AN ANALYSIS OF THE BANKS' WRITE-OFFS 1999 - 2003

I would like to thank the Institute of Bankers, Pakistan for inviting me to this auspicious occasion of the Annual Prize Award Ceremony. Let me offer my sincere felicitations to those of you who have won distinctions, awards and prizes. I would hasten to add that you should consider this as a beginning of a long journey towards professional growth and accomplishments. Those who will make a commitment to acquiring skills and knowledge throughout their careers will have nothing to fear about – but those who become complacent or rest on the laurels they have achieved by obtaining degrees and certificates and passing examinations should remain worried.

I would like to devote my remarks this morning to address the question of write-offs by Public Sector Banks/Development Finance Institutions (DFIs) during the last three years. It is my duty to explain the rationale as to why write-offs take place, what is the policy guiding these write-offs, place this write-off in the overall context of the strategy for resolving the Non-Performing Loan (NPL) issues, present the facts as to how much amount has been written-off or waived during the last three years, including its impact upon the banking system and finally who are the beneficiaries from this write-off.

Rationale: The banks are in the business of risk taking and there are occasions when economic shocks or business cycles or frequent changes in government policies do turn some of their assets sour. Until and unless there is no personal motive of the bankers or any political pressure, the write-off of irrecoverable loans and cleaning up of their balance sheets is the normal practice of the banks all over the world.

Pakistani banks have also taken action, like other banks, to write-off loans and waive off charges on the basis of transparent criteria and policy guidelines during the last three years. The only exception is that wilful defaulters are taken to task and made to pay their liabilities. Legal action is taken against them and their cases are referred to National Accountability Bureau (NAB). But there are legitimate businessmen and individual borrowers who have been victims of circumstances such as business down turn, erratic government policies of tax and tariff, abrupt changes in regulatory environment as well as business misjudgments, etc. They may not be in a position to continue making payments according to the original contractual agreements under the changed circumstances. Both parties – the banks and borrowers – are better off if they take timely action to restructure the loans and turn them into a performing contract. In doing so, the banks may have to waive off i.e. write-off some accrued charges and/or take a partial discount on the principal. The upside, however, is that the quality of restructured asset gets upgraded. The borrower will then be in a position to operate the unit and generate cash flow to service liabilities. In some cases and where justified, the banks may even provide fresh working capital subject to their credit satisfaction and collateral coverage.

Therefore, write-offs are in essence a recognition of reality – that the original asset has diminished in value and therefore, it needs to be carried on the balance sheet at its realistic value. For many years, the nationalized commercial banks (NCBs) and DFIs were carrying huge non-performing assets but were not recognizing this value erosion. It should also be noted that a write-off represents an accounting entry recognizing that a loan has become uncollectable but does not in any way impair a bank's ability to take action against a borrower in case assets belonging to the borrower be identified at a later point in time. The exception is when a compromise agreement is arrived at or in the case of settlements made under SBP's scheme or banks' own schemes. Another frequently asked question related to write-offs is: Why is there in some cases a large difference between outstanding liabilities and collateral value? The answer is that whereas the outstanding liabilities go on increasing because of the application of mark-up, the collateral value goes on receding because the unit is shut down and this explains why often the outstandings of closed units are substantially greater than the collateral or forced sale value.

In absence of these write-offs, the banks have to make provisions out of their income against these NPLs. On a sustained basis this translates into accumulated losses which, in turn, diminish the capital of the banks. This is why the Government of Pakistan/State Bank of Pakistan had to inject Rs.46.6 billion to make up the shortfall in the Capital Adequacy of Habib Bank and United Bank.

Business failures are a normal event in the life cycle of an economy. In England, for example, the Bank of England has reported that there were more than 43,000 business failures in the year 2001. As all businesses are not fully equity financed there are bound to be defaults on bank loans once there is a failure. But the advanced countries have orderly legal procedures whereby the businesses could file bankruptcies and restructure their financial position. In case of Pakistan, we do not have this mechanism available and once enacted it will lead to even greater transparency in the settlement of defaulted loans between the banks and the borrowers who have filed bankruptcies.

Policy Guidelines: The Prudential Regulations require all the banks to classify their non-performing loans under four categories (a) Other assets especially mentioned (b) Sub-Standard (c) Doubtful, and (d) Loss. The SBP has allowed the Board of Directors of Banks to write-off loans in the loss category in a transparent, non-discriminatory and uniform manner according to well defined policies. The banks are required to disclose the details of the parties and individuals who have been allowed write-off of above Rs. 0.5 million in their annual financial statements.

In addition, the Corporate and Industrial Restructuring Corporation (CIRC) has been empowered under the law to acquire NPLs from the public sector banks/DFIs and the difference between the acquisition price and book value is written-off from the books of the banks.

