much too narrow if the analyst's canvas is the whole country and its socio-economic framework. To adopt such approach towards value maximization entails posing (and being able to answer coherently) three very basic questions. They are as follows: -

- Where are we??
- Where do we want to be??
- How do we get there??

In order words, the desired outcome(s) should determine the choice of tools and implements to be used. As Walter Gropius (Bauhaus school of architecture) stated in the 1920's: "the function must determine the form." Therefore, while planners and regulators (quite understandably) agonize over "the NPL problem" and how to deal with it, they often fail to see that the NPL issue also has up-sides. The main "advantage" of high NPL is that it can be creatively handled in way that the post-NPL economy is much more efficient than the pre-NPL economy – i.e., by making a well reasoned judgement on "sickness worthy of revival", the planner/regulator can change the shape of the future economy.

Where Are We?? – Key Features of Pakistan's NPL

At the time of independence in 1947, the country had virtually no industrial base – it was an agrarian economy with around three-fourths of the population living in rural areas. The population of Pakistan's economic capital, Karachi (now over 12 million) was less than half a million. Fairly rapid (and sustained) industrialization started after the Korean War boom (which resulted in a major jump in commodity prices). The process of industrialization itself can be broken down into three distinct phases. The import substitution phase (up to 1980) – a major emphasis on building infrastructure and industries like fertilizers, chemicals, engineering, etc. This was followed by the export-oriented phase (1980-1995) - this phase was primarily led by textiles (spinning and weaving) and its related down-stream industries like knitwear, garments, bed sheets, towels, etc. The third phase (1995 onwards) is consumer-oriented industries – substantial growth in sectors like automobiles, cement, consumer durables, food processing, telecommunications, etc.

The key characteristics of the country's NPL are as follows: -

1. <u>Concentrated in the (large-scale) manufacturing sector.</u> With a few exceptions (e.g., trading, construction, etc.), the worst affected sector was the large-scale manufacturing sector with key

concentrations in textiles, cement, sugar and public sector companies. Interestingly, the SME (small and medium enterprises) sector was not seriously impacted. This was primarily because of high leverage/under-capitalization in the former (i.e., large-scale manufacturing) and debt aversion/low leverage in the SME sector.

2. Concentrated in the public sector banks and financial institutions. To a significant extent, Pakistan's NPL was "man-made" and avoidable. The proof of this is that at peak nearly 90% of the country's NPL was concentrated in banks and financial institutions in the public sector. The ratio of NPL to total loans in the private sector and the foreign banks has rarely exceeded single digits. The reason for low NPL to be the norm rather than the reverse is not difficult to understand. Except for the 1990's (the country's so-called "lost decade"), economic (and industrial) growth rates have been fairly robust. Additionally, large segments of industry (till recently) have enjoyed protection from overseas competition – i.e., tariffs for the import-substitution industries and a mixture below-market interest rates and direct subsidies for the export-oriented industries.

3. Culture of "zero equity" projects. In the 1980's and 1990's a lethal cocktail of liberal project financial (minimal/cosmetic due diligence by the banks), collusive lending, poor corporate governance and bureaucratic regulators led to what (understandably) became a major problem. In this period, hundreds of projects were set-up where in many cases the "kick-back" (received by the sponsors of the project from the overseas machinery supplier) exceeded the paid-up capital of the company!!! With under-capitalization and high gearing becoming the norm, many of these projects could not withstand even a minor business downturn.

4. Dilettante entrepreneurs. While there are several well-established (and well managed) business groups, around a third of the NPL comprised new entrants into industry with "diverse" backgrounds (e.g., agriculturists, bureaucrats, military seniors, judges, etc.). "Vertical mobility" may be a laudable characteristic in society. However, the passage of time has proved that the capacity of these dilettante entrepreneurs to run an efficient enterprise along with their motives (to set up a project) is questionable. Furthermore, efforts at any form of "enlightened" reform in the area of NPL reduction is often blocked by these influential defaulters (nick-named "the protected species").

