An Analysis of Non-Performing Loans in Pakistan

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CHAPTER 1

INTRODUCTION

1.1 INTRODUCTION

Economy of a country is dependent on various segments like production or manufacturing sector, agricultural sector, and service sector. In the past few decades, the data shows that the traditional major portion of industry and agriculture in the economies of the countries is decreasing with the passage of time. It is the service sector, which is taking more and more portion in the economies of the countries. In the developed nations, this trend is a bit old but in Less Developed Countries (LDCs), like Pakistan, this trend is still emerging. This is pretty obvious from the fact that service sector in Pakistan contributes now more than 50% in the economy as against industry and agriculture, both with their contribution of 25% each.

Banks are-an important part of service sector, contributing to the economy. Banks play an important role in the economy of a country. Banks are custodian to the assets of the masses. Managing a bank promises to be a challenging task now a days. A difficult economic environment, a changing regulatory environment, a rapid rate of technological development, an increasingly intense level of competition, and some worrisome trends in the banking industry have combined to create a demand for strong bank management.

Many bankers believe that defining business of banking is lending. Extension of credit is one of the most important functions of banks and financial institutions. Earning from loans which banks and financial institutions extend constitute the single largest item in their profit and loss statements. Banking sector has been undergoing a complex, painful, but comprehensive phase of restructuring to make it sound, efficient, and at the same time forging its links firmly with the real sector for promotion of savings, investment, and growth. Although a complete turnaround in the banking sector performance is not expected, but still signs of improvement are visible.

Bank lending is not without the element of risk. In recent past the risk has been enormous especially in the developing countries like Pakistan. Due to non- observance of established norms and practices, a pretty large number of loan accounts has turned into bad debts leading to the losses of billions of rupees to the national economy.

1.2 OBJECTIVE OF STUDY

The core objective of this project was to carry out the analysis of lending function in banks in Pakistan and to find out the reasons for non-performing loans and recommending some concerted and plausible measures and remedial actions in the light of existing economic and social environment in the country,

1.3 SCOPE OF STUDY

During the entire study, the critical focus was on covering the following scope of:

- Problem loans in banks in general
- Problem loans in banks in Pakistan
- Major causes of problem loans in Pakistan
- Concerted measures and plausible recommendations to help sector come out of this menacing trend of non-performing loans

1.4 RATIONAL OF STUDY

Banks are considered the backbone of economy of a country. This is so because banks do channelise small savings towards commercial and industrial sectors; Banks also act as financial intermediaries thereby providing an impetus to investment and economic growth of the country.

To measure the performance of a bank, the asset quality of a bank is one of the important criteria, it is measured in relation to the level and severity of non-performing assets, recoveries, the adequacy of provisions, and the distribution of assets. For the past two decades the increasing trend of non-performing loans in the financial sector of Pakistan has severely affected the operational performance and the efficiency of the financial institutions. The consequences of this trend have resulted in the bankruptcy of many financial institutions. This is the reason, the financial sector, particularly the banks has degraded their credit worthiness not only in Pakistan but also outside the country. Moreover this effect has passed throughout the economy thus deteriorating the already ailing economy of Pakistan.

ABBREVIATIONS

ABL	Allied Bank Ltd
ADBP	Agricultural Development bank of Pakistan
BEL	Bankers Equity Ltd
CA	Chartered Accountant
CY	Calendar Year
DFIs	Development Finance Institutions
FY	Fiscal Year
GST	General Sales Tax
HBL	Habib Bank Ltd
IMF	International Momentary Fund
KESC	Karachi Electric Supply Corporation
LDCs	Less Developed Countries
MCB	Muslim Commercial Bank
NAB	National Accountability Bureau
NDFC	National Development Finance Corporation
NIT	National Investment Trust
NOC	Non Objection Certificate
NPLs	Non Performing Loans
PIA	Pakistan International Airlines
RBI	Reserve Bank of India
SBFC	Small Business Finance Corporation
SBP	State Bank of Pakistan
SBPBSC	State Bank of Pakistan Banking Services Corp
UBL	United Bank Ltd
WAPDA	Water and Power Development Authority
WB	World Bank
WTO	World Trade Organization

TERMS AND DEFINITIONS

Account. In the context of bookkeeping, refers to the ledger pages upon which various assets, liabilities, income, and expenses are represented.

Account Holder. Means a person who has opened any account with a bank or is a holder of deposit / deposit certificate or any instrument representing deposit / placing of money with a bank / DFI or has borrowed money from the bank / DFI.

Advance. Increase in the market price of stocks, bonds, commodities, or other assets.

Bank. Means a banking company as defined in the Banking Companies Ordinance, 1962.

Borrower. Means a person on whom a bank / DFI has taken any exposure during the course of business.

Capital. Money invested in a firm.

Capital flight . The transfer of capital abroad in response to fears of political risk.

Capital loss. The difference between the net cost of a security and the sales price, if the security is sold at a loss. Also used in a more general context to refer to the market for stocks, bonds, derivatives and other investments

Capitalization ratios. Also called financial leverage ratios, these ratios compare debt to total capitalization and thus reflect the extent to which a corporation is trading on its equity. Capitalization ratios can be interpreted only in the context of the stability of industry and company earnings and cash flow.

Cash. The value of assets that can be converted into cash immediately, as reported by a company. Usually includes bank accounts and marketable securities, such as government bonds and banker's acceptances. Cash equivalents on balance sheets include securities that mature within 90 days (e.g., notes).

Cash account. A brokerage account that settles transactions on a cash-rather than credit-basis.

Cash flow. In investments, cash flow represents earnings before depreciation, amortization, and non-cash charges. Sometimes called cash earnings. Cash flow from operations (called funds from operations by real estate and other investment trusts) is important because it indicates the ability to pay dividends

Cash ratio. The proportion of a firm's assets held as cash.

Collateral. In the context of project financing, additional security pledged to support the project financing

Commercial bank. Bank that offers a broad range of deposit accounts, including checking, savings and time deposits and extends loans to individuals and business. Commercial banks can be contrasted with investment banking firms, such as brokerage firms, which generally are involved in arranging for the sale of corporate or municipal securities

Commercial loan. A short-term loan, typically 90 days, used by a company to finance seasonal working capital needs.

Commercial Mortgage Backed Securities. Similar to MBS but backed by loans secured with commercial rather than residential property. Commercial property includes multi-family, retail, office, etc., They are not standardized so there are a lot of details associated with structure, credit enhancement, diversification, etc., that need to be understood when valuing these instruments

Contingent liability. Means:

(a) A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non- occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

(b) A present obligation that arises from past events but is not recognized because:

(i) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

(ii) The amount of the obligation cannot be measured with sufficient reliability; and includes letters of credit, letters of guarantee, bid bonds / performance bonds, advance payment guarantees and underwriting commitments.

Corporate Card. Means credit card issued to the employees of an entity where the repayment is to be made by the said entity.

Current Ratio. Refers to the amount of an entity's current assets divided by the amount of current liabilities.

Default. The failure to make timely payment of interest or principal on a debt security or to otherwise comply with the provisions of a bond indenture. A breach of a covenant. In context of project financing, a technical default signals a project parameter is outside defined or agreed limits or a legal matter is not yet resolved.

Debt to Equity Ratio. Refers to the capitalization relationship of securities. Here, it is the amount of bonds and preferred stocks relative to the corporate equity position.

DFI. Means Development Financial Institution and includes the Pakistan Industrial Credit and Investment Corporation (PICIC), the Saudi Pak Industrial and Agricultural Investment Company Limited, the Pak Kuwait Investment Company Limited, the Pak Libya Holding Company Limited, the Pak Oman Investment Company (Pvt.) Limited, Investment Corporation of Pakistan, House Building Finance Corporation and any other financial institution notified under Section 3-A of the Banking Companies Ordinance, 1962.

Documents. Include vouchers, cheques, bills, pay-orders, promissory notes, securities for leases / advances and claims by or against the bank / DFI or other papers supporting entries in the books of a bank / DFI.

Economic growth. An increase in the nation's capacity to produce goods and services. Usually refers to real GDP growth.

Economic growth rate. The annual percentage rate of change in the Gross National Product.

Equity. Ownership interest in a firm. Also, the residual dollar value of a futures trading account, assuming its liquidation is at the going trade price. In real estate, dollar difference between what a property could be sold for and debts claimed against it. In a brokerage account, equity equals the value of the account's securities minus any debit balance in a margin account. Equity is also shorthand for stock market investments.

Equity of the Bank / DFI. Means Tier-I Capital or Core Capital and includes paid-up capital, general reserves, balance in share premium account, reserve for issue of bonus shares and retained earnings / accumulated losses as disclosed in latest annual audited financial statements. In case of branches of foreign banks operating in Pakistan, equity will mean capital maintained, free of losses and provisions, under Section 13 of the Banking Companies Ordinance, 1962. For the purpose of Regulation R-1, reserve shall also include revaluation reserves on account of fixed assets to the extent of 50% of their value. However, for this purpose assets must be prudently valued by valuers on the panel of Pakistan Bank Association (PBA), fully taking into account the possibility of price fluctuations and forced sale value. Revaluation reserves reflecting the difference between the book value and the market value will be eligible up to 50%.

Equity of the Borrower. Includes paid-up capital, general reserves, balance in share premium account, reserve for issue of bonus shares and retained earnings / accumulated losses, revaluation reserves on account of fixed assets and subordinated loans.

Exposure. Means financing facilities whether fund based and / or non-fund Based.

Financial Institutions. Mean banks, Development Financial Institutions (DFIs) and NBFCs.

Financial leverage. Use of debt to increase the expected return on equity. Financial leverage is measured by the ratio of debt to debt plus equity.

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Forced Sale Value (FSV). Means the value which fully reflects the possibility of price fluctuations and can currently be obtained by selling the mortgaged / pledged assets in a forced / distressed sale conditions.

Gross domestic product (GDP). The market value of final goods and services produced over time including the income of foreign corporations and foreign residents working in the U.S., but excluding the income of U.S. residents and corporations overseas.

Growth rates. Compound annual growth rate for the number of full fiscal years shown. If there is a negative or zero value for the first or last year, the growth is N.M. (not meaningful).

Government Securities. Shall include such types of Pak. Rupee obligations of the Federal Government or a Provincial Government or of a Corporation wholly owned or controlled, directly or indirectly, by the Federal Government or a Provincial Government and guaranteed by the Federal Government as the Federal Government may, by notification in the Official Gazette, declare, to the extent determined from time to time, to be Government Securities.

Group. Means persons, whether natural or juridical, if one of them or his dependent family members or its subsidiary, have control or hold substantial ownership interest over the other. .

Inflation. The rate at which the general level of prices for goods and services is rising.

Interest. The price paid for borrowing money. It is expressed as a percentage rate over a period of time and reflects the rate of exchange of present consumption for future consumption. Also, a share or title in property.

Interest rate. The monthly effective interest rate. For example, the periodic rate on a credit card with an 18% annual percentage rate is 1.5% per month.

Investment. The creation of more money through the use of capital.

Investment bank. Financial intermediaries who perform a variety of services, including aiding in the sale of securities, facilitating mergers and other corporate reorganizations, acting as brokers to both individual and institutional clients, and trading for their own accounts. See: Underwriters.

Investment company. A firm that that invests the funds of investors in securities appropriate for their stated investment objectives in return for a management fee. See also: Mutual fund.

Islamic Loan. A loan that interest cannot be charged on. Instead, the loan is structured using discounts, sale or lease, profit participation, or repurchase agreements.

Kickback. In the context of finance, refers to compensation of dealers by sales finance companies for discounting installment purchase paper.
In the context of contracts, refers to secret payments made to insure that the contract goes to a specific firm.

Know your customer. An ethical foundation of securities brokers that an adviser who recommends the purchase or sale of any security to a customer, must believe that the recommendation is suitable for the customer, given the customer's financial situation

Lend. To provide money temporarily on the condition that it or its equivalent will be returned, often with an interest fee.

Lending at a rate. Interest paid to a customer on the credit balance received from a short sale.

Liability. A financial obligation, or the cash outlay that must be made at a specific time to satisfy the contractual terms of such an obligation.

Liquidation. Occurs when a firm's business is terminated. Assets are sold, proceeds are used to pay creditors, and any leftovers are distributed to shareholders. Any transaction that offsets or closes out a long or short position. Related: Buy in, evening up, offset liquidity.