The Committee for Revival of Sick Industrial Units (CRSIU) formed by the Government of Pakistan also restructures the loans of the sick industrial units to make them viable and the banks have to write-off or waive off the amounts decreed by the CRSIU.

There are 80,157 cases pending in the Courts of Law and the decretal amounts given by the Court, at times, fall short of the book value of the loans. The banks have, therefore, to make up this shortfall through write-offs or waivers. In some of the well publicized cases of some industrialists, the write-offs have resulted because the auction amounts recovered due to execution of Court decrees were lower than the book value of the loans carried by the banks.

Strategy for dealing with Non-Performing Loans:

I wish to emphatically declare that write-offs and waivers are an integral part of the banking business – be it modern or primitive. What can be done is to put in place policy, regulatory and incentive structures which prevent or minimize large scale defaults.

I would like to acknowledge, as I have done before, that it was the Nawaz Sharif Government that had taken very courageous decisions by appointing professionals of highest caliber and integrity to the Boards of Directors and Chief Executives of the nationalized commercial banks beginning 1997. This tradition was carried out by the previous Military Government and has been endorsed by Prime Minister Jamali. The result of this upgradation in quality of management and boards is that the ratio of non-performing loans to total loans disbursed since 1997 has declined to less than 5 percent, which is close to the international norm. This may be contrasted with 25 percent ratio for the period before 1997, which these banks had inherited. The new loans since 1997 have been approved strictly on merit and not on political considerations. We should all take pride that at least one sector of the economy was de-politicized and both the political and Military Governments worked on the same lines and continued the same policies.

As the stock of non-performing loans held by the banks was 25 percent of loans it had serious negative repercussions for the financial health of the banking industry. High lending rates prevailing in the country for a long time were the result of this high level of loan default, poor quality of underlying collaterals or guarantees and the slow recovery process through the legal system. The borrowers had thus to pay higher than normal rate and the depositors received lower than normal rate of return on their deposits. If this trend had continued, the rate of private investment and the economy would have continued to suffer and saving mobilization would have been adversely affected.

As you are aware, the banking spreads i.e. the difference between lending and deposit rates consist of four components (a) Net Interest Margins (b) Drag of NPLs and provisions thereof (c) Administrative Cost, and (d) Taxes and reserve requirement. For the last three years, it has been our consistent endeavour to reduce the banking spreads by bringing about intermediation efficiency and reducing administrative costs. All the three big NCBs have succeeded in improving their Cost-Income ratio by shedding off excess labour and rationalizing branch network. The Cost-Income ratios have declined from 97.4 percent in 2000 to 89.8 percent in 2002. Corporate Income Tax rate has been reduced from 58 percent in 1999-2000 to 44 percent this year and is scheduled to come down to 35 percent by 2007. Net Interest Margins are subject to competitive pressures of the market and all that State Bank can do is to create a level playing field and allow all the banks to compete according to the rules of the game. Thus, the only variable in this banking spread equation that needed some concerted and focused attention was to deal with the stock of NPLs particularly for the seven institutions which accounted for 80 percent of the total NPLs. The other motivation was that in Pakistan, if new investment was not forthcoming in a big way, we should at least make all possible efforts to revive those industrial units which could become economically and financially viable by restructuring their balance sheets. The revival of these units will generate thousands of jobs for the growing reservoir of unemployed in the country. It was with these considerations in mind that a strategy had to be evolved to deal with Non-Performing Loans.

The thrust of this multi-pronged strategy was to deal with this issue in a comprehensive, open and transparent manner. The objectives of this strategy were (a) to improve the coverage and reporting of NPLs (b) to proactively manage the existing stock of NPLs (c) to stem flow of new NPLs, and (d) to improve the policy and regulatory environment.

I will not repeat today what I have already written and explained in my article that appeared in Daily Dawn of October 21 and October 22, 2002 on different elements of this strategy. Today, I will focus on only one part of the strategy i.e. the proactive management of the existing stock of NPLs under the following five pronged approaches i.e..

i. Put pressure on the banks and DFIs to accelerate recovery. During the last three years, an amount of Rs. 124.1 billion or 58.6 percent of 1999 outstanding stock of NPLs has been recovered in cash. If such a large amount has been recovered the question arises: Why is there a continuous rise in the stock of NPLs which stand today at Rs. 266 billion? As I have explained in the article, when the principal amount becomes non-performing, the mark up on the principal amount continues to accrue and accumulate with the passage of time until such time the loan is written-off. Furthermore, the SBP has also introduced more rigorous classification of loans which the banks have implemented and has resulted in downgradation of previously treated performing loans into non-performing loans.

