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The Financial System & Legal Environment:
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The Financial System and the Legal Environment

- 1997 was a turning point for both the financial system and the under-lying legal environment for a variety of reasons.
- The powers of the central bank were enhanced and its independence was strengthened/re-enforced (amendments to the Banking Companies Ordinance).
- A financial sector reform was initiated (backed by the World Bank). The senior management of all public sector banks was changed, and individuals from the private sector were inducted.
- The NPL issue hit the national radar for the first time – previously buried under the carpet through "innovative" tools and practices like annual "cosmetic" re-schedulings of corporate debt/loans.
- A new creditor-friendly recovery law was enacted – the Recovery Act of 1997 (RA 1997). This law has recently been re-packaged and made even more creditor-friendly. Banks can now auction mortgaged assets without the intervention of the court (i.e., through a private sale) – the Recovery Ordinance of 2001 (RO 2001).
- RA 1997 changed the basic ground-rules for getting a decree – debtors now needed to seek the permission of the court to defend.
- Specialized courts were created. Under both RA 1997 and RO 2001, the costs of legal delays are borne by the debtor – i.e., decrees are awarded with interest.
- In parallel, in 1997 the central bank launched a nation-wide "incentive scheme" to reduce the stock of NPL.

Relevant Legal Enactments – 1997-2002

- During this period, the "recovery" (of debt/NPL) has been a key national priority.
- Successive waves of creditor-friendly laws have been enacted on a regular basis, particularly post-1999 – i.e., after the military take-over.
- Both the "balance" (between creditors and debtors rights) and legal predictability have been badly mauled.
- These creditor-friendly laws enacted during this period have had (and are continuing to have) a major impact on the financial landscape – particularly the investment climate.

NAB Ordinance of 1999 Leading to the Creation of the National Accountability Bureau (NAB)

- This was the first major legal enactment of the military regime that permitted the presumption of guilt and shifted the burden of proof to the accused. The "target

market" of this law was corruption in all its forms including non-payment/delayed payment of bank debt.

- For borrowers, a new legal term/concept was introduced. Any default (even a utility bill) of more than 30 days to any government institution was defined as "wilful default". Thus, a large proportion of the country came under the ambit of this draconian law. Wilful defaulters were subject to imprisonment, debarred from holding any public office, put on the Exit Control List, etc.
- For bankers, NAB could declare any transaction (e.g., a corporate debt re-structuring) to be "against the public interest" without assigning any reason whatsoever. Likewise, they could take (punitive) cognisance of any write-off and/or any form of relief to a borrower. It is worth mentioning that senior military officers ran NAB – i.e., straight from the barracks to the world of corporate finance!!!
- The under-lying theory/premise was very simple – all the NPL is recoverable. The premise was that the un-recoverable portion of NPL must be lying somewhere (e.g., in the borrower's house). Hence, by arresting borrowers the NPL problem would be "solved" in a few years.
- In practice, since this law was used in a highly selective and discriminatory manner (e.g., against the political opponents of the military regime) it failed to achieve its "design objectives" on the NPL. Although this law has lost its credibility, it is still on the books backed by a large (and threatening) bureaucratic machinery.

Corporate and Industrial Re-structuring Corporation (CIRC) Ordinance of 2000 and the Committee for the Rehabilitation of Sick Industrial Units (CIRSU)

- CIRC is an asset management company (AMC), created in 2000 and empowered through a wide-ranging law. CIRSU is an "informal" loan work-out/debt re-structuring body with representation from the banks and the borrowers (through the Federation of Industry) – it does not have an enabling law.
- So far, CIRC has acquired/taken over around 10% of the country's NPL.
- CIRC's "design" and its enabling law were both ambitious in scope – covering the whole spectrum from rehabilitation to liquidation.
- In practice, however, it has simply focussed on liquidation and has not developed internal capacity to perform any other role.
- Till June 2002 CIRC had sold/liquidated 54 industrial units. The under-lying mathematics is quite interesting:

banking system:	$1
Purchase price paid to the banks by CIRC:	6.4c
Sale price achieved by CIRC:	15.7c
CIRC's "profit on the auction/sale:	9.3c
Balance un-secured NPL (awaiting write-off??):	93.6c

- Net net, the AMC appears to be using its (monopoly) clout to cherry-pick "easy" NPL at un-reasonably low prices from the banking system. It leaves over 90% of the under-lying NPL in **the** banking system without any under-lying security.
- CIRSU is an un-empowered window. Its main role is to "ratify" decisions on debt re-structuring that had already been made, but not implemented – e.g., the fear of NAB.