Liquid Assets. The assets which are readily convertible into cash without recourse to a court of law and mean encashment / realizable value of government securities, bank deposits, certificates of deposit, shares of listed companies which are actively traded on the stock exchange, NIT Units, certificates of mutual funds, Certificates of Investment (COIs) issued by DFIs / NBFCs rated at least 'A' by a credit rating agency on the approved panel of State Bank of Pakistan, listed TFCs rated at least 'A' by a credit rating agency on the approved panel of State Bank of Pakistan and certificates of asset management companies for which there is a book maker quoting daily offer and bid rates and there is active secondary market trading. These assets with appropriate margins should be in possession of the banks / DFIs with perfected lien. Guarantees issued by domestic banks / DFIs when received as collateral by banks / DFIs will be treated at par with liquid assets whereas, for guarantees issued by foreign banks, the issuing banks' rating, assigned either by Standard & Poors, Moody's or Fitch-Ibca, should be 'A' and above or equivalent. The inter-branch indemnity / guarantee issued by the bank's overseas branch in favor of its sister branch in Pakistan, would also be treated at par with liquid assets, provided the bank is rated 'A' and above or equivalent either by Standard & Poors, Moody's or Fitch-Ibca. The indemnity for this purpose should be similar to a guarantee i.e. unconditional and demand in nature.

Liquidity. A high level of trading activity, allowing buying and selling with minimum price disturbance. Also, a market characterized by the ability to buy and sell with relative ease. Antithesis of illiquidity.

Liquidity ratios. Ratios that measure a firm's ability to meet its short-term financial obligations on time, such as the ratio of current assets to current liabilities.

Loan. Temporary borrowing of a sum of money. If you borrow $1 million you have taken out a loan for $1 million.

Major Shareholder. Means any person holding 5% or more of the share capital of a bank / DFI either individually or in concert with family members. Family members have the same meaning as defined in the Banking Companies Ordinance, 1962.

Medium and Long Term Facilities. Mean facilities with maturities of more than one year and Short Term Facilities mean facilities with maturities up to

Merger.

(1) Acquisition in which all assets and liabilities are absorbed by the buyer.

(2) More generally, any combination of two companies. The firm's activity in this respect is sometimes called M&A (Merger and Acquisition)

Merchandise. All movable goods such as cars, textiles, appliances, etc. and 'f.o.b.' means free on board.

Monetary indicators. Economic indicators of the effects of monetary policy, such as the condition of the credit market.

NBFC. Means Non-Banking Finance Company and includes a Modaraba, Leasing Company, Housing Finance Company, Investment Bank, Discount House, Asset Management Company and a Venture Capital Company.

Open-market operation. Purchase or sale of government securities by the monetary authorities to increase or decrease the domestic money supply.

Other Form of Security. Means hypothecation of stock (inventory), assignment of receivables, lease rentals, contract receivables, etc.

Paid-in capital. Capital received from investors in exchange for stock, but not stock from capital generated from earnings or donated. This account includes capital stock and contributions of stockholders credited to accounts other than capital stock. It would also include surplus resulting from recapitalization.

Paid up. When all payments that are due have been made.

PBA. Means Pakistan Banks Association.

Person. Means and includes an individual, a Hindu undivided family, a firm, an association or body of individuals whether incorporated or not, a company and every other juridical person.

Privatization. The transfer of government-owned or government-run companies to the private sector, usually by selling them.

Quick ratio. Indicator of a company's financial strength (or weakness). Calculated by taking current assets less inventories, divided by current liabilities. This ratio provides information regarding the firm's liquidity and ability to meet its obligations. Also called the Acid test ratio.

Ratio analysis. A way of expressing relationships between a firm's accounting numbers and their trends over time that analysts use to establish values and evaluate risks.

Real assets. Identifiable assets, such as land and buildings, equipment, patents, and trademarks, as distinguished from a financial investment.

Readily Realizable Assets. Mean and include liquid assets and stocks pledged to the banks / DFIs in possession, with 'perfected lien' duly supported with complete documentation.

Real GDP. Inflation-adjusted measure of Gross Domestic Product

Security. Piece of paper that proves ownership of stocks, bonds, and other investments.

Real income. The income of an individual, group, or country adjusted for inflation.

Real interest rate. The rate of interest excluding the effect of expected inflation; that is, the rate that is earned in terms of constant-purchasing-power dollars. Interest rate expressed in terms of real goods, i.e. nominal interest rate adjusted for expected inflation.

Risk. Often defined as the standard deviation of the return on total investment. Degree of uncertainty of return on an asset. In context of asset pricing theory. See: Systematic risk.

Securities. Paper certificates (definitive securities) or electronic records (book-entry securities) evidencing ownership of equity (stocks) or debt obligations (bonds).

Secured. Means exposure backed by tangible security and any other form of security with appropriate margins (in cases where margin has been prescribed by State Bank, appropriate margin shall at least be equal to the prescribed margin). Exposure without any security or collateral is defined as clean.

Shares. Certificates or book entries representing ownership in a corporation or similar entity.

Shareholder. Person or entity that owns shares or equity in a corporation.

Shareholders' equity. This is a company's total assets minus total liabilities. A company's net worth is the same thing.

Speculative. Securities that involve a high level of risk.

Speculator. One who attempts to anticipate price changes and, through buying and selling contracts, aims to make profits. A speculator does not use the market in connection with the production, processing, marketing, or handling of a product. See: Trader.

Spread.

(1) The gap between bid and ask prices of a stock or other security.

(2) The simultaneous purchase and sale of separate futures or options contracts for the same commodity for delivery in different months. Also known as a straddle.

(3) Difference between the price at which an underwriter buys an issue from a firm and the price at which the underwriter sells it to the public.

(4) The price an issuer pays above a benchmark fixed-income yield to borrow money

Tangible Security. Means readily realizable assets (as defined in these Prudential Regulations), mortgage of land, plant, building, machinery and any other fixed assets.

Weighted average cost of capital (WACC). Expected return on a portfolio of all a firm's securities. Used as a hurdle rate for capital investment. Often the weighted average of the cost of equity and the cost of debt The weights are determined by the relative proportions of equity and debt in a firm's capital structure.

Yield. The percentage return paid on a stock in the form of dividends, or the effective rate of interest paid on a bond or note.

Yield curve. The graphic depiction of the relationship between the yield on bonds of the same credit quality but different maturities. Related: Term structure of interest rates. Harvey (1991) finds that the inversions of the yield curve (short-term rates greater than long term rates) have preceded the last five US recessions. The yield curve can accurately forecast the turning points of the business cycle.

CHAPTER – 2

RESEARCH METHODOLOGY AND PROCEDURE

2.1 RESEARCH METHODOLOGY

To make this research study meaningful, following methodologies were used:

- Extensive literature review was carried out through papers, articles, publications, and internet to get the past trend in the banking sector of Pakistan and to make comparison of the present and future performance of the sector as a whole and forecast the sector's performance in the near future on the basis of past and present trend the banking sector

- The researcher personally visited different banks. In visits this was kept in mind the different views and operational performance of different banks in different sectors. So the nationalized banks, private commercial banks and the central banks were visited along with foreign bank to get the viewpoint on this very topic.

Besides banking sector official, experts were also consulted through questionnaire to get the neutral viewpoint about the problem of non- performing loans and to reconfirm the causes and measure describe by the banking sector officers

2.2 INTRODUCTION TO BANKING

Today the banks are the most important financial institutions, which play a pivotal role throughout the world's economic system. According to The Oxford English Dictionary, the term "Bank" means:

> "An organization or a place that provides financial services. Customers keep their money in the bank safely and it is paid out when needed by means of checks, etc."

Bank is also defined as "an institution for the collection of funds from the community and credits to its customers by way of advances against securities or by discounting bills for their useful purposes."

In the other words, "a bank is a custodian of wealth and people have faith in it to invest their funds wisely."

Furthermore, a bank is also responsible for its stockholders, being a profit seeking business and not a community charity, which tends to maximize the wealth of its shareholders. A bank is therefore a person or a corporation that deals in credit i.e. accept deposits from the public, withdrawals by checks while advances loans by various sorts.

2.3 ORIGIN OF BANKING

The origin of banking is traceable in the ancients Assyrian Babylonian and Athenians but the "Bank of Venice" (1171), the Bank of Geneva (1320), and the "Bank of Amsterdam" (1609) are considered the pioneers of banking business. The system of banking arose out of the fact that people who possessed surplus coins, deposited for sale keeping with persons in whom they had confidence and to be paid after a period of time when they might need them.

Holders of the coins soon found that it was profitable to lend the money provided loans were repaid before the date when money would e needed.

2.4 BANKING IN PAKISTAN

Prior to pre-partition, the entire banking sector was dominated by the Hindus, which created a great financial vacuum after shifting of their business to India.

2.4.1 STATE BANK OF PAKISTAN

Post-partition banking operations, at the government level, were recommended by an expert committee to utilize the services of the Reserve Bank of India (RBI), being Central Bank of the undivided India to function and the Indian Currency notes were continued in use as legal tender in Pakistan till 30th September 1948. In view of the monetary requirements of Pakistan, Quaid-e-Azam decided to have its own Central Bank in the country. The State Bank of Pakistan was inaugurated by the Quaid-e-Azam on July 1, 1948, at Karachi.

2.4.2 PRIVATE BANKING IN PAKISTAN

Habib Bank Ltd., which was functioning in Bombay, shifted to Pakistan in the year 1947, and activated its network throughout the country, with its head *office* at Karachi. The Australasian Bank Ltd had already been in operation in Pakistan since 1942. The first two banks, which were established in the private sector, were the Muslim Commercial Bank Ltd. (MCB) and the Bank of Bahawalpur in the year 1948. In the year

1949, the National Bank of Pakistan came into operations to act as a semi-government treasury in the country. In the year 1959, the Seigal Group of Companies established the United Bank Ltd. List of scheduled banks is enclosed as annex A.

2.4.3 NATIONALIZATION OF BANKS

According to a policy of the then government, the banks were nationalized through an "Act", called "The Banks (Nationalization) Act 1974", which came into effect on the 15 day of January 1974.

After nationalization, all the small units were merged into five large banks; Commercial Bank Ltd. Merged with the United Bank Ltd., Standard Bank Ltd. With the Habib Bank Ltd., the Bank of Bahawalpur Ltd. With the National Bank of Pakistan, the Australasian Bank Ltd., the Sarhad Bank Ltd., the Lahore Commercial Bank Ltd., the Pak Bank Ltd., were merged into a large unit and a fifth largest bank in the name of Allied Bank of Pakistan Ltd. Came into operation.

2.4.4 ISLAMISATION OF BANKING IN PAKISTAN

The Islamic banking system was introduced in the year 1979, by the elimination of interest from the major financial institutions via National Investment Trust (NIT) and Small Business Finance Corporation (SBFC). Bankers Equity was incorporated in the year 1979 to provide financial assistance to the industrial sector on interest free basis. Later on, this system was introduced in throughout the general banking and International Finance on the profit/loss sharing account in Pakistan.

2.5 COMMERCIAL BANKING -TODAY AND THE PAST

The commercial bank of today bears little resemblance to its counterpart of thirty years ago. Banks, now offer a variety of innovative credit, cash management, consumer Banking and investment services that were until recently, not available to the business customers.

Today, banks do not simply recommend loan products, such as a seasonal line of credit that can help a business prosper. Banks, now assume a more comprehensive role. For example, businesses sometimes, call upon banks to help collect accounts receivables. This can include every thing from billing the accounts and processing the payments to preparing management reports.

2.6 WORLD BANKING SECTOR - CURRENT SITUATION

The banking industry of United States of America, Germany, Switzerland, and United Kingdom clearly demonstrate that they have very organized banking structure and comprehensive financial systems which ultimately boost their macro and micro economies and save them from any sudden deadly banking and financial crisis.

Banking industry of many countries has been badly affected by the drawn of the globalization of services and the integration of financial markets. Japan has large bank loan defaults running up to 700-800 billion dollars, which was the result of its recent decline in economic growth. Large loans were obtained from banks and invested in buildings in the hope of demand for office space increasing and rents rising further. But the economy collapsed leaving behind too many empty new skyscrapers.

South Korea's large Chaebols [1](large companies group) had borrowed heavily from banks. Presuming the economic boom would go on forever, and then found the economy crash along with East Asian economies in 1997, revealing the flaws of an over grown system.

In spite of the competence and diligence of Dr. Mahatir Muhammad, ex prime Minister of Malaysia, the loan default in Malaysia is very large as big loans were given to help Malays take control of economy vis-à-vis the Chinese who dominate the corporate sector.

Turkey and Argentina, which were facing major economic crisis, have major default problems and imperiled banks.

China has serious problem of large loan default by its public sector units, some of which have closed down or are too sick.