ii. The wilful defaulters who had the means and ability to repay their loans but were deliberately avoiding to do so were investigated and prosecuted under the NAB Ordinance. The NAB has so far facilitated cash recovery of defaulted loans worth Rs. 86.6 billion. But the most salutary effect of NAB law is that it acts as a deterrent against those who were used to getting away scot free and had no intention to meet their obligations to the banks. A responsible borrower does not have to fear the NAB. The difference in the various amounts of loans recovered by NAB arises due to the timing of reports, the cash recovery and amounts restructured. What this amount of Rs. 86.6 billion include is both the cash recovery as well as amounts restructured.

iii. The Government has created an asset resolution framework in the form of Corporate and Industrial Restructuring Corporation (CIRC). This body is authorized to acquire the NPLs at discount from the nationalized commercial banks/DFIs and auction them through public tenders thus taking away the assets from the existing owners and repaying the proceeds to the banks. So far, the CIRC has purchased loans worth Rs. 31.28 billion from the banks at a discounted price of Rs. 5.13 billion and auctioned off 77 units, recovering Rs. 2.66 billion.

iv. The Committee for Revival of Sick Industrial Units (CRSIU) has also restructured loans worth Rs.44.1 billion and helped revive 163 sick units by allowing waivers and write-offs.

v. As all above measures were still not successful in resolving the dead and irrecoverable assets, the Banks' Board of Directors have been authorized by the SBP to write-off loans in a non-preferential, across-the-board and uniform manner under the given criteria. The President of Pakistan has also waived off agriculture loans in the calamity affected areas particularly in the provinces of Balochistan and Sindh.

Despite the above measures, there are still aged and old loans on the books of the banks which have not been serviced for at least last five years and thus fall in the loss category. There is very low probability that these loans can be recovered as with the passage of time the value of their collateral is, by and large, eroding while the mark-up on outstanding but non-performing loans keeps on adding. This has led to a situation where the units are closed but their outstanding bank liabilities are increasing every day. The banks thus in the past were inflating their balance sheets by showing these loans, which could never be recovered, as part of their asset base. SBP in the last few years has disallowed this kind of game playing and dissemination of misleading information, hence the public is now provided an accurate picture about the banks' financial health. The SBP has, therefore, developed general guidelines and issued BPD Circular No. 29 asking the Boards of Directors of Banks to frame policies for cleaning up of their balance sheets by recovering the forced sale value of the underlying collaterals of the loans in the loss category for three years and waiving off the remaining amount. This initiative has been generally welcomed by the industry and business as they will be able to start operations of thousands of units currently shut down.

I would like to alert everyone that the application of this Circular may result in waiver and/or write-off of non-performing loans worth about Rs. 25-30 billion by end August 2006. We should be prepared for this eventuality and not get any shocks about it. However, the banking system is protected from these shocks as the banks hold adequate provisions and the write-offs will have virtually no effect on their profitability or capital. To bring you up-to-date 40,333 account holders have applied to the banks for settling their outstanding loans in the amount of Rs. 80.6 billion. Of this, the banks have settled 32,049 accounts in the amount of Rs. 18.8 billion and the remaining 8,284 accounts will be decided up to August 31, 2003. If we further assume an optimistic scenario that one half of the total amount is settled by the banks by that date, this will mean that at least Rs. 40 billion will be eliminated from the stock of banks' NPL portfolio reducing it by 15 percent to Rs. 226 billion by August 2006. In terms of the ratio of gross NPLs to gross advances it means a decline from 25 percent at present to 21.4 percent. This cleaning up of balance sheets along with the heavy provisioning already made by the banks will improve the net NPL ratios and strengthen the soundness of the banking system. I would like to report that the spread between deposit and lending rates have already declined in the last two years by 475 basis points from 9.43 to 4.68 percent and will be further lowered benefiting both the depositors and the borrowers.

Facts of Write-offs since October, 1999:

I would now focus specifically on the write-offs/waivers of Rs. 23.5 billion which have been granted by the Boards of Directors of 11 public sector banks/DFIs during the last three years.

