Financial restructuring

BY DR FAISAL BARI

Almost through the entire Pakistani history, and well into the 1990s, the dominant sources of project finance for Pakistani corporations have been either state-owned Development Finance Institutions (DFIs) or state-owned banks. The Non-Performing Loans (NPLs) that accumulated at almost all of these institutions, the general inefficiency that prevailed in the financial sector when it was dominated by state-owned and run financial institutions, and the waves of privatization that have washed the shores of many sectors, and in many countries, have all resulted in the dismantling of the older system of project finance. The question is what is going to replace it? Do we have the alternative institutions in place? And if not, what needs to be done to get these institutions in place?

That the old system is gone is under no doubt. Many of the state-owned banks, like the Muslim Commercial Bank, Allied Bank and United Bank, have been privatized, the remaining state-owned banks are not only being prepared for privatization, they have had significant structural adjustment and corporatization imposed on them so that they cannot do lending of the same sort and at the same level as before. Many of the DFIs have also been closed down, others have been privatized, and some have been merged with other institutions. Even where DFIs have remained in public ownership, they have stopped getting as much funds from the state as they used to, their foreign concessionary lines have been cut or disrupted, and consequently they have cut down on disbursements drastically. Another source of funds, the National Savings Schemes (NSS) under the Central Directorate of National Savings (CDNS) has also been rationalized to a degree. This is also going to allow private banks to offer services in competition with the public sector. This was previously not possible due to the dis-intermediation that was taking place due to the high interest rate that CDNS was offering on what were risk free investments.

Private sector played an insignificant role in project finance up to the mid 1990s. There were no domestic private banks in the country till the early 1990s, and their size remains relatively small to date (leaving aside the banks that have been privatized by the government). The private NBFIs, though large in number, had a very small share in financing. Equity markets were, and in many ways still are, very small, shallow and non-transparent. There were only 400 odd firms listed on the stock exchanges in 1990, and this was hardly one or two percent of all registered firms in the country. Most of the trading volume was restricted to a few shares, and there were clear indications of insider trading being quite prevalent in the market. Even more significantly, a lot of the firms had enlisted on the stock market for getting the tax breaks that were being offered on the basis of enlistment after a certain size had been attained.

The problem with the older model came from the fact that the public sector managed the lending institutions very poorly. Lending was done on the basis of political and family connections, nepotism and outright corruption. Loans were not collateralized properly, the lender as well as the borrower, in many cases, knew that they would not be honouring the contract, and there were right-offs on political basis as well. This was true of banks as well as state-owned NBFIs. In effect, we had a very large welfare system in place where money was being transferred from taxpayers to industrialists and the corrupt elements in the society, and the entire cost of the structure was being borne by the taxpayers and the citizens of the country. The question is not whether industry was established under the structure or not, but rather, at what cost was the structure created, and could this have been done at a lower cost, or could we have created a larger structure with the same amount of resources. The answer is clearly yes.

In the process some financial institutions accumulated a large portfolio of bad debts.

In the process these financial institutions accumulated a large portfolio of bad debts, and a number of them became economically unviable. They require large transfers from the state all the time, and could not function without consistent support. But the most damaging impact that this older structure had was that it did not allow other channels for mobilizing investment funds to develop at all. In fact, it positively hurt the development of equity markets, private capital mobilizers, venture capital firms and other kinds of instruments for raising capital. The private and foreign banks never thought of entering project finance, and more importantly, the government did not really feel the need to develop markets, institutions, regulatory framework, and organizational structures that would lead to the development of private capital markets.

Today the equity market has 700 odd companies listed on them, in the last two years there have only been three or four new issues, many companies, on the introduction of corporate governance (CG) reforms, have threatened to de-list from the market, in the last year 80-85 percent of the trading volume was dominated by a handful of companies, the turnover of shares in smaller family owned and controlled firms is extremely low, and to top it all, the markets are not transparent at all. Recent research has shown that there are brokers in the market that make consistently higher returns than others, and there are trades that go on that could only happen if there was manipulation of the market going on, there were too many na_ve investors, or there was insider information available to a few of the players.

Though the Securities and Exchange Commission of Pakistan (SECP) has instituted a number of very concrete and positive steps to improve the chances of development of the equity markets, but the reform is going to take time before it becomes effective. The reform measures include the imposition of the new code of corporate governance, changes in the management and organization of stock markets, license for an electronic exchange, better regulations for all firms, but especially for NBFIs and the insurance sector, and much better enforcement and monitoring measures for the listed and other corporate sector. These reforms have been and are being resisted by some lobbies and corporations who are not only likely to lose monopoly rents, but also some control over their corporations, but these reforms, and many more to come, might be a necessary pre-requisite before capital markets can develop further and take-off.

The main problems in the equity markets have to do with two basic asymmetries. Potential and actual small scale equity holders, and even large scale equity holders who are not the controllers of the firm do not have access to good quality, credible information on the corporation. They depend on the management and controlling owners for information, and that information is often created or slanted to keep the benefits of the controlling owner or management in mind. The problem gets compounded due to the low general literacy levels in the country, the lack of reliable outside information generated by credit rating agencies, consumer and investor groups and investment companies. The SECP has tried to make the information systems better by mandating internal audit committees, internal accounting controls and by increasing the checks on external auditors (the accountants), but these changes will take sometime before they become effective. Furthermore, the basic problems of asymmetric information, in markets that are small and shallow, will remain.

The other important asymmetry has to do with the fact that the control of most family firms is vested with the majority owners, or in other words there is no distinction between ownership and control for the main family. This means that the family, though it has less than 100 percent of the ownership, has control over all of the decision-making. This leaves the minority shareholders on a weak limb. They cannot control the actions of the key family. The family can pack the board, and use other means (proxy board membership, pyramiding and tunneling) to control the decision-making of the firm in question. Furthermore, for every rupee of profit that the controlling family can divert to private benefits, the equity holders lose out that dollar, while the controlling family gains the share of the other equity holders. The incentives to cheat can thus be high, while the minority shareholder cannot do much to counteract the impact of the controller.

The SECP has again tried to institute the role of non-executive directors, the rights of shareholders to demand information, as well as their right to haul directors in front of courts as well as other tribunals for mismanagement, and they have also tried to make shareholder organization to take on the directors stronger, but these changes, when the controlling family is all powerful and not willing to honour some of the commitments, are going to be very hard to institute, operationalize and make effective.

The same problems exist for the banks as well. Though debt is given priority in repayment, banks too have problems related to getting access to the right information, ensuring the credibility of that information, and ensuring that the information has not been manipulated to deliver desirable results. Banks also have issues related to control that are similar to ones that have been mentioned for the equity holders. Banks also have the additional problem that banks need to have good legal structures, recovery laws and regulatory structures to ensure that in the case of default they can get their money back by taking over collateral or by liquidating the assets of the company. Again the SECP and the State Bank of Pakistan (SBP) have only just started looking into these issues and it will be a number of years, and will take a number of iterations, before we can come to systems that deliver the desired objectives effectively and efficiently.

It is also important to realize that unless these systems are put in place, unless lenders and equity holders are given effective protection, it will be hard for them to enter the area of project financing. With the collapse of the older system, we need the new system before we can achieve effective intermediation. The SECP and SBP have taken some steps in the right direction in the last few years, but these are just initial steps and we have a long way to go. More importantly, these steps have to be built upon consistently. If the state wavers, if policies are reversed, due to pressure from the corporate sector or for any other reason, it will take even longer for us achieve the requisite financial depth and structure.

E-mail queries and comments to: faisal@nation.com.pk