5. Chronic over-capacity/lack of competitive advantage. These factors are responsible for a large chunk of NPL. Certain (large) industrial segments have significant over-capacity, which only a sustained period of high economic growth can cure – e.g., the cement industry has been functioning at less that two-thirds capacity utilization for over a decade. There are other industrial segments that suffer from an inherent lack of competitive advantage and should not have been set up in the first place – e.g., sugar, where the average yield for most of the mills (sugar extracted as a percentage of sugarcane crushed) is 7%, which is 30%-40% below the yield in efficient producers like Cuba and the Philippines.

6. Directed lending. The senior management of the public sector banks (and other public sector enterprises) traditionally was selected (by politicians and/or military commanders) for considerations in which professional competence was viewed as an un-necessary qualification. These (very grateful) individuals were often asked to repay in kind through making loans (political patronage) that were designed not to be repaid – i.e., NPL at birth. Needless to say, bankers did what they were told, and, in many cases, joined the bandwagon by being fairly generous to themselves in terms of using public money.

Where Do We Want to Be?? And How Do We Get There?? Value Maximization: The Basic Imperatives

Viewing this NPL map in the late 1990's, a value maximization/NPL reduction strategy was required which should have contained the following key ingredients/features: -

1. Fast-track implementation is crucial. With well over three-quarters of the NPL concentrated in manufacturing (with many of the distressed assets being relatively new/modern industrial plants), speed and the avoidance of closures were of the essence. Allowing manufacturing entities to close often results in degeneration (i.e., pilferage, lack of maintenance of sensitive equipment, etc.), which in turn substantially increases the cost of rehabilitation. Even in the simple cases of a change of management through court auction, the value received from closed units is much lower than running plants. For example, savvy banks/bankers were extracting settlements from NPL/distressed borrowers at values as high as P (Principal) + 50%, and managing to auction running companies at values ranging from P + 40% to P + 25%.

2. Avoidance of "cosmetic" tools. Traditional methods (of corporate re-structuring and debt re-scheduling) involving small deferrals of debt instalments and balance sheet "patch-up's" by lengthening loan repayment tenors had caused much harm by creating the fiction that all NPL can eventually be recovered. Whereas in reality, deep hair cuts (write offs) were required. This needed a new methodology to determine the level of "sustainable debt", which can be defined as a level of term debt that can be paid from cash flows over the remaining useful life of the project (i.e., 10-12 years). Unfortunately, the regulatory environment (till recently) continued to view write offs as criminal loss of public money. This (issue) got much worse after the military take-over, whereby under the NAB (National Accountability Bureau) law bankers could be nabbed (i.e., jailed) and tried (in an Accountability court) for causing write offs – an extreme form of regulatory supervision!!!

3. Change of management as a value maximization tool. The treatment of distressed assets under existing insolvency systems (including the legal system – both the laws and the related procedures) and the regulatory environment has an in-built preference for retaining the existing management. Whereas, in reality, in many cases the management is the cause of the asset becoming distressed in the first place. In such cases, the removal of existing management and their subsequent replacement is the best way to cure the company's NPL and to maximize value. To do this successfully, the AMC (asset management company) or the larger banks must have the capacity/skills to run the project/distressed asset till the new management can be found and inducted through an auction or a private sale.

4. Creating a (national) scale of priorities. Just like a fire cannot be extinguished by throwing a little bit of water on the whole affected area, value maximization is often best achieved by creating priorities across the whole spectrum of industrial default/NPL. The 80:20 rule actually becomes the 67:33 rule – i.e., if two-thirds of the most significant (in terms of the national economy) NPL is "cured" and the related distressed companies are jump-started back into normal health, the entire industrial economy will rebound several years earlier than the typical case-by-case approach. In Pakistan's context, we had the opportunity of creating priority segments (e.g., textiles – the growth engine of the export base) and non-priority economic segments (e.g., sugar – a perpetually sick industry). This is particularly important when the whole banking sector has low loan loss reserves and a feeble provisioning capacity (e.g., where the bulk of the provisions in the public sector banks come from periodic re-capitalization of their balance sheets). In such an environment (which surely is not unique), scare resources (e.g., write offs) need to flow to those economic segments which have the capacity to jump start the national economy quickly, provide maximum employment opportunities, are economically viable in the long-term, etc. Conversely, the denial of these resources can contribute to the early demise of the terminally ill segments, which are a long-term liability in socio-economic terms.