Under-lying Reasons and Rationale for the New Corporate Insolvency Law

- The "hard" approach to the NPL problem has clearly not worked – partly because of non-cerebral/simplistic implementation – a "blind leading the blind" situation.
- The ratio of NPL to total lending remains virtually un-changed at 20%. Positive progress on "stock" has been overtaken by new NPL "flows".
- NPL to capital ratio remains at well over 100% - a serious threat to the capital base of the banks.
- The investment to GDP ratio (well over 20% over a decade **ago)** has plummeted to a new low of 14%.
- Likewise, corporate credit demand has slumped, causing excess liquidity. All the banks are now aggressively promoting consumer finance products.
- Owing to the NAB law, bankers are not willing to take any financial risks (e.g., hair-cuts). They have become trigger-**happy** and tend to favour liquidation as the only option – even for companies that are in full production!!!
- It is in this context that we have been able to persuade the GOP to modify their approach/strategy. More specifically, we are seeking the enactment of a new corporate rehabilitation law – i.e., to de-criminalize "failure" and thereby encourage risk-taking and an overall improvement in the investment climate.
- We are also seeking to change the legal/semantic environment from "wilful default" (i.e., all NPL is recoverable) to "sustainable debt" (i.e., deep hair-cuts are required).
- A copy of the full text of the final draft of the Corporate Rehabilitation Act (CRA) is in your folders.

Design Issues in the Drafting of the CRA

- The Banking Laws Review Commission (BLRC) considered three alternative models – i.e., an empowered administrative body (Indian model), judicial administration (English model) and Chapter 11 (American model).
- The idea of an empowered (via an insolvency law like India's SICA) body had a fair amount of support – we operate in an environment where the bureaucracy is very powerful!!! The counter-argument was that it would not be a good idea to

give jurisdiction to a group of disinterested (and financially un-trained) bureaucrats. This argument was (finally) accepted.

- Given a widespread suspicion about the under-lying motives of debtors, models involving "debtor-eviction" were considered – e.g., the English model. The perceived advantage was "contested entry" – i.e., seen as a method to remove the danger of countless frivolous insolvency petitions. The other advantage is management by a judicial administrator – this person/body of persons would also prepare the rehabilitation/reorganization plan for the court.
- The key hurdle in adopting this model is that there is no reservoir of competent administrators who could perform these functions/obligations under the law. In fact, even "basic" supporting institutions do not exist – e.g., qualified receivers, auctioneers, etc.
- There was also a feeling in the BLRC that a contested entry system would add an extra layer of litigation, which would cause un-necessary delays to the whole process.
- What has finally been adopted is the US model with significant modifications.
- Entry into rehabilitation proceedings is a right – i.e., the analogy here is a hotel with a "welcoming lobby". However, there is a dungeon behind the reception desk – i.e., an automatic conversion into liquidation if no rehabilitation plan is adopted/approved.
- The process is entirely stakeholder driven. Both the debtor and the creditor(s) can file plans. The court will consider the latter if the debtor's plan is not approved/confirmed.
- The entire process has been compressed with finite time-lines – e.g., the debtor has a maximum of one month to file a plan. In fact, there are fairly stringent/tight time-lines throughout the whole process.
- In Pakistan, taxes, levies and government dues enjoy substantial legal protection – e.g., income tax, sales tax and customs officers can "re-open" cases several fiscal years later. In fact, bankers have often engineered rehabilitation via a change of management/induction of a new entrepreneur only to be thwarted by extortionist claims/demands for back-taxes. In the CRA, we have converted all such taxes and levies into un-secured creditors – a fairly eclectic move!!! The idea is to move some of the costs of the inevitable haircut away from the banking system.
- We have recognized the limitations of "weak judicial capacity" – i.e., no specialized judges in the superior courts. We have inserted a provision for a 3-man Advisory Committee (comprising bankers, corporate finance specialists, etc.) to assist the insolvency judge/court.
- This committee should be an excellent resource for judges/courts that are unsure about the correct treatment of complex financial issues. Furthermore, they should be able to offer lucid advice in the (expected) situation of several competing plans being submitted – particularly when cram-down is being exercised.

- Cram-down. In the US this is clause is a threat designed to force consensus on a rehabilitation plan. In our national context, we expect fairly active use of this provision – at least, in the first few years till case law emerges and the whole system develops maturity.

Implementation is the Key Issue

- Our history is unfortunately littered with good ideas that have floundered on account of weaknesses in implementation and insufficient attention to capacity building.
- CRA is a specialized law. It can only fulfil its full "design" potential if the GOP provides post-enactment support in terms of creating a strong institutional infrastructure.
- At a minimum, support will be needed on judicial training, the creation of self-governing bodies (e.g., administrators, receivers, etc.) and the fast-track closure of competing insolvency windows/structures.
- This may seem self-evident. However, past experience in this area has been very poor – the culture favours taking a decade to ponder the self-evident and a similar amount of time to implement the inevitable. The unique and complex stakeholder map of Pakistan causes un-necessary complexities, difficulties and delays. Perhaps our situation is best summed up in the following verse: -

And we are here as on a darkling plain
Swept with confused alarms of struggle and flight,
Where ignorant armies clash by night.

Matthew Arnold (1822-1888)