[1] http://www2.sjsu.edu/faculty/watkins/chaebol.htm

2.7 SCHEDULED BANKS IN PAKISTAN

As on 30 June 2004, forty banks are operating in Pakistan[2], which include 2 *Nationalized* banks, 4 Denationalized banks, 3 Specialized banks, 17 private banks, 12 Foreign banks, 2 Provincial banks. In addition to these scheduled banks 6 DFIs[3] and 2 micro finance banks are also operating.

Total branches[4] were 7178 in June 2002, which increased 7196 in June 2003 and then decreased to 7028 June 2004. Total foreign bank branches were 85 in June 2002, decreasing to 81 in June 2003 and 2004. Closing down of redundant/loss making domestic bank branches is a part of the comprehensive reform program initiated in the financial sector, mainly to bring efficiency, reduce cost overheads, and facilitate speedy privatization of nationalized banks.

2.8 PAKISTAN'S BANKING SECTOR: CONSTRAINTS AND PROSPECTS

The banking sector of Pakistan has remained under pressure due to the changing economic preferences and conditions of the people and the country. Banking industry of Pakistan has been suffering *from* many integrated problems: Although there is a positive change of introducing use Information Technology tools, however there is still lot of room for improvements in computerization and electronic commerce facilities in the domestic banking sector.

2.8.1 CHANGE IN BANK'S LENDING RATIOS

Economy of Pakistan has been suffering *from* many integrated problems. Capital flight is increasing day by day. Domestic atmosphere of business was not up to the mark. Local businessmen were not ready to invest in the country. Now the banking lending rate has been reduced from 20 % in Nov 1996 to 7.5 % in Nov 2002 and it has shown positive sign and ratios of the lending increased. Foreign banks in Pakistan also showed gain in the lending ratios.

During Fiscal Year (FY) 2002, Pakistani banks offered an average weighted rate of 4.84 percent in 2003 it decreased to 2.17 percent and in 2004 it further decreased to 1.31 percent. This decrease has resulted in boosting the investment climate in Pakistan. Rolling in excess liquidity enabled the banks to offer loans at lower rates. It has

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[2] Pakistan 2005 Statistical Pocket Book
[3] BPD Circular Letter No.06 dated 25 Feb 03
[4] Ibid

generated the economic activity in the country, which could create employment and provide goods and services to the people. Nonetheless, corruption, lack of infrastructure, and low industrial productivity are supposed to be the main actors for not being able to achieve desired results. Unsecured local business conditions, continues tussle between the government and the traders on the issues of income tax and General Sales Tax (GST) have also worsened the economic recession.

Nuclear explosions in May 1998 following by Kargil Crisis in 1999 and change in country's political scenario had badly hit the economic stability and financial integrity of the banking sector and then a series of steps taken thereafter that appear to have scared the business community and the bankers as a result of which business activity became virtually standstill.

2.8.2 POLICY OF MERGER & ACQUISITION

Policy of merger and acquisition are also followed in the banking sector of Pakistan. The recent merger of Standard Chartered and ANZ Grindlays is the prime example. In fact, this merger was nothing but a small offshoot of the current trend in the global markets. The last decade is marked with worldwide super mergers of which European concerns accounted for two-thirds of the entire merger activity. State Bank of Pakistan has already instructed the small banks and financial institutions of the country to adopt that useful policy in order to cope with the dangers of globalization and World Trade Organization (WTO). The moratorium of National Development Finance Corporation (NDFC) with the National Bank of Pakistan (NBP) is an example of the policy of State Bank of Pakistan.

2.8.3 HIGHER PAID-UP CAPITAL FOR BANKS

The State Bank of Pakistan has set 2000 million rupees as the minimum paid-up-capital for banks as per the latest rules. The minimum capital requirement was initially set at 500 million rupees in 1994, and then raised to *1 billion* rupees in 2002 and it was further raised to 2 billion in 2004[5].This increase has been taken in the best interest of the banking sector and prepares it for any sudden banking or financial crisis or any threat from the globalization of the financial war and the economies. Banks, which will not meet their minimum capital requirement, stand, rescheduled and converted into a non -scheduled bank.

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[5] BSD **Circular** No. 12 of 2004 dated 25 Aug 04

2.8.4 PERMISSION OF EVENING BANKING & AUTONOMY OF SBP

The Bank of Pakistan has also allowed all the banks for the facility of evening banking. Time of evening banking is 2-8 pm. It had been the demand of business community and overseas Pakistanis for quite some time. This facility has increased the overall profitability and goodwill of the banks. Although, the autonomy has been granted to State Bank of Pakistan but still International Monetary Fund (IMF) demands for the complete and the true autonomy of the Central Bank.

2.8.5 INTEREST RATE TRENDS

The easy monetary policy posture that the SBP had adopted for a couple of years paid off amply as various interest rates touched all-time lows with credit to the private

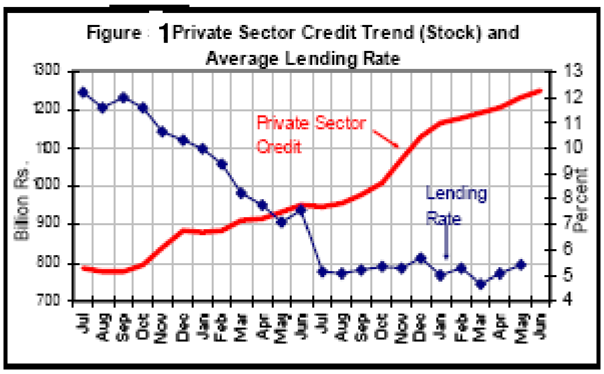
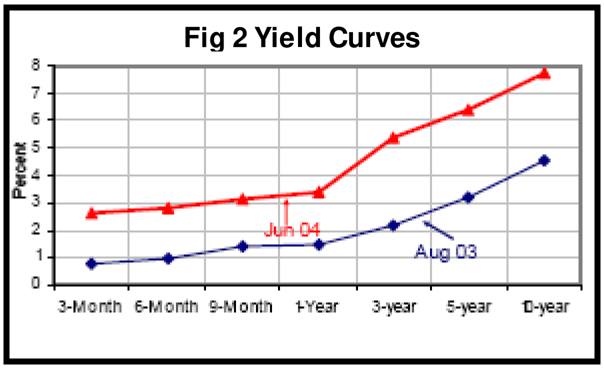


Figure 1 Private Sector Credit Trend (Stock) and Average Lending Rate

sector reaching its historic highs (***Figure 1***). The low interest rate environment pushed the benchmark TBs rate as low as 1.27 percent in August 2003 and the average lending rate as low as 4.69 percent in March 2004. This led the private sector to raise its credit off-take as high as Rs.301.2 billion towards the end of the last fiscal year. This suggested the increased efficacy of the monetary policy transmission mechanism reinforced by the on-going banking and other economic reforms. The liquidity position of banks during FY04 was not as comfortable as it was during the last couple of years, on account of fast-dwindling net capital inflows from overseas. The inter-bank liquidity also shrunk because SBP injected Rs.52 billion on account of net foreign exchange purchases of $0.9 billion compared with the injection of Rs.263 billion (against the purchase of $4.55 billion in FY03) and record-high lending to the private sector. This eventually reversed the direction of interest rates as the cut-off *Monetary Policy Statement July-December, 2004. Economic Policy Department* 11

Figure 2 : Yield Curves



yield on the benchmark 6-month TBs started to go up gradually and recorded a rise of 96 basis points to 2.23 percent during August-May FY04. Cut-off yields on other shortand long-term government papers also increased by varying magnitudes. The rising interest rates outlook is also reflected in the upward shift in the yield curve between August 2003 and June 2004 (***Figure 2***). The present rising trend of interest rates is expected to continue for some time to come in view of decelerating foreign capital inflows, modest inflationary expectations, significant credit provision for the private sector (Rs.200 billion) during FY05 and also rising interest rates in the international financial markets. However, SBP will be quite vigilant and will make sure that the process of interest rate hikes is gradual and that it does not adversely impact the on-going growth momentum essential to achieve the growth target of 6.6 percent set for FY05.

2.9 PRUDENTIAL REGULATIONS OF SBP

2.9.1 PER PERSON EXPOSURE LIMIT

This regulation prescribes the limit of a bank's maximum exposure on account of a single person/borrowing entity. According to this regulation, the total outstanding facilities by a bank to a single person should not exceed 30 percent of the bank's equity (unimpaired capital and reserves).

2.9.2 RESTRICTION ON ACCOMODATION TO BANK'S DIRECTORS

This regulation says that no bank shall provide any accommodation to any of its: -

- Directors
- Chief Executive
- Shareholders holding 5 percent or more of the share capital of the bank

2.9.3 BANK'S EXPOSURE AGAINST UNSECURED ADVANCES

According to this regulation, financing on unsecured basis may be granted up to a maximum of 500,000 rupees to anyone borrower for agriculture, facilities do not exceed the amount of banks unimpaired capital and general reserves. However, advances given to employees of a bank in accordance with their entitlement are exempted from the application of this regulation.

2.9.4 LINKAGE BETWEEN BORROWERS EQUITY AND HIS TOTAL BORROWING FROM BANKS

2.9.4-a Requirement as to obtaining borrower's accounts

This regulation implies that every bank shall, as matter of rule, obtain in the following manner the copy of borrowers business accounts (except in cases where loans do not exceed 500,000 rupees per borrower) for analysis and record:

- When bank's exposure exceeds 500,000 rupees but does not exceed 2 million rupees. The borrower should duly sign accounts.
- Where the exposure exceeds 2 million rupees but does not exceed 10 million rupees, then accounts should be duly signed by the borrower and countersigned by the bank's internal auditor or a C.A.
- When the exposure exceeds 10 million rupees, then the practicing accountant should duly audit accounts.

2.9.4-b Linkage between Borrowers's Equity and his Total Borrowing from Banks

- While any financial accommodation, banks must ensure that the total fund based accommodation availed by any borrower from banks or financial institutions does not exceed ten times of the unimpaired capital and reserves of the borrower as disclosed by this audited accounts.

The regulation does not apply to the loans not exceeding 500,000 rupees per borrower.

2.9.4-c Maintenance of Borrowers Current Ratio & Debt - Equity Ratio

- The current ratio (the ratio of current assets to current liabilities) of the borrowers should not fall below the minimum 1: 1
- The fresh or additional long-term debts should provided on the basis of a debt-equity ratio not exceeding 60:40

2.9.5 FINANCING AGAINST SHARES

- No bank can provide unsecured credit to finance subscription of shares floated by public limited companies.

- No bank can allow any financing facility against shares of non- listed companies.

The loan issued for more than five years is termed as long-term loan such as loan for big projects. It is worthwhile to mention that for running finance, it is up to the borrower's discretion to avail the funds whenever required. The interest is charged only on the used funds.

CHAPTER – 3

LITERATURE REVIEW

3.1 CLASSIFICATION OF LOANS

Banks carry out classification of loans as part of internal mechanism based on ' various methods to enable a systematic assessment of loan portfolio quality, credit risk and concentration, and portfolio diversification. Loans may be classified in several ways as follows:

- By purpose or use of loans such as working capital, trade financing, or seasonal business loans; mortgage, construction or house building loans; maintenance and improvement loans; or loans for refinancing, lease financing, educational loans.

- By type of security or collateral tendered such as finished goods and inventories, liquid assets such as cash or near cash or marketable securities; free hold or lease hold on property, buildings, machinery, and other fixed assets; assignments of receivables; signature and guarantees.

- By term of loans, the rate of interest charges such as fixed or floating interest rate loans.

- By type of borrowers and scale of borrowings such as government or private businesses; large businesses, manufacturing, trading or service enterprises; small and medium enterprises; profit or non-profit institutions.

- By maturity of loan such as short term, medium term or long term

- By credit rating of clients such as prime or non-prime; rating of clients through private or recognized institutions.

In Pakistan, Development Finance Institutions generally issue long-term loans, which are called project appraisal loans. These can prolong to fifteen to 20 years.

These are basically meant for the starting of a new business enterprise, and for heavy plant, land, raw material, and machinery purchases. These are the most risky loans as these are subject to many risks such as project failure risk, and many others. So during such lending process, development finance institutions carefully evaluate the feasibility and viability of the project plan and the repayment capacity of the borrower. Any carelessness or discrepancy during such process can lead to heavy losses and may lead to the financial and survival problems for the lending institution.

Commercial banks in Pakistan generally issue short-term working capital loans generally on the basis of one two or maximum five years based. Two main categories are worth discussing here:

3.2 CASH FINANCE

These are the short-term loans for one year generally. These loans are issued against pledged securities. The limits of these loans vary with the period of time. For example, during the season the limit goes high and in off-season limit goes down. Margin on such loan also varies depending upon the nature of pledged security. For example, if the pledged security is a perishable good then bank can extend the credit even on 100% margin basis and if it is normal security margin is usually 10 %.