5. Clarity and consistency is required in terms of the regulator(s) signals to the market. Regulators have to drive the whole process, and both banks and borrowers watch their signals (words, deeds and nuances) carefully. In the context of fast track NPL reduction, these signals need to be very focused, consistent and unidirectional. In Pakistan, the regulator(s) opted to spend a lot of time seeking consensus-based solutions. This (a quid pro quo for all players) strategy in

what is a zero-sum game has resulted in fuzzy signalling and significant value (of NPL/distressed assets) erosion.

6. The need for capacity building. The NPL crisis revealed, that just when they were needed, skills were absent (either partially or wholly) in several key areas of specialization and expertise. The areas where there is an urgent need to build capacity and to create an institutional framework include professional receivers, auctioneers, administrators, forensic accountants (important in a culture where the majority of balance sheet's are "cooked"), asset tracing specialists, evaluators, etc., etc.

Value Maximization: Challenge and Response

How well did the country and its regulatory systems cope with and respond to these challenges (growing NPL, low economic growth rates, decline in fixed investment, etc.) during the past four years?? The first legal enactment of the military government (who seized power in a coup in October 1999) was the NAB (National Accountability Bureau) Ordinance. It was clearly drafted in a couple of weeks, and like all hasty legislation (e.g., the Patriot Act in the US) was seriously flawed. A deadline was announced whereby all loan defaulters were asked to settle their outstanding loans or face the consequences. The under-lying theoretical premise was that NPL could be recovered in full – some of it from the project's cash flow and the balance from the sponsors. The (somewhat simplistic) assumption was that if a company was making a loss, then an equivalent amount of cash had to be lying somewhere (e.g., in the sponsor's house or under the mattress). In this line of thinking, a genuine business loss was a fiction. The first batch of industrialists was arrested late at night in November 1999. They were treated very crudely – e.g., made to sit on cold floors, no blankets were provided, etc. They were photographed and these pictures were gleefully circulated in military circles as a great achievement. This (Sheriff of Nottingham) phase of NPL reduction through the use of coercive techniques continued for a year or so. In spite of this, NPL continued to grow, economic growth stagnated and investment slumped. Bankers stopped making decisions (particularly in the areas of debt restructuring and write offs), as they were also (potential) NAB targets.

The negative consequences of these actions on the country's NPL can be seen from the following chart (the conversion rate is 1 US $ = Pak. Rs. 57.4): -

$ 3.4 billion (December 31, 1998)

$ 3.9 billion (December 31, 1999)

$ 4.9 billion (December 31, 2000)

$ 5.4 billion (December 31, 2001)

$ 5.1 billion (December 31, 2002)

$ 4.9 billion (June 30, 2003)

Note: At peak (2001), NPL amounted to over 25% of total loans.

To disguise the growth in the country's NPL, the regulators (for the past 2-3 years) have starting reporting "net NPL" in most public documents. Net NPL is defined as gross NPL minus provisions held by the banking system ($ 3.2 billion) minus NPL transferred to CIRC ($ 0.6 billion) – the Corporate and Industrial and Restructuring Corporation is a public sector AMC. An additional problem in calculating correct NPL figures is the existence of two different regulators in the financial system. The banking system is regulated by the central bank – the State Bank of Pakistan (SBP). SBP publishes NPL figures regularly. However, the NBFI's (non-bank financial institutions) are supervised and regulated by the Security and Exchange Commission (SECP). SECP does not publish NPL data

for the NBFI's. The consequence of this dual regulator system is that the total NPL for the financial system cannot be accurately measured. It is, however, estimated that the correct figure for the whole financial system could be $ 1 billion higher than the reported figure reported by SBP (for the banking system).

