

Bankruptcy Law

Keynote Address at the Seminar on 'Bankruptcy Law'
organized by the Federation of Pakistan Chamber of
Commerce and Industry at Karachi on
Monday, 28th January, 2002

I would like to commend the Federation of Pakistan Chambers of Commerce and Industry (FPCCI) and its President, Mr. Iftikhar Ali Malik for organizing this Seminar. I consider this as a paradigm shift from the traditional way of the FPCCI presenting a Charter of demands to visiting government officials towards a joint collaborative way of solving practical problems facing the industry. This seminar represents an excellent initiative to explore an issue, which is of utmost significance for the business community.

The State Bank has engaged in a continuous consultative process with the business leaders, exporters associations, chambers etc. We have established Credit Advisory Committees at 16 of our offices where the bankers and the business community get together to resolve their collective and individual problems concerning credit, recovery, export finance etc. In addition, we have circulated the draft financial sector strategy paper to elicit the views of the various stakeholders including the Federation. The strategy consists of three main planks. First, the existing nationalized commercial banks (NCBs) and stateowned Development Financial Institutions (DFIs) and specialized banks should be restructured, liquidated and privatized. Second, the private domestic and foreign banks should be encouraged to merge and consolidate into a fewer but stronger and healthy banks. These two planks will foster competition in the financial markets. But the third plank is equally important and that is to strengthen the capacity of the State Bank of Pakistan in regulating and supervising the financial sector.

Our banking laws were enacted several decades ago and need complete revision and re-examination in the light of the developments which have taken place and to tackle the problems which may arise in the future by their application in the present form and shape. I would therefore very much welcome the recommendations of this seminar as you deliberate upon this topic. These recommendations would be taken into account as an input by the Banking Law Reforms Commission.

Bankruptcy and insolvency are a natural phenomenon of doing business in a capitalist economy. Our Islamic economic model is also based on the same principles of private enterprise, trade and sharing of profits and losses. Thus business will flourish, new firms will enter and old firms will die out. Profit making is the essence of capital formation, expansion of economy, employment

generation and export growth. Bankruptcy laws in Pakistan has to strike a right balance between the rights of creditors and the rights of debtors. There is no magic solution to this problem and every country has come up with its own peculiar solution. But I would suggest that in Pakistan we should follow some ground rules under which profits have to be made and bankruptcy and insolvency can be avoided.

First, if profits are privatized then the losses should not be socialized. While the private entrepreneurs in Pakistan gladly appropriate the profits whether normal or windfall-they are always reluctant to bear losses. They run to the Government for absorbing their losses in form of various relief and concessions putting unnecessary burden on the Government exchequer. This tendency has to be curbed. Profits and losses should both be borne by the private investor himself without any intervention by the Government.

Second, if the businesses make profits then it is incumbent upon them to pay a portion of their profits as taxes. Unless the Government has recourse to financial resources with which it can provide public goods such as defence, law and order, infrastructure, social sector services, the cost of production to the private entrepreneurs will be exorbitant putting them at a comparative disadvantage. Thus the present practice of evading taxes by those who make profits should be discontinued and every business which is making profits should pay its due share of taxes.

Third, profits made in Pakistan by utilizing the country's resources should be reinvested in its economy for maximizing economic activity and employment rather than keeping them away in foreign bank accounts overseas. Unless these profits are reinvested, investment and economic expansion will come to a grinding halt and we will be faced with declining standards of living and worsening poverty for the majority of our population. This social discontent is inimical for the business community and its security and safety.

Fourth, profits have to be generated through competition in a level playing field and not through selective favors, concessions and privileges to a chosen few among the business community. The culture of issuing SROs to allow imports for the benefit of one individual and discriminate against the rest has to come to an end. There should be a uniform rule and its consistent application both for the ruling as well as the opposition parties. The government should have no favorites and no opponents in business. Similarly the businessmen should also carry out their functions on professional basis without getting affiliated with any political parties.

There are a plethora of laws on bankruptcy in the country and a number of institutions such as Corporate and Industrial Restructuring Corporation (CIRC), Committee on the Revival of Sick Units etc. But what is missing is the supporting infrastructure which would enable these laws to act as deterrent and the institutions to become effective. What do I mean by this supporting infrastructure? There are at least six essential ingredients of this environment.

First, the banks require specialists in remedial asset management who can distinguish between willful defaulters and circumstantial defaulters. There should be no concession or restructuring for those who have defaulted willfully and they should be sent to NAB for accountability purpose. But those who are unable to meet their original contractual obligations due to circumstances beyond their control – either due to changes in government policies or for other unforeseen external events – should be given adequate relief.

In this connection, I would like to make it clear that the bankers have to make judgment and not adopt a mechanical approach whereby any borrower who is included in the C.I.B. list is automatically denied new credit. We need bankers who are able to make prudent judgments on the viability of the loan proposals on the basis of projected cash flow, collaterals and securities and appraisal of risks.

Second, the auditing standards need to be improved. One of the pillars of good corporate governance is external auditor. Auditors have to enforce and observe rigorous standards conforming with international practices. They have to ensure that there is full disclosure of financial information so that the stakeholders have adequate knowledge about the company's operations.

Third, we have to introduce forensic accounting. Detection of white collar crimes, tracking of vital transactions, fudging of the books, parking of losses off the balance sheets require specialized expertise which is not available in Pakistan as yet. Training in forensic accounting is therefore imperative.

Fourth, our judges have to be trained in commercial, corporate, banking and tax laws. Their training at the Judicial Academy should be expanded to include courses in these fields. A lot of times cases are adjourned or judgments are postponed because the judges lack the ability to fully grasp the complexities and intricacies of these laws.

Fifth, Pakistan needs informal alternative dispute resolution mechanisms. The tendency to rush to the courts at the first sound of disagreement between the borrower and the banks has clogged our court system and result in unnecessary delays. The losses of production, the unbearable burden on the borrowers and piling up of unrecoverable assets by the banks are detrimental to the smooth

functioning of the economy. Creditors Committees, Conciliation Committees, Sick Unit Revival Committees and other such informal mechanisms should be exhausted first before the borrowers or the banks get entangled in legal battles and waste their time, energies and financial resources.

Sixth, the official receivership system for executing the Court decrees and judgments requires a specialized set of skills. The present system prevailing under the Sind High Court is functioning relatively better and can be further improved. I would submit that the other High Courts should consider adopting this system in their provinces too. But for this purpose it is essential that training should be undertaken for the official receivers.

These laws, institutions supporting infrastructure will make sense if the private companies also improve their corporate governance which in case of private limited companies and even public limited companies is quite weak today.

Transparency and disclosure of financial information to the minority shareholders are minimal. Shuffling of assets takes place too often than is desirable. Book keeping and accounting practices are not uniform. Family-owned and managed businesses dominate the spectrum. We have to shift from these existing structures and practices to professionally managed firms in order to derive the benefits of economies of scale, efficient use of resources, lower unit cost of production and acquire competitive edge. Failed enterprises which are no longer able to cater to the market demands have to be weeded out and eliminated.

Change of management, take over and acquisitions and change of ownership should form the array of options to reach the threshold standards of performance.

I am confident that if these ground rules are observed, the supporting infrastructure is put in place, the attitudes of bankers is altered, and corporate governance in the private sector is improved the need for bankruptcy and insolvency will be minimized. In that event, bankruptcy laws will be applied and court system will be utilized only selectively.