3.3 RUNNING FINANCE

Running finance is just the form of overdraft facility. The basic motive of this facility is to meet the day-to-day expenses of the borrower. This form of lending is more risky than cash finance because the bank becomes dependent on customer's will to repay. However, banks do cover the risk of default by the mortgage of property of the borrower. So, generally these types of loans are issued only to most credit worthy customers. The procedure for the facility is that an account is opened in the name of borrower and a certain credit line is set by the bank for the borrower depending upon his or her financial soundness and general reputation in the market. The customer withdraws the amount when need and interest is charged only on the used amount. However, if for a certain period of time if the borrower does not utilize funds, then 2-3% penalty is charged on the entire amount. The basic purpose of this penalty is to discourage the availability of unutilized funds. As the sales proceeds come for the borrower, he or she deposits the used amount. This facility is also renewable on yearly basis.

3.4 BAD/DOUBTFUL LOANS

These are non-performing loans in the portfolio of a bank, classified as bad or doubtful. These loans have to be removed from the loan portfolio and their book value is to be charged to a loan loss reserve account.

3.5 CLASSIFICATION OF NON PERFORMING LOANS

These are the problem loans classified according to the time period in default status and by maturity of loans. In Pakistan, the classification of problem loans stipulated by State Bank of Pakistan is as follows:

3.5.1 LOSS

For short, medium and long term loans, where mark up / interest or principal is overdue by one year or more from the due date or where Trade Bills (import/export or Inland Bills) are not paid /adjusted with in 180 days of the due date, are considered as "loss".

3.5.2 DOUBTFUL

If the interest or principal is overdue by 180 days from the due date for short, medium and long term loans , then such loan is considered as "doubtful loan".

3.5.3 SUB-STANDARD

If the interest or principal is overdue bye 90 days from the due date for all types of short, medium and long term loans, then such type of loan is called as "substandard loan".

3.5.4 OTHER ASSETS ESPECIALLY MENTIONED (OAEM)

For short term finance facility where mark up/interest or principal is overdue (past due) by 90 days from the due date.

3.6 EARLY WARNING SIGNALS/INDICATORS FOR NON PERFORMING LOANS

GUIDELINES IN THE MATTER OF CLASSIFICATION AND PROVISIONING FOR ASSETS (REGULATION R-8)

(I) SHORT TERM FINANCING FACILITIES :

CLASSIFICATION	DETERMINANT	TREATMENAT OF INCOME	PROVISIONS TO BE MADE
1	2	3	4
OAEM (Other Assets Especially Mentioned).	Where markup/ interest or principal is overdue (past due) by 90 days from the due date.	Unrealized markup/ interest to be put in Suspense Account and not to be credited to Income Account except when realized in cash.	No Provision is required.
2. Substandard.	Where markup/ interest or principal is overdue by 180 days or more from the due date	As above.	Provision of 20% of the difference resulting from the outstanding balance of principal less the amount of liquid assets realizable without recourse to a Court of Law and adjusted forced sale value of mortgaged/ pledged assets as valued by valuers fulfilling prescribed eligibility criteria, in accordance with the guidelines provided in this regulation.
3. Doubtful.	Where markup/ interest or principal is overdue by one year or more from the due date.	As above.	Provision of 50% of the difference resulting from the outstanding balance of principal less the amount of liquid assets realizable without recourse to a Court of Law and adjusted forced sale value of mortgaged/ pledged assets as valued by valuers fulfilling prescribed eligibility criteria, in accordance with the guidelines provided in this regulation.

4. Loss.	(a) Where mark-up/ interest or principal is overdue beyond two years or more from the due date.	As above.	Provision of 100% of the difference resulting from the outstanding balance of principal less the amount of liquid assets realizable without recourse to a Court of Law and adjusted forced sale value of mortgaged/ pledged assets as valued by valuers fulfilling prescribed eligibility criteria, in accordance with the guidelines provided in this regulation.
	(b) Where Trade Bills (Import/Export or Inland Bills) are not paid/adjusted within 180 days of the due date.	As above.	As above.

(II) MEDIUM AND LONG TERM FINANCING FACILITIES :

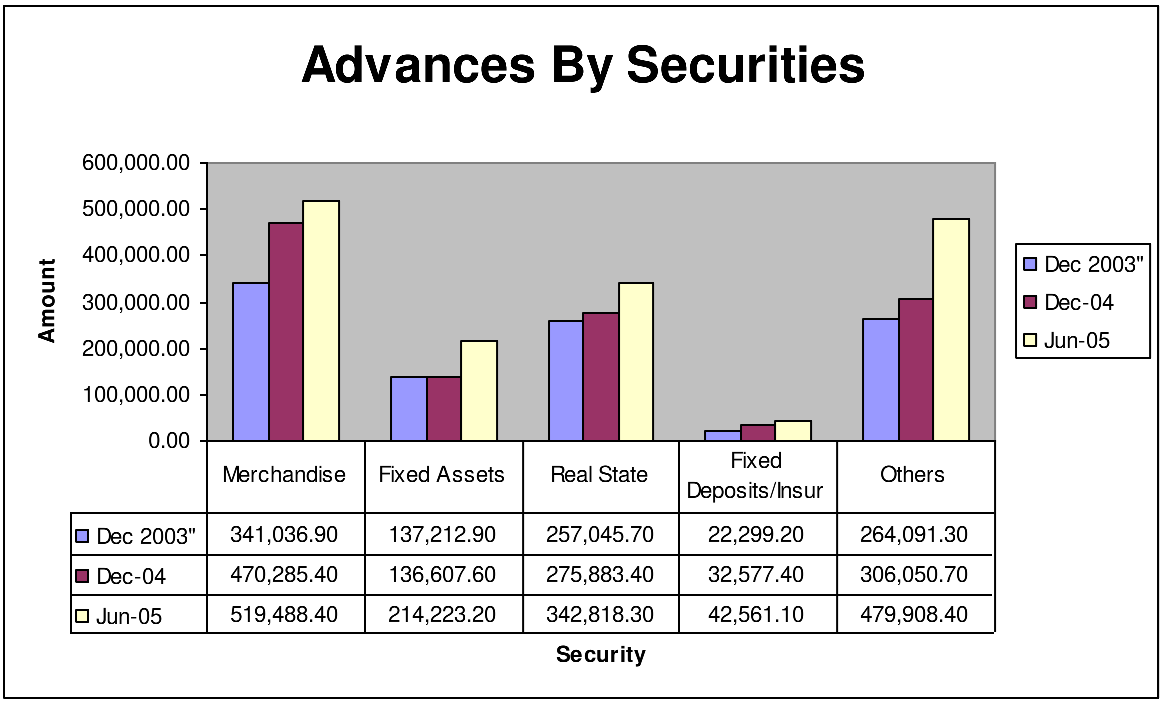
1. OAEM (Other Assets Especially Mentioned).	Where markup/ interest or principal is overdue (past due) by 90 days from the due date.	Unrealized markup/ interest to be put in Suspense Account and not to be credited to Income Account except when realized in cash.	No Provision is required.
2. Substandard.	Where installment of principal or interest/ markup is overdue by one year or more.	As above.	Provision of 20% of the difference resulting from the outstanding balance of principal less the amount of liquid assets realizable without recourse to a Court of Law and adjusted forced sale value of mortgaged/ pledged assets as valued by valuers fulfilling prescribed eligibility criteria, in

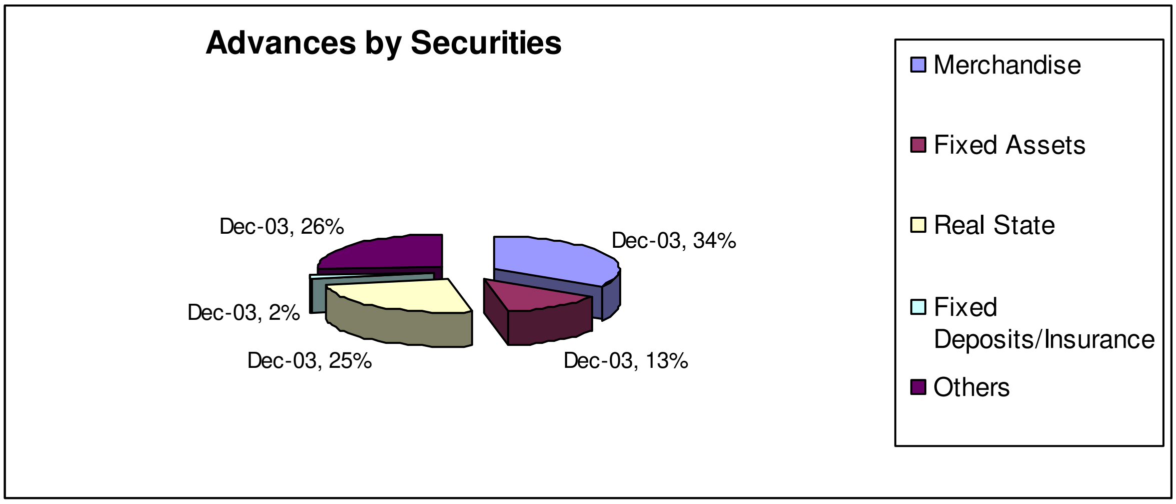
			accordance with the guidelines provided in this regulation.
3. Doubtful.	Where installment of principal or interest/ markup is overdue by two years or more.	As above.	Provision of 50% of the difference resulting from the outstanding balance of principal less the amount of liquid assets realizable without recourse to a Court of Law and adjusted forced sale value of mortgaged/ pledged assets as valued by valuers fulfilling prescribed eligibility criteria, in accordance with the guidelines provided in this regulation.
4. Loss.	Where installment of principal or interest/ markup is overdue by three years or more.	As above.	Provision of 100% of the difference resulting from the outstanding balance of principal less the amount of liquid assets realizable without recourse to a Court of Law and adjusted forced sale value of mortgaged/ pledged assets as valued by valuers fulfilling prescribed eligibility criteria, in accordance with the guidelines provided in this regulation.

3.7 ADVANCES BY SECURITIES

Graph shows that merchandise as a security has contributed a major portion in extension of loans in Pakistan. The share of merchandise has remained somewhat constant, approaching to more than 34 percent of share among all acceptable securities. Real estate comes after merchandise, share of which has also remained constant above 25 percent.

ADVANCES BY SECURITIES (ALL BANKS)			
	Dec-03	Dec-04	Jun-05
Security	Amount (Million)	Amount (Million)	Amount (Million)
Merchandise	341,036.90	470,285.40	519,488.40
Fixed Assets	137,212.90	136,607.60	214,223.20
Real State	257,045.70	275,883.40	342,818.30
Fixed Deposits/Insurance	22,299.20	32,577.40	42,561.10
Others	264,091.30	306,050.70	479,908.40



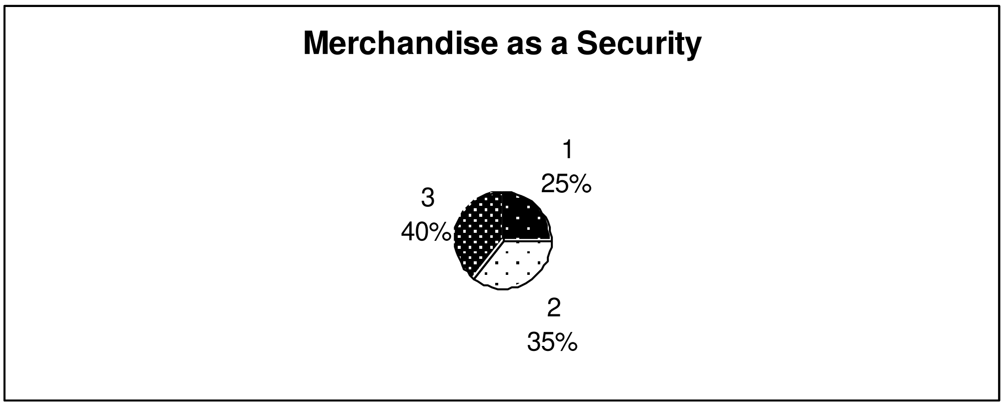


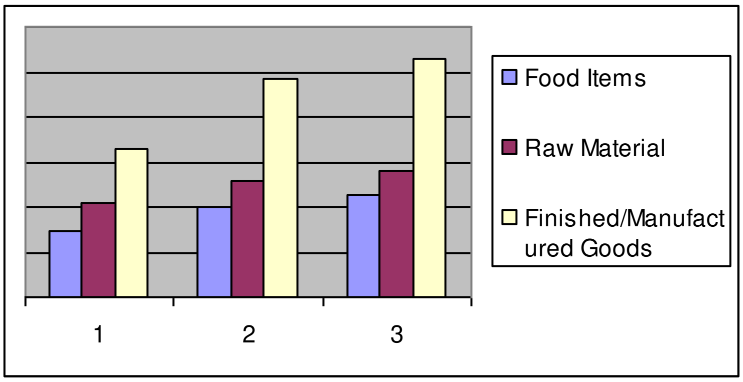
Source: Statistical Bulletin 2005- SBP

3.7.1 MERCHANDISE AS A SECURITY

Among merchandise as a security, finished goods/ manufactured goods are the most widely acceptable securities contributing 40% in 2005. Share of Raw Material the second most acceptable security among merchandise has increased to 35 percent in 2005.