CIRC had been set up in 2000 and was assumed that it will clean up a large portion of the stock of NPL. However, it appears the sheer volume of new NPL flows in 2000-2002 took the regulator(s) by surprise – i.e., they had not planned for it. Consequently, by the autumn of 2002, the combined failure of NAB, CIRC and the informal loan workout process (through a national committee for the rehabilitation of distressed assets forced the regulator(s) to re-vamp the whole strategy. In line with military thinking (where the opposite of a floundering advance is a retreat), the SBP executed a sharp U-turn on the NPL reduction strategy. Through a directive issued to the banking system in October 2002 banks were mandated to effectively cut their losses and run. They were directed to make "aggressive" settlements with their defaulting borrowers at values well below the actual debt outstanding and/or the amount awarded through the court process – i.e., large haircuts/ write offs. This was radically different from the premise (only a couple of years earlier) that NPL is recoverable in full and write offs were viewed with great suspicion. This directive looks at all NPL in terms of liquidation/fire sale value (FSV) and not in terms sustainable debt (going concern valuation principles). The directive contains detailed mechanics of the repayment procedure(s) and puts severe limitations on the flexibility (in terms of debtor-creditor negotiations) of individual banks that may be able to strike a better deal for themselves. Borrowers are encouraged to pay a 10% down payment of the FSV pf the project, and pay the balance 90% over a 3-year period. The remaining amount would be written off – i.e., at the end of Year 3. This (sudden change of heart) went far beyond the wildest dreams of most borrowers.

The major positive outcome of this (forgiving) approach is that it should make a major dent in the country's NPL. Although the final figures will not be clear till next year, it is expected that NPL amounting to over $ 1.5 billion may be settled. This, in itself, is a welcome change. Another positive outcome for the beneficiaries of this scheme is that within 3 years, the balance sheets of borrowers will look quite respectable – i.e., when the write off benefit is exercised. However, these positive outcomes carry some fairly heavy costs, some of which are as follows: -

1. Heavy guzzler of provisions. As mentioned earlier, prior to 1999 (i.e., the military coup), some of the smarter banks were making aggressive one-shot settlements with borrowers at values ranging from P (Principal) + 25% to P + 50%. Whereas, now (under this directive) similar distressed assets are being settled at values as low as P – 75% to P – 25%. Consequently, the quantum of provisions used up by this scheme could exceed $ 1 billion. In fact, some of the weaker banks in the public sector may require yet another dose of re-capitalization to beef up their provision/reserves. This amount could have been substantially reduced had going concern/sustainable debt concepts been used and not FSV. Furthermore, instead of maximizing value from distressed assets, this methodology actually minimizes value.

2. The mechanics of determining FSV. We do have professional evaluators in the country and the SBP maintains an "approved" list. However, these firms have evolved over time without any licensing requirements, no professional body and (most importantly) there is no significant cost/penalty for being economical with the truth. This scheme has given these individuals/firms enormous power – i.e., their determination of the FSV of a company's distressed assets fixes the final settlement amount between the debtor and the creditor. It should come as no surprise that some of these individuals will have a very comfortable retirement (and, so will their next generations)!!!

3. This scheme protects all existing managements. As discussed earlier, the current (poor) condition of a significant number of sick companies/distressed assets is on account of the poor managerial capabilities of their sponsors. This scheme makes it practically impossible for creditors to evict inefficient sponsors and to replace them with more professional owners. This feature of the

scheme is very unfortunate as many of these companies will return to NPL status within 5-6 years. It is a pity that an opportunity to weed out inefficient sponsors has been lost.

4. Promotes a continuation of the default culture. This (debtor-friendly) scheme is the second amnesty scheme announced by the central bank within a relatively short period of 6 years. The first scheme of this kind (i.e., allowing the old stock of NPL to be settled on terms favourable to the borrower) was announced and implemented in 1997. The "moral hazard" created by successive waves of amnesty and "incentive" schemes does more harm than good. This is because borrowers who have been adhering to agreed repayments terms (in good times and in bad times) feel cheated. More seriously, this feeling gives rise to an emulative instinct ("NPL desires") based on the belief that they should not miss the next round of freebies – i.e., the next amnesty or incentive scheme. This whole process results in retarding the development of corporate good governance, reduces the incentive to improve financial disclosure standards and generally promotes what has come to be known as the default culture.

Corporate and Industrial Restructuring Corporation (CIRC)

Having given a more detailed analysis of the functioning of this public sector AMC at the FAIR II conference, only an brief up-date is being presented here in order to avoid repetition. CIRC was launched in 2000 with very high expectations. It was expected to make a significant contribution it terms of eliminating a large chuck of the stock of NPL (in the public sector banks). It was also expected that since it operated under a strong enabling law, it would be able to extract better value from distressed assets than the banks operating under the auction process (through the courts). Finally, it was expected to complete its mandated tasks with considerable speed. Hence, it has a "sunset clause" built into its enabling law whereby it is to be wound-up six years after commencing operations – i.e., by September 2006.