	Dec-03	Dec-04	Jun-05
Security	**Amount (Million)**	**Amount (Million)**	**Amount (Million)**
Food Items	72,350.10	99,442.00	113,316.50
Raw Material	104,768.70	128,466.80	140,624.40
Finished/Manufactured Goods	163,918.00	242,376.70	265,547.50



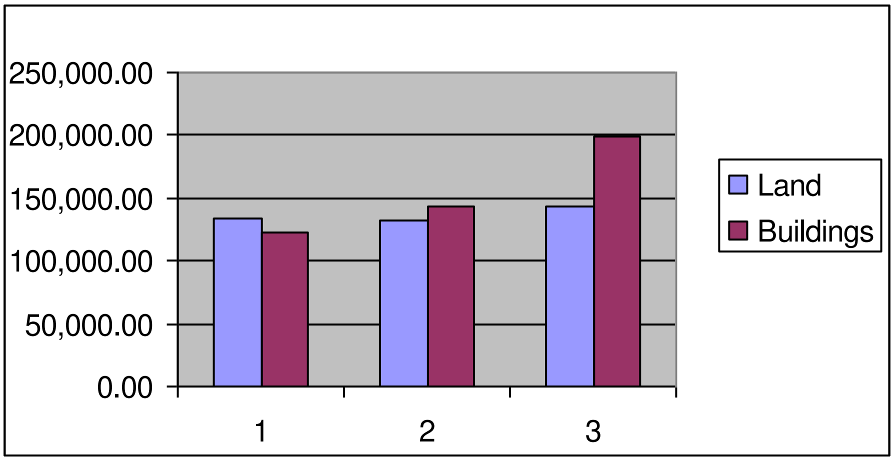


Source: Statistical Bulletin 2005

3.7.2 REAL ESTATE AS A SECURITY

Real estate, the second most acceptable security after merchandise has two types of securities. These are land which contributed 133,787.9 Million in 2003 and 144,098.3 Million in 2005, as a security, and the other one is buildings which include both residential and non-residential buildings, contributed 123,257.8 Million in 2003 and its share increased to 198,720 Million in 2005.

Security	**Amount (Million)**	**Amount (Million)**	**Amount (Million)**
Land	133,787.90	132,460.20	144,098.30
Buildings	123,257.80	143,423.20	198,720.00

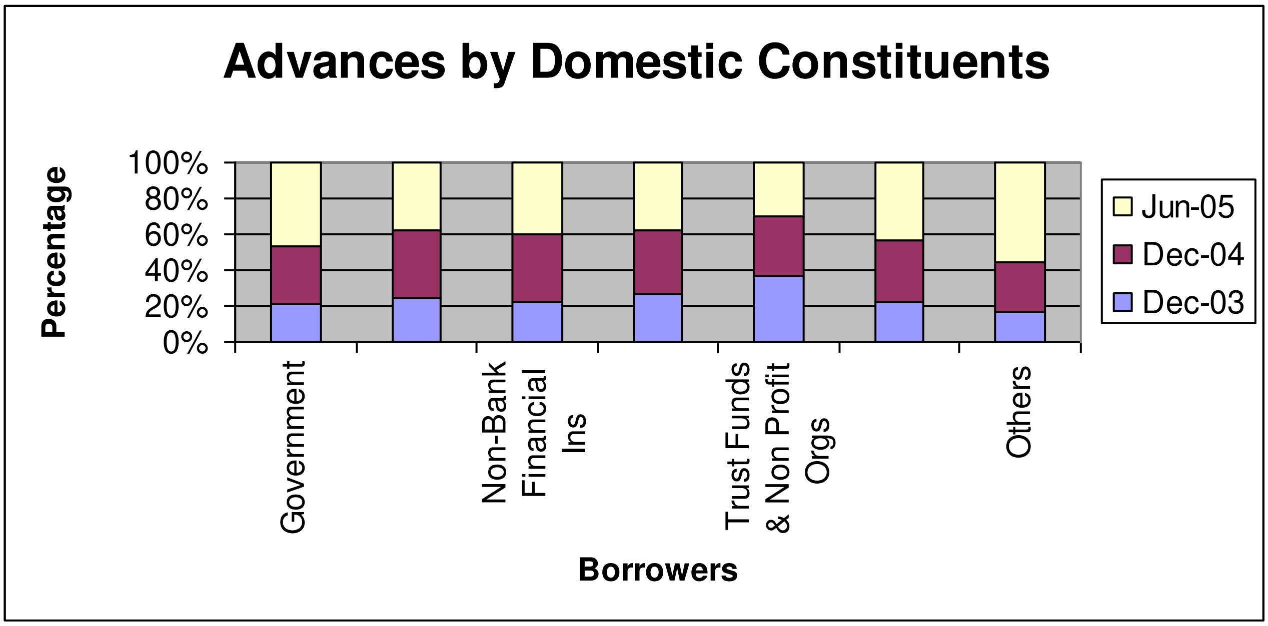


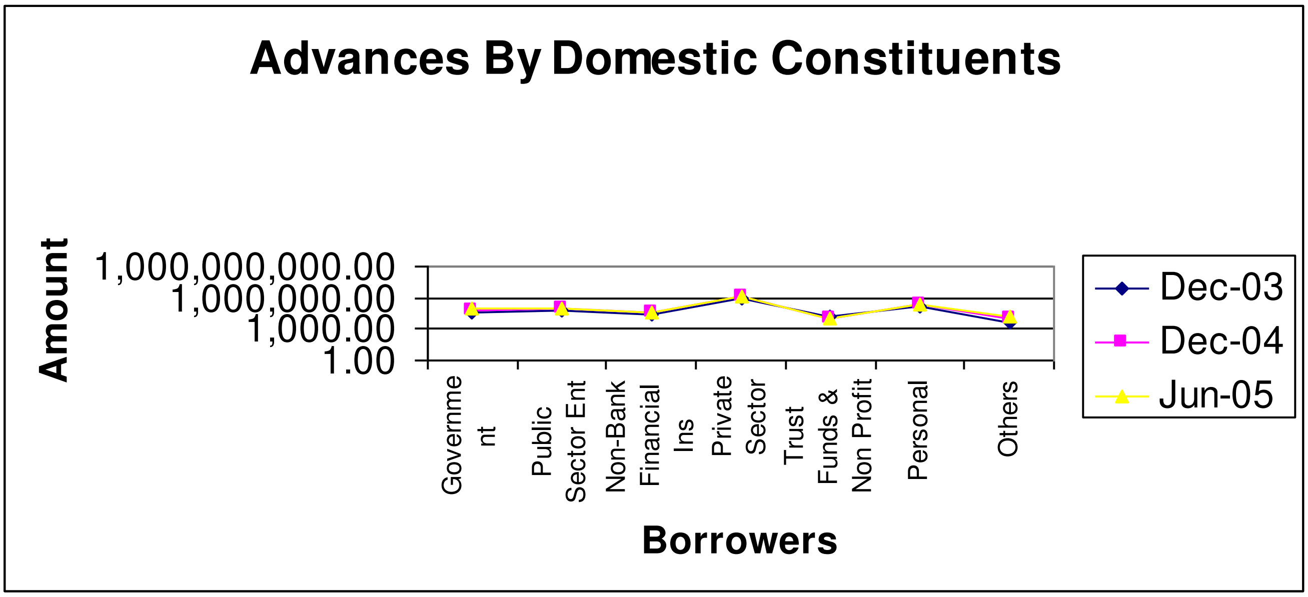
Source: Statistical Bulletin 2005

3.8 ADVANCES BY DOMESTIC CONSTITUENTS

The utilization of loans from banks, in Pakistan, has been somewhat embedded in the private sector, utilizing more than 10 percent of the total amount lent. Ratio of personal loans has increased from 128,449.30 Millions in 2003 to 258,004.7 Millions in 2005, while share of public sector has increased from 53,163.7 to 82,960.10 Millions in 2003 and 2005, respectively.

ADVANCES BY DOMESTIC CONSTITUENTS		PERIOD	
Borrowers	Dec-03 Amount (Rs.Million)	Dec-04 Amount (Rs. Million)	Jun-05 Amount (Rs. Million)
Government	37,455.80	58,255.70	83,770.20
Public Sector Ent	53,163.70	80,929.90	82,960.10
Non-Bank Financial Ins	21,487.10	35,444.30	38,457.90
Private Sector	835,684.70	1,135,797.30	1,201,390.70
Trust Funds & Non Profit Orgs	14,391.00	13,029.20	11,986.60
Personal	128,449.30	203,725.30	258,004.70
Others	5,117.40	8,709.80	17,571.90





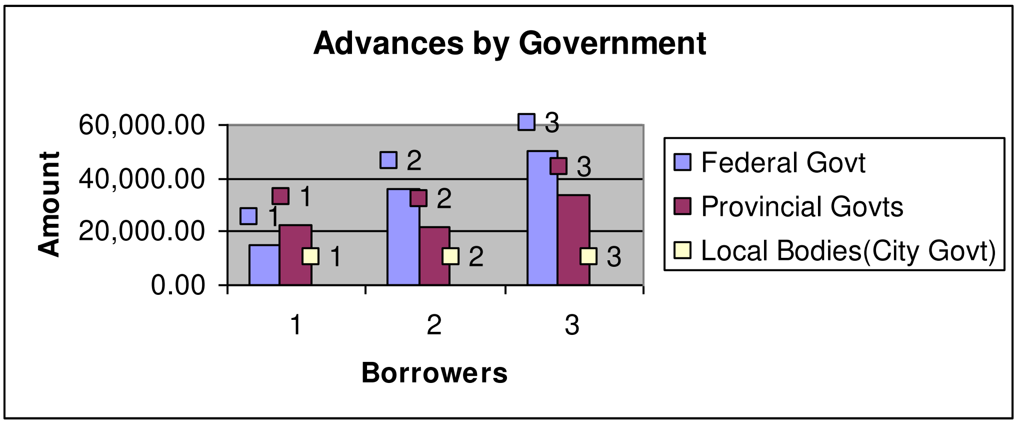
Source: Statistical Bulletin 2005-SBP

3.8.1 ADVANCES BY GOVERNMENT

Among loan utilization by the government sector, the share of federal government has increased considerably from 14,776.80 Million in 2003 to 50,107.6 Million in 2005, while provincial governments' share has increased from 22,679.00 Million to 33,662.6 Million in 2003 and 2005, respectively. Local bodies' share is negligible until now.

ADVANCES BY GOVERNMENT

	Dec-03	Dec-04	Jun-05
Borrower	**Amount (Million)**	**Amount (Million)**	**Amount (Million)**
Federal Govt	14,776.80	36,207.00	50,107.60
Provincial Govts	22,679.00	22,048.70	33,662.60
Local Bodies(City Govt)	0.00	0.00	0.00



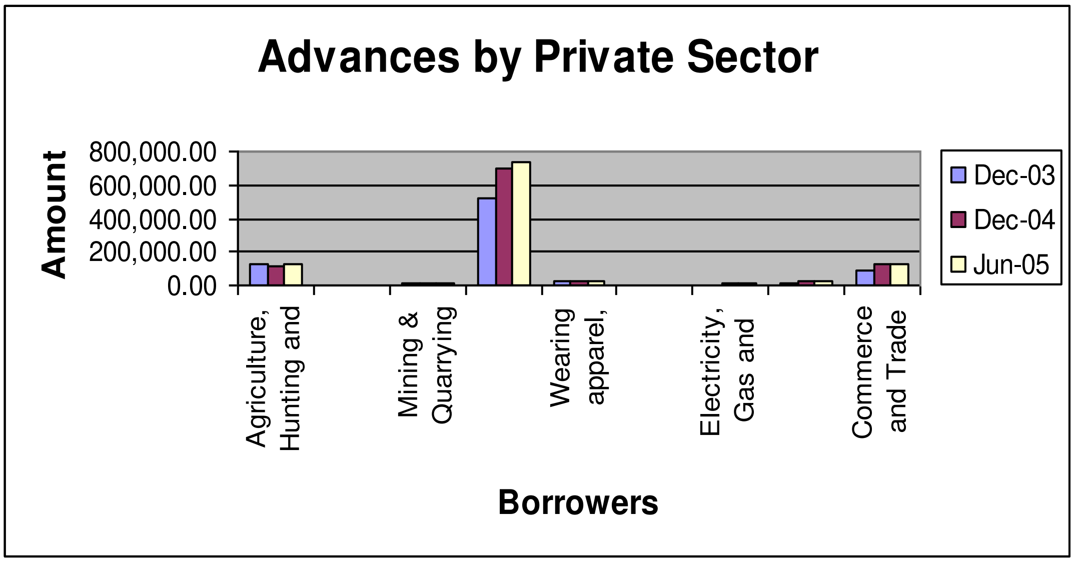
Source: Statistical Bulletin 2005-SBP

3.8.2 ADVANCES TO PRIVATE SECTOR

In private sector business, manufacturing sector has been the major utilizer of loans contributing from 515,409.10 Million in 2003 to 735,867.6 Million in 2005. Agriculture sector comes after manufacturing, utilizing about 126,156.30 Million. Commerce sector is another major utilizer contributing 89,395.30 Million in 2003 and 124,817.4 Million in 2005.

ADVANCES TO PRIVATE SECTOR

Borrower	**Dec-03 Amount (Million)**	**Dec-04 Amount (Million)**	**Jun-05 Amount (Million)**
Agriculture, Hunting and Forestry	126,156.30	118,759.70	127,106.10
Fishing and Fish Farming	3,427.70	2,596.00	2,380.80
Mining & Quarrying	8,741.10	8,836.30	8,112.70
Manufacturing	515,409.10	698,301.50	735,867.60
Wearing apparel, ready made garments etc	23,678.10	25,756.90	29,709.20
Ship Breaking and waste/scrap etc	2,291.90	3,016.50	2,517.30
Electricity, Gas and Water Supply	6,143.30	12,450.40	14,176.80
Construction	15,539.40	22,543.50	29,426.10
Commerce and Trade	89,395.30	128,217.50	124,817.40



Source: Statistical Bulletin 2005-SBP

3.9 ASSET QUALITY

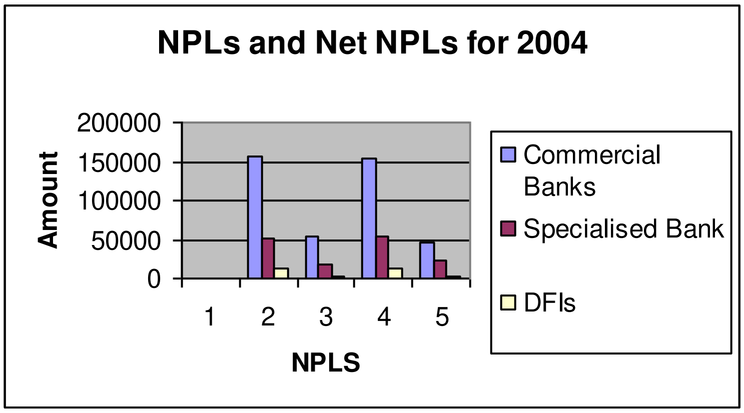
Asset quality is generally measured in relation to the level and severity of non-performing assets, recoveries, the adequacy of provisions, and distribution of assets. Although, the banking sector in Pakistan is infected with large volume of non-performing loans, its severity has stabilized to some extent, if we analyze the past trend and data. This is not to say that problem of non-performing loans has taken the secondary position. Unfortunately, it still remains the most dominant factor affecting the earning capacity of most of the banks in Pakistan.

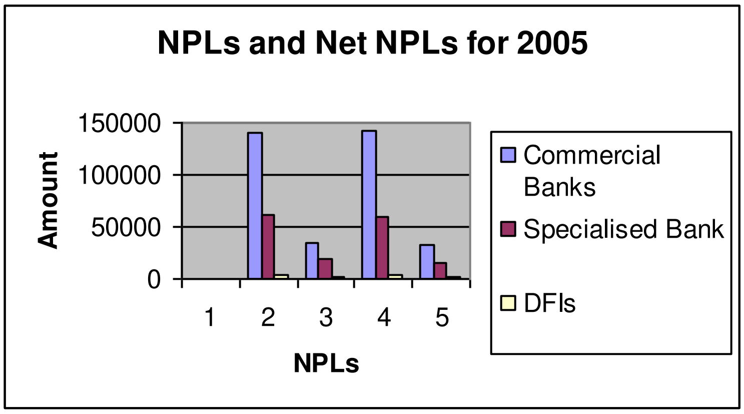
3.10 NET NPLs TO NET ADVANCES RATIO

Ratio of net non-performing loans to net advances shows some improvement in the overall banking sector from 156,567 million CY Mar 04 to 141,591 million in CY Sep05. Remarkable improvement is visible in case of specialized banks like Agricultural Development Bank of Pakistan (ADBP), and Industrial Development Bank of Pakistan (IDBP not because of improvement in their operational efficiency but largely due to the provisioning. Nationalized commercial banks also show considerable improvement.

Banks and DFIs	Mar-04 NPLs(Rs.Million)	Mar-04 Net NPLs(Rs.Million)	Jun-04 NPLs(Rs.Million)	Jun-04 Net NPLs(Rs.Million)
Commercial Banks	156,567	53,094	152,998	46,940
Specialised Bank	50,393	17,015	54,794	22,011
DFIs	12,719	2,796	12,240	2,369

	Jun-05 NPLs(Rs.Million)	Jun-05 Net NPLs(Rs.Million)	Sep-05 NPLs(Rs.Million)	Sep-05 Net NPLs(Rs.Million)
Commercial Banks	139,461	33,875	141,591	33,287
Specialised Bank	61,921	19,367	59,601	14,566
DFIs	4,065	1,958	3,792	1,670





Source: Statistical Bulletin 2005-SBP

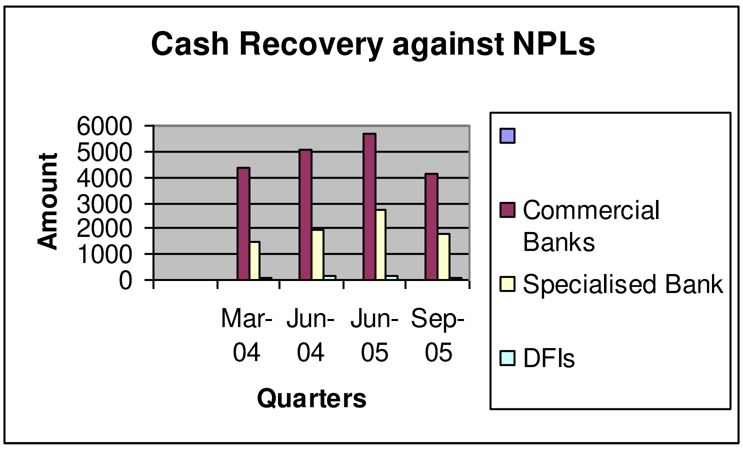
3.11 CASH RECOVERY TO LOAN DEFAULT

Cash recovery to loan default ratio shows considerable improvements from the foreign banks, specialized banks and privatized commercial banks. However the overall position of banking sector in terms of cash recovery has not improved too much

CASH RECOVERY AGAINST NPLs (Rs. Million)

Banks / DFIs	Mar-04	Jun-04	Jun-05	Sep-05
Commercial Banks	4,353	5,054	5,680	4,135
Specialised Bank	1,452	1,926	2,755	1,771
DFIs	90	134	119	85

Source: Statistical Bulletin 05-SBP



Source: Statistical Bulletin 05-SBP

3.12 NON-PERFORMING LOANS

Overall position of non-performing loans shows continuous hike in the amount from 5895 million rupees in CY 2004 to 8554 million rupees in CY 2005.

CHAPTER 4

ANYALYSIS OF DATA

4.1 FINANCIAL ANALYSIS

During the lending process, following statements are analyzed to minimize the risk of loss and to verify the financial soundness of the borrower and his or her company. The entire lending process is dependent on this function of analysis of financial statements of the company of the borrower.

4.1.1 FINANCIAL STATEMENTS

Financial Statements comprise three statements, which are:
Profit & Loss Account
Balance sheet
Cash Flow statement
Each statement has its own importance as follows:

4.1.1-a Profit & Loss Account

Profit & Loss account summarizes financial results of an enterprise in a particular year. It shows sales and its related costs in order to arrive at a net profit or loss, which is also called “. Primary objective of every business is maximization of profit related to its investments. This objective can be achieved through a number of strategies such as: maximization of sales or cost efficiency or both many business houses highlight these objectives in their advertisement and publicity campaigns such as: “We are a billion rupee company now” is a slogan of Adamjee Insurance Company or From Karachi to Khyber” is what polka ice Cream would tell its customers. Both are market oriented expanding left and right. On the other hand, there are many successful companies, which have maximized profit through being most cost efficient. For example,Haffaz Seamless Pipe Ltd, a hi-tech concern, has shown good profitability by utilizing only 15 percent of its installed capacity. Similarly, Liberty Ltd. is cutting costs through:

- Energy conservation by installing its own generator
- Reducing steam losses
- Introducing state-of-the-art machinery like automatic color kitchen and dozing equipment to reduce wastage.

4.1.1-b Balance Sheet

Balance sheet shows financial health of a company at a particular point of time, usually end of a year, which may be calendar year ending on December 31, or fiscal year ending on March 31, June 30, September 30 or any other date. The chosen date is the one when stocks of a company are minimal. When sugar mills close their accounts on September 3D, their sugar inventories should be low as these mills had been selling sugar long after close of their cane crushing and sugar producing season. The companies, which rely on, imported raw materials link their fiscal year with Government fiscal year as they import raw materials only after announcement of import policy, taxes and duty structure.

4.1.1-c Cash Flow Statement

Cash Flow statement narrates two flows:

- Cash Inflow
- Cash Outflow

Cash inflow describes cash flowing into the business from profitable operations or fresh cash introduction by the shareholders or proceeds of loan contracted with banks and financial institutions. Side by side, cash outflow is recorded showing whether the cash has been spent on operational activities i.e. payment for raw materials or wages or investment activities such as purchase of fixed assets of financial activities such as investment in shares of other companies listed on the stock exchange or own associate companies. More details are provided later in this paper.

4.2 RATIO ANALYSIS

In simple words, ratio is one thing expressed in terms of another. It could be in the form of:

- A percentage like 12 percent gross margin.
- A rate such as commission @ Rs. 5 per kg.
- An average e.g. Price per unit.

Ratio reduces complex data into meaningful and simple indicators.
Analysis is:

- Breaking down a whole into its components
- Finding out causes form results.

During the lending process, these are the ratios, which are extensively analyzed as part of loan policy and credit decision-making.

4.2.1 Operational

These are based on Quantity, like cotton and silk yarn mix of 55/43 or operating efficiency (cane crushing, glass melting, pipe forming, carpet waving).

4.2.2 Financial

These are based on Value; these ratios are further divided into four broad categories:

Activity ratios

Fixed assets turnover Inventory turnover Average collection period

Liquidity ratios

Current ratio

Acid test ratio

Profitability ratios

Leverage

Fixed Asset Cover
Debt/Equity Ratio

4.2.3 Managerial

These ratios concern Employees, such as wage per worker, labor turnover, absenteeism, and benefits as percent of wage.

4.2.4 Economic

Finally, there are economic ratios, which are calculated keeping economy or country in view such as' investment per project generated. Capital output ratio, Value added in manufacture.

The interpretation of ratios is different from person to person. Here are some examples of different interpretations made by different persons of different categories.

	INVESTORS	MANAGEMENT	LENDERS
They consider the:			
Business entity as	Dynamic	Dynamic	Static
They watch	Returns on equity	Activity/ Turnover	Credit worthiness
They are Interested in	Growing Dividends/ Rise in Value of Shares	Profitability/ Collection	Debit Servicing/ Security margins
They concentrate on	Income statements	Cash Flows	Balance Sheet

The stock of gross non-performing loans (NPLs) that amounted to Rs 252 billion and accounted for 22 percent of the advances of the banking system and DFIs has been reduced to Rs. 225 billion i.e. 14 percent of advances. More than two-thirds of these loans are fully provided for and net NPLs to net advances ratio has come down to as low as 5 percent for the commercial banks. The positive development is that the quality of new loans disbursed since 1997 has improved and recovery rate is 95 percent.