It has, unfortunately, not lived up to expectations owing to a variety of factors – e.g., poor quality of staff, lack of expertise, bureaucratic procedures, lacks any procedures for corporate rehabilitation, etc. With exactly half its mandated "shelf life" left, the following data on progress made so far does not inspire much confidence: -

- 722 cases (of distressed assets/companies) were referred to CIRC by the banks with an NPL of $ 2.1 billion.

- CIRC returned 387 cases back to the parent bank(s) with an NPL of $ 1.0 billion. The main reason for returning a case is that the under-lying asset/company is operational and can be revived by the bank(s) themselves.

- Out of the balance of $ 1.1 billion, CIRC has actually acquired 191 cases with an NPL of 0.6 billion at a "purchase price" of $ 89 million (cherry picking??). The remaining 144 cases with an NPL of $ 0.5 billion are still under discussion with the banks (i.e., their acquisition status is still pending).

- Since inception, CIRC has sold 77 units (40% of the units acquired). These assets were sold for $ 46 million, and the under-lying NPL "settled" as a result of these sales was $ 0.2 billion (around 4% of the country's NPL). In terms of value maximization, initial data suggests that the banks have been able to extract better values from distressed assets (either through aggressive settlements with borrowers or through the auction process) than CIRC.

Last year, the World Bank did a detailed analysis on the workings of CIRC. This report was released in January 2003, and contained several key recommendations in terms of changes to CIRC's working procedures, valuation criteria with respect to asset acquisitions, personnel issues including the need to up-grade skills, etc. The best part of a year has passed without much evidence that these recommendations are being implemented. This could mean that the regulator(s) have determined that

there is very little merit in allocating more resources to an entity that is designed to fade away in a few years. In anticipation of this, we (at the Banking Law Review Commission - BLRC) have incorporated enabling provisions for the creation and emergence of private sector AMC's/Corporate Restructuring Companies (CRC's) into the draft Corporate Rehabilitation Act.

The draft Corporate Rehabilitation Act (CRA)

At the FAIR II conference, we had given a fairly detailed account of the deliberations within the BLRC (Banking Laws Review Commission) on the design of (and the desired outcomes from) the CRA. This law is clearly needed – designed to assist in improving the investment climate (fresh investment in industry is a major national problem) and promote risk-taking. The draft law has been essentially ready for enactment for nearly a year. However, owing primarily to a "hung" parliament (since October 2002), it has still not been presented to the legislature. We (at the BLRC) have used this time to make some significant changes and improvements in the draft law. My colleague will brief you about these changes (and the under-lying rational) in the presentation that follows.

The Beginning of the End or the End of the Beginning???

It has been over six years since the recognition that resolving the NPL crises is one of the key elements for the financial sector reform agenda. While the country has made significant improvements in several areas of financial sector reform, the handling of issues relating to the maximization of value from NPL remains seriously flawed. The battle against increasing NPL is being won with significant assistance from the War on Terror!!! Pakistan's external debts have been re-scheduled, the economic growth rate has improved, foreign exchanges reserves are at an all-time high (thanks to terrorized overseas Pakistani's sending money home), the stock (and real estate) markets are booming, etc. The SBP's debtor-friendly scheme should be able to reduce NPL by around $ 1.5 billion – however; it will do so at a fairly heavy cost. The CRA, once implemented, should restore balance between the rights of debtors and creditors and enhance predictability in the legal process. However, if the law is enacted in a vacuum without addressing issues like judicial capacity building and creating a strong institutional infrastructure, then it (i.e., the CRA) will be unable to deliver its "design" potential. To conclude, we are currently on at the end of the beginning (in this long process of maximizing value from distressed assets). Our current situation can perhaps be better summarized by the following verse: -

Turning and turning in the widening gyre

The falcon cannot hear the falconer;

Things fall apart; the centre cannot hold;

Mere anarchy is loosed upon the world,

The blood-dimmed tide is loosed, and everywhere

The ceremony of innocence is drowned;

The best lack all conviction, while the worst

Are full of passionate intensity.

William Butler Yeats (1865-1939)