4.3 KINDS OF DEFAULTERS

There are three major kinds of defaulters:

- Defaulters who borrowed through political pressure or large bribes to the bankers with no intention of repaying and hoping to change sides politically as the situation demands.

- Those who got the loans and mismanaged or wasted them and do not have the means to repay.

What is remarkable is while big borrowers are being punished and ridden rough shod by the NAB, the bank executives who gave large loans without real collateral are not being identified and punished. Nor are those bankers being punished who allowed the defaulters remove the dubious collateral and dispose them. At least there should be some punishment for some of them.

- Loans have been dispersed to new businesses with inexperienced owner managers
- Borrower’s cash flows and repayment capacity is not properly analyzed.
- Loan officers often fail to review the loan's status frequently enough.

4.4 MAJOR CAUSES OF SICKNESS OF PROJECTS

Before we delve into the subject of restructuring, rescheduling of a project or even into rehabilitation of sick / closed units, it imperative to *first* determine the factors that have bought the project to this level. These factors could be endogenous to the project, meaning that they are controllable, while others could be exogenous, determined by the external environment within which the project operates.

A study of such factors would enable us to understand the nature of the problem in a particular project, its enormity, and the ways to tackle the problem much before getting ourselves in the time consuming and mentally fatiguing exercise of rehabilitation. These factors are:

4.4.1 PROMOTION OF ENTREPRENEURSHIP

The success that the west has enjoyed in economic development can be attributed to the development of its entrepreneurial class. Development Finance institutions (DFIs) therefore, have also taken lot of risk by encouraging development of this class. A number of such management cases have led to problem projects. This may then be regarded as part of the bearing cost to the economy, which will be recovered in the long run. The symptoms that should be keeping one's eyes open *for* here are:

- All people in the project reporting to one director, the entrepreneur
- No second tier management.

4.4.2 The Sponsor's Godfather approach

Sometimes sponsors start involving themselves in politics, civic organizations, charity, and campaign drives at the cost of the main project. More often than not, this is an indication that something is wrong with the project and the sponsor is building up protective barriers.

4.4.3 The Sponsor is losing interest

Project officers should be alert to indications that a sponsor may now be tired of running the project. Social gathering signs of this would include:

(a) His spending time

(b) Lack of attention to receivables collection.

4.4.4 The Sponsor is over-ambitious

Some sponsors like to be involved in too many diversified businesses. One should keep his/her eyes open for such over-ambitious sponsors. A sponsor who is successful running a weaving unit will not be successfully running a textile dyes producing plant. A project officer .should not let venture capitalism creep into the mind of his sponsor.

4.4.5 Death of a Sponsor, conflict between sponsors

If one is used to seeing sponsors visiting the bank's premises as a team during sanctioning and implementation stages, but with project going into commercial operations only one of them is showing up, the things may not be all that bad. However, this could also be indicative of conflict amongst sponsor group itself, departure of one sponsor or even death of a sponsor. All of these events could easily lead the project into trouble as a project officer may hear about the feud through court notices shortly.

4.4.6 Fraud

If a project-monitoring officer discovers on more than one occasion that sponsor has attempted to hide or misrepresent facts, then he/she should realize that there is no point in dealing with a con artist.

4.4.7 TECHNICAL PROBLEMS

Technical problems manifest themselves in many ways:

4.4.8 Technology/Plant and Equipment

A well conceived project can lead itself into trouble if the technology used totally new and no local maintenance and repair services are available, machines/equipment selected parts and if too much of plant and machinery was/and is being procured form abroad. This last aspect may be indicative of over-investment in plant and machinery and sponsor's reliance on kickbacks to enhance his equity into the project.

4.4.9. Marketing Problems

Marketing problems have emerged as major factor in industrial projects becoming sick. Export oriented projects have suffered because of poor export market research, quality-wise noncompetitive, reliance on over incentives, etc. One home from, projects have suffered due to poor marketing plans and poor research and development to challenge product innovations and substitutes launched by competitors. Some major problems encountered under marketing are:

4.4.9-a Quality of Products

There are several ways available to the project-monitoring officer to determine the quality of product being manufactured by the sponsors. Go out in the market and conduct primary research by interviewing retailers and consumers. From financials statements, increasing warranty expenses are increasing special entry called "gross sales, less returns, and allowances." If such an entry is not used in financial statement then this is sub-standard accounting and in this case only decreasing sales may point to poor quality. However, an analysis of poor inventory turnover may also indicate poor quality of products.

4.4.9-b Sales force Yes, After Sales Support No!

Some businesses out there are looking for new clients, so they have a sound sales force. This sales force may be over-incentives and may be selling products like anything. However, once the product is sold, the company staff goes on hibernation. A client keeps ringing the battiness for assistance, but the business itself has lost interest in the client because the sale has been made. In short, a company that is promising big to the client during sales, but falls severely short is going to be in trouble soon.

4.4.9-c Strategic Marketing Planning

In view of several multinationals joining the local competition, local business are in grave danger of being wiped out. Project officers should keep their eyes open for businesses whose main defense is trade protective barriers set by the government, such as duties on imported goods. Under the GATT arrangement, the duties have to be reduced on a voluntary compulsory basis. Thus the defense left for local businesses would be continuous product innovations, after sales support, quality and cost minimization.

4.4.10 FINANCIAL PROBLEMS

Major factors here are:

4.4.10-a Non-availability of funds

If a sponsor is regularly approaching banks and Development Finance Institutions (DFIs) for working capital loans then this is an indication that his company is having a chronic problem of fund shortages. Also a company, which after servicing its working capital loan is approaching a bank or a DFI again very soon' or is constantly requesting a loan rollover, is having a chronic problem. This needs to be addressed as a package, not superficially.

4.4.10-b Non-availability of Budget

The sponsor should always be asked to provide a budget for next year. This budget should then be used for performance evaluation inside the company and for determining abilities of financial planning by the project officer. If a sponsor is too casual in providing a budget and then too evasive in letting the monitoring officer gauge actual performance against it, there is a reason to worry.

4.4.10-c Falling Sales

It is bit natural that when the project goes into commercial production, sales may not be enough to cover the overheads. However, if this if happening to a seasoned business, it may be indicative of terminal illness in the face of changing market, increased competition, etc.

4.4.10-d Financial Statements- Poor Accounting methods

If a project officer is in the habit of going through the audited and/or provisional financial statements submitted to him/herby the sponsor form time to time, he/she may find that the facts that these statements do not say far outweigh the facts that these statements say. Moral of the story is: if there are discrepancies in the financial statements, it is not only reflective of casual attitude of the sponsors, but also of the whole business.

4.4.10-e Under-capitalization

If under-capitalization is because of owner's excessive withdrawal then this should be a cause of concern for the monitoring officer. One or several of the following may cause the under-capitalization in such circumstances:

- Sponsors paying themselves too much or borrowing form the ,business heavily
- Sponsors having a fleet of Pajeros, Land Cruisers, Toyota Corolla etc
- Sponsors having several relatives in the payroll who are unskilled and are performing questionable work, if at all.

Besides these, there are few other reasons due to which businesses in Pakistan have suffered heavy losses in the past:

- Diversion of borrowed funds for other purposes then Predetermined
- Carrying of inflated inventories.
- Sale on credit to unsound clients. Ineffective marketing techniques. Sudden changes in styles, fashions or needs of product line. Last but not the least is the unwillingness to pay the debts.
- Many of them are family managed companies in the traditional manner without modern management or strategic planning.
- Most of the industries set up through such borrowing came up for import substitution behind high tariff walls average rate of duty in many cases was 110-120 percent and that has been coming down steadily since then, and the average duty has now come down to 30 percent and is to slip to 25 percent next July.
- On the other hand competing with the imported goods, particularly the smuggled goods, has become too tough.
- Change in technology and new products made by the new competitors at lower cost have also hit their trade.
- With more and more new products coming in consumers preferences have also changed, hitting the old producers.
- The sluggishness of the economy and small demands for goods because of the 15 percent sales tax and other fiscal levies, and the small disposable income after paying for the heavy and rising utility bills also affect the old industries.
- Some of the industries like sugar have create an our capacity by borrowing heavily from bank through political patronage. As a result the capacity of sugar mills is double the need of country for sugar. Sugar cannot be exported because of high cost of production. And the demand for cement is far below the installed capacity and taxes are too high. High cost of production stands in the way of exports.

Heavy and sustained devaluation *of* the rupee has also been a major cause of loan default as that threw the industries totally out of the gear and made non-sense of there feasibility studies on the basis of which their units were set up.

4.5 EARLY WARNING SIGNALS

If the project officer has valid reasons to doubt the company's standing as indicated by passive monitoring, he/she should run his/her analysis on the following immediately:

4.5.1 Cash position of the Company

Downward trend in cash position may be O.K., but a sudden fall may be a harbing+er of severe cash flow problem. The sponsor, in order to meet cash requirement elsewhere, will default on payment of loan.

4.5.2 Cash Position of the Company

If cash collected against receivable is slow, the loan repayment is going to be slow. The excuse by the sponsor is that he will pay the bank its dues if he gets his from the creditors.

4.5.3 Inventory Turnover

Slow down in inventory turnover is a cause for concern. It reflects on poorly management of the company and the operations. It means too much of inventory is lying idle. The project officer is well advised to keep his eyes open for a sudden fall in inventory from a least over last 3 years analysis.

4.5.4 Non-current Assets

A sudden jump in the amount of non-current assets, such as notes receivable, machinery and equipment, land, advances to subsidiaries; etc should be noticed as this is going to lead to cash problems in future soon.

4.5.5 Current Liabilities

Project officers should be alert to sudden jumps in current debts and notice if these debts are financing non-current assets.

4.5.6 Debt Equity Ratio

All Development Finance Institutions (DFIs) and banks finance new projects in commercial operation are highly leveraged by up to 60:40 or higher. However, a project officer should watch out for an established company's debt to equity ratio suddenly changing direction for the worse.

4.5.7 Current Ratio

A declining current ratio should be viewed with concern, a sudden drop in current ratio, with double concern.

4.5.8 Gross profit Margin

Declining gross profit margins indicate that either the business is not passing along increased costs to its customers, or it is not controlling its cost going into cost of goods sold. The former situation is very difficult to find in Pakistan as any increased cost of manufacturing the prices. However, under new competition scenario, increases in prices will be a difficult proposition to resort to.

4.5.9 Sales, Profits and Losses

If sales go up, profit should go up too. It is as simple as that. However, the project officer should watch for the worst, sales going up but profit are eroding or even losses are there. In such a case, the sponsor will need additional loan to prevent default on what he already owes.

4.5.10 Patterns of Borrowing

This situation would apply to working capital loans. If a soft drink company is asking for a working capital loan in November, then problem is on the cards. Project officers should be aware of seasonal patterns of borrowing. In addition to the above, there are certain non-financial symptoms of a problem project. Project officers should keep their eyes and ears open for the following:

(i) Evidence of legal action and income tax enquiry.

(ii) Deterioration of relationship with trade suppliers.

(iii) Sudden jump in the request of NOCs at one's bank or at others.

(iv) Notice of insurance cancellation or failure to pay premiums.

(v) Turnover of key employees (s).

(vi) Inability to obtain financial statements on a timely basis.

(vii) Personal problems of sponsor.

(viii) Failure to file the returns, if applicable.

(ix) Changes in communication habits (telephone and letters).

4.6 LOAN WORKOUT

A workout situation is one in which the lender works closely with the borrower with the long-range intention of ending the relationship. The object is to minimize losses, or may be eliminate them entirely, and then get out. A bank/Development Finance Institution (DFIs)'s first order of business in facing a loan workout is to determine how the borrower will pay back what he owes- or as much of it as he can. Principal sources of repayment by sponsor group are:

4.6.1 Additional Capital

Here comes into play the net worth analysis by the appraiser during the project appraisal stage. The sponsor group can be asked to generate additional capital by selling off its liquid fixed assets defined as plots and land in urban area, residential bungalows other than the ones under their own uses etc., thus in general all such assets which the group will willingly be able to sell generate fund.

The second source would be through public offering of shares. This is not going to fetch much especially due to image problem that the business may be having by now.

4.6.2 Cash Flow

Although cash flow is a major source of repayment for most companies, in case of a problem loan, negative cash flows are normally occurring on a monthly basis. However, an attempt should be made to generate positive cash flow at least on the operational side of the business. This would mean that net operational profit and current liabilities should remain stable if not increasing and current assets should this is not going to happen.

4.6.3 Conversion of Assets

This last repayment source has three distinct options:

(a) Repayment thought the normal workings of the operating cycle encompassing the purchase of inventory and the advancing of working capital to pay for it, Inventory is then sold creating gross profit and an account receivable.

(b) Collection of the account receivables creates cash, which is then used to repay part of the original as well as the entire working capital loan.

(c) Liquidation of assets not normally sold in the course of business, such as real state collateral or business assets that are not necessary to future operation. This may include part of main plant and machinery, which has been rendered idle because sufficient expertise is not available to run it or alternate cheaper machinery, is available with which it can be replaced.

It may be borne in mind, however, that the workout may involve more than one source for repayment. The project-monitoring officer should come up with a plan himself or help the sponsor to come up with a plan. The following will be required to help in a well-organized work plan.

4.6.4 Projections

For large clients that the Development Finance Institutions (DFIs) are used to now, projections should be made for at least 3 years and should include a cash budget. The officer will be able to determine sponsor's immediate cash requirements form such a budget. The assumptions of such an exercise should be mutually agreed.

4.6.5 Backlog and expected Sales Order

The project monitoring officer should be able to learn what orders have been received and from whom, if any, and to whom the expected sales will be made. The basic idea here is to determine the strength of the customers of the sponsor. If the customers are weak, it will be very difficult to collect the receivables generated.

4.6.6 Reducing tile Overheads

This reduction will involve a complete review of the company's staff, its marketing, and sales force and also expenditures associated with directors and Chief Executive Officer.

4.6.7 Evaluating tile Assets

The project monitoring officers should evaluate the company's assets using the latest balance sheet and transforming it into a pro-forma balance sheet on a realistic basis.

CHAPTER 5
CONCLUSION AND RECOMMENDATION

5.1 CONCLUSION

Pakistan has been working for the last five years to decrease the lending rates to the extent that middle and low-income professionals, who have no other source than their monthly income, may get a home or a car on installments from the banks. If he/she is a small entrepreneur he/she can get loans from SME. Agriculture, the largest sector of economy, which the commercial banks had neglected, has now begun to receive large allocations. The commercial banks are giving more agriculture loans than the ZTBL. If this trend persists, the rural households will be able to intensify the use of modern inputs and raise their productivity and income.

Credit cards, debit cards, personal loans and consumer durable loans are catching up fast. Refrigerators, air conditioners, VCRs, Televisions are now available on credit. The consumers are forced to save when a specific amount is cut from their salary every month to pay the installment. Mortgage financing is one way in which wealth is created. For example, if an apartment is bought for Rs.100,000 and paid Rs.20,000 as equity and borrowed Rs.80,000 from the bank. Next year, the value of the same apartment rises to Rs.120,000/-. loan is still Rs.80,000, but the equity has now doubled from Rs.20,000 to Rs.40,000. In this way, growth of the middle class wealth takes place through judicious use of bank credit. As the lending rates have come down drastically from 21% to 5% the banks find it profitable to extend the customer base for mortgage and auto loans, agriculture credit, small business and consumers. For the first time in the history of Pakistan, the middle class is beginning to benefit from the banking system. Before these reforms only 400,000 farmers used to get loans from the Agriculture Development Bank, but this year, more than one million farmers have been granted loans by the banking system.

For the poor, there is nothing to mortgage. Government of Pakistan has established microfinance banks where no collateral is required. They can get up to Rs.20-25 thousand in micro loans. Many people have availed this opportunity, some bought a cow, some bought a buffalo or opened a small shop and female borrowers bought sewing machines. They have started income-generating activities and recovery is no problem from the micro-finance banks. Approximately, 125,000 poor people have been given loans in the last two years.

The customer base of the banks has more than doubled during the last few years and covers almost 2 million households in agriculture, SMEs, Microfinance, Credit Cards, consumer loans, mortgage and auto loans, etc.

Another initiative taken by the State Bank of Pakistan was to revive sick units which were lying closed due to unsustainable debt burden. Now these sick industries can be revived through a well designed and transparent scheme. If the loanees pay 75% of the forced sale value to the bank, then these units would be handed over back to the owners. They can run the units and create employment opportunities. If it's an export industry, it will increase exports. This scheme is for all and sundry, across the board and round about 51,000 borrowers will be benefiting from it. The banks will be able to clean up their balance sheets by transforming these stuck loans into paying loans.

Pakistan is one of the few developing countries where the public sector banks went to the private hands in a very short span of time. The government only owns the National Bank, while 80% of the bank assets are in the private sector. And there is tough competition among the banks as in the private sector everything is performance-based. Unlike the public sector or the Government, any employee not producing results is fired because he affects profit of the organization. The bankers these days go out of their cozy offices to market their financial products and build up customer base. The seller market has changed into a buyer market. The customer may choose the bank with best products and services. There was a time – only a few years back - people used to go to the banks and the staff treated them shabbily, was generally uncooperative and unfriendly. Now, they are after the customers.

Cynics say that banking reforms are also promoting consumerism but when you give loan to a consumer, he goes and buys a car. But loan is given to a person who can demonstrate that he has sufficient disposable income to repay the monthly installments after taking care of his family needs. Before 1999 only 30 thousand cars were produced but in the last fiscal 100,000 cars[6] were being produced. 70% of the parts and components for these cars are manufactured in Pakistan which is creating employment. Those who are producing the auto parts have made an investment of millions of rupees and generated new job opportunities. As they have attained economies of scale, Pakistani auto parts are being exported to Dubai and other countries. The whole industry is benefiting from it. Very limited numbers of air-conditioners were

[6] Pakistan Economic Survey2004-5 Ch3

manufactured here but now they are produced in hundreds of thousands, similarly several hundred thousands of refrigerators and television sets are manufactured locally. If a company produces such products, they make huge investments in industry, people are employed and incomes are generated. This is not consumerism; rather Government is stimulating demand in the economy by giving purchasing power to the people who can afford to pay them not in one shot but in installments spread over several years. If domestically manufactured goods are bought it's boosting the industrial growth. How Pakistan has achieved 17% industrial growth during the last fiscal year. The private sector is doing all this because they see a rising demand for their goods. For the first time in the history of Pakistan, the private sector received bank credit worth more than Rs.325 billion. They used this money to invest in the industry and expand their capacity.

This is a complete cycle – banks provide credit to consumers who purchase goods with this money, the manufacturers respond to this higher demand by investing in new capacity and employing more people. As the new employees receive income they also add to the demand for these goods.

Similarly, the housing industry where steel, cement, paint, timber wood, electric gadgets, etc. are used is creating many more jobs in this sector. Unless there is credit available, except the millionaire/billionaire, the common man doesn't have enough money to build a house for himself. Credit increases his purchasing power. Home is a basic need. He will cut his monthly expenses but pay installments to the bank to keep his house. It will change his thinking. This is a kind of motivation for him. Everybody wants to have a home and a car. The banking sector is catering to such needs all over the world.

One of the adverse effects of lower interest rates in the country has been erosion of rates of returns on bank deposits. Small depositors who keep their savings in the banks have been badly hurt as they hardly get a decent return these days. The Government, therefore, had to come up with some scheme to safeguard the most vulnerable groups of our society whose only source of livelihood is their savings. To compensate the senior citizens, pensioners and widows Pakistan has launched "Behbood Scheme" through which they get 10.25% per annum. These returns are not affordable by the Government as they have reduced their fiscal deficit and do not need this money. Moreover, people used to misuse the saving schemes. They were in the habit of buying national saving certificates and then getting loans against those certificates and again buying more saving certificates.

As interest rates move up in the economy, it will be the depositors who will get the benefit while the borrowers will have to a pay higher price. This is the normal cycle through which market-based economies work. If Pakistan has chosen to live with this type of economy, it has to bear its costs along with its benefits. But it is also important to protect the poor and vulnerable groups of the society. Here the Behbood saving schemes, Bait-ul-Mal, Zakat, Microfinance loans and Poverty Alleviation Funds come handy.

It can be seen from the above description and analysis that in the banking system the interests of depositors and borrowers are quite different. What Pakistan has been able to ensure is that competition reduces inefficiencies in the system and the gains are passed on to both the depositors and the borrowers. But, beyond this, there will always remain a tension between depositors who want higher returns on their savings and the borrowers who want lower interest rate on their loans.

To sum up, banking sector reforms have brought in competition within the system, improved internal efficiency, reduced the lending rates significantly and broadened access to the middle class. While these results are encouraging, a lot more needs to be done and, therefore, Pakistan has spelled out the agenda for the second generation reforms in the financial sector covering the period 2005-2010.

5.2 RECOMMENDATIONS

Pakistan's economy is no longer fragile and its balance of payments is no more vulnerable to external shocks. Wide ranging structural reforms, prudent macroeconomic policies, financial discipline and consistency and continuity in policies can transform Pakistan into a stable and resurgent economy. To go forward, sound macroeconomic policies, financial discipline, continuity of policies, political and regional stability will be the key to sustain growth momentum. Although a number of steps have taken in this regard but so far, the results of those steps have not been so fruitful or up to the mark as were expected. After going through all the details of the causes of non-performing loans, following recommendations, in the light of present prevalent economic environment, are suggested:

5.2.1 Inexperienced Owner Managers

It has been observed that loans were issued to the businesses with inexperienced owner managers, which resulted in a loss because of the failure of the so-called feasibility plans of such kind of borrowers. Banks should make sure that loans could not be issued to new businesses with inexperienced owner manager unless bank officers are not sure about the feasibility of the projects and the repayment capability of the borrower. Loan officers should review the loan's status frequently enough to minimize the loan losses.

5.2.2 Punishment to Top Management

Top management has often bypassed the laid down procedures and loan policy of the bank in extending loans to their relatives or the persons of their vested interests. This factor is very much prevalent in the nationalized commercial banks, especially. Banks executives and loan officers should be given severe punishments. They should be black listed and publicly named for future employment or consultation services.

5.2.3 Purpose of Loans

In the past, banks have failed to check the mis-utilisation of funds. They were either utilized for their personal use or in somewhere else. This resulted in loss in the end. Bankers should make sure that funds are applied to the purpose mentioned in the loan request. They must be very careful to avoid any diversion of funds to borrower's personal use.

5.2.4 Conflict resolution

It is very unfortunate that the conflict resolution process is not present or it has not developed so far. After brief discussion between bank and the borrower, banks go for litigation in the court. There should be place for arbitration and other conflict resolution process before going for litigation. Conflict resolution process should be improved in terms of its speediness to avoid the troubling legal defenses by the borrowers.

5.2.5 Follow-up and Monitoring

Banks have lacked this area that once the loan has been lent, loan officers and the lending department as a whole did not do their work done fully by neglecting the proper follow-up and monitoring of loan to avoid any loss by acting on the warning signals in the loan portfolio of the borrowers. This has been the typical case with the nationalized commercial banks. There should be proper follow-up and monitoring of the loans.

5.2.6 Minimizing tile Political Interference

Political interference has played a key role in jeopardizing the loan portfolio of the banks in Pakistan. This is very hard to recommend that political interference should be minimized. This does not seem possible until State Bank of Pakistan gets the real autonomy and the institutions and constitutions become strong enough to oppose any violation in the laid down policies and procedures.

5.2.7 Improvement in Central Bank's Efficiency

Prior to the privatization, State Bank of Pakistan failed to do efficiently its core function of supervision of financial institutions. It has failed to warn the depositors about the collapsing performance of many banks, which ultimately resulted in loss. Similarly, it also failed to supervise and correct the loan portfolio of different banks, which resulted in the bankruptcy of such institutions. Indus Bank, Prudential Commercial Bank, bankers Equity Ltd. and National Development Finance Corporation are the recent examples of central bank's inefficiency. But with the Privatization and then bifurcating its management has yielded very useful result and is able to concentrate more on the core issues of central banking rather than issuing notes and bonds. Furthermore , its now focusing on formulating and following the monetary policy and regulating and supervising the banks and other financial institutions.

5.2.8 Eye on the Negative Credit Reports

Bankers should keep an eye on the negative credit reports of the borrowers. Bankers should immediately call the loans or to move against collateral quickly when deterioration becomes obviously hopeless. Borrower's cash flows should be carefully analyzed to avoid any losses in the future.

5.2.9 Bank as an advisor

Banks role as an advisor should be enhanced so that not only banks should contribute towards the success of the business but also safeguard their own interests by minimizing any loan losses through prior noticing the signals of deterioration the loan quality of the borrowers.

5.2.10 Outsourcing recovery of Loans

Banks should also avail the opportunity of outsourcing recovery defaulted loans. In this regard, CIRC was established but so far it has not produced the desired results. But still banks should go for discovering such channel to minimize the loan losses.