Let me place the facts before you. First, what is the exact amount written-off? Since October 12, 1999 the total amount of loans written-off by eleven public sector owned DFIs and nationalized commercial banks amount to Rs. 20.251 billion. The amount of Rs. 23.5 billion disclosed in reply to a question raised in the National Assembly included Rs. 3.355 billion of loans written-off between January 1 – October 11, 1999. It is interesting to note that the principal amount involved in these write-offs during the last three years was only Rs. 7.6 billion. Most of these loans were very old (10 to 25 years) which have been stuck-up for at least five years. Although these loans had already become bad and were not being serviced by the borrowers, the mark-up kept on accruing every year and by end December 2002, the accrued mark-up on these loans was Rs. 16 billion. You can appreciate that this is an untenable position. If the factory has already stopped producing goods or services and generating cash flow and the borrower was unable to pay the principal due, in the first place, how do we expect them to pay 212 percent accumulated mark-up on the principal amount. I may also clarify that the major portion of the amount which represents mark-up/interest charged to the delinquent borrowers is not taken into banks' profits but placed in a suspense account. Thus, the waiver of this amount of Rs. 16 billion does not affect the financial health in general, and profitability in particular, of the banks in any way.

It should also be mentioned that the names of all the borrowers, whose loans of Rs. 0.5 million and above were written-off, have already been published in the annual accounts of the banks for the years 1999, 2000, 2001 and 2002 with complete details. There is nothing new in the reply provided to the question raised in the National Assembly but a summary of all the details which had already been disclosed to the public at large by every single bank during the last three years.

Impact of the Write-offs:

I would like to draw your attention to the impact of these write-offs/waivers on the banks' financial position presented in Table I. The largest impact was in 2002 when these write-offs accounted for 3.62 percent of the total NPLs and 0.9 percent of total outstanding advances, i.e. less than 1 percent of banks' advances have been affected by these actions of the banks. You can realize that these write-offs formed a very negligible proportion of both the NPLs as well as total advances. Even if you take the extreme case i.e. aggregate all these write-offs for the entire period October 1999 – December 2002 and relate them to the stock of NPLs and advances outstanding on December 2002, these account for merely 7.9 percent of NPLs and 2.19 percent of advances outstanding.

Beneficiaries from the Write-offs:

The bulk of Rs. 23.5 billion written-off or waived since 1999 was concentrated in four public sector banks – NBP, HBL, ZTBL and SME Bank. An analysis of the borrowers by the size of the loans written-off by these banks is presented in Table II. Contrary to popular perception as many as 262,209 small borrowers benefited from this policy and got relief of Rs. 7.6 billion. Of this, Rs. 5.0 billion was written-off for small-scale agriculture borrowers and Rs.1 billion to SME borrowers. Thus, the reported allegations that the army generals and politicians are the main beneficiaries of the banks' write-offs since October 1999 are not only inaccurate but also misleading. It is true that 1408 borrowers also got relief of Rs. 9.7 billion but this list consists of those businesses which met the criteria set up by the respective Banks' Boards of Directors. There was no directive given by the President House, Ministry of Finance, State Bank of Pakistan or any other Government Ministries to the banks in these cases. I can say without fear of contradiction that during the last three and a half years neither the President nor any of his Generals or Cabinet Members ever interfered or exerted any pressure to grant any new loans or write-off any old loan. Thus, the decisions on write-offs were taken by the Management and the Banks' Boards according to their own professional judgment or in compliance of the Court judgments, acquisition by CIRC, decisions of CRSIU or general amnesty granted for calamity affected borrowers of ADBP. The President only agreed to provide relief to the calamity struck small farmers in Balochistan and Sindh from their ADBP loans and this was done across the board for the whole areas rather than for specific individuals.

Future Direction:

As you know, we have embarked upon the course of privatization of banks along with introduction of strong regulatory and supervisory regime and corporate governance rules. With the HBL out of the Government hands, 80 percent of banking assets in Pakistan will be held by the private sector but under the vigilant eyes of the State Bank of Pakistan. Effective credit policies and professional management has already led to an enormous improvement in the quality of new loans booked e.g. at HBL nearly Rs. 50 billion of new loans booked in the last five years show a loss ratio of less than 0.5%. This will be further reinforced by the private owners of the banks as they will be interested in maximizing profits, and will also ensure that the loans are given purely on commercial considerations so that they can be serviced and repaid on time. If the private banks don't follow these rules, they will have to make provisions which have to come out of their profits and the owners will earn no return on their investment. The managers of these privatized banks will either lose their jobs or their bonuses and increments. Thus, it is in the overall interest of the shareholders and managers that the quality of assets is ensured and recovery is prompt. That is why the existing private banks and foreign banks have such low ratios of NPLs to advances and their write-offs and waivers are insignificant. I believe this is the way forward in which we can ensure that the customers get better service, the quality of banking assets is satisfactory and the overall banking sector is in good financial health.

Conclusion:

The write-offs of defaulted loans by the banks is very much part of their normal business and is in accordance with the international practices. There are clear procedures and guidelines in place since 1997 whereby these decisions are taken by the Banks' Boards in a transparent, uniform manner and disclosed to general public. Since October 1999, an aggregate amount of Rs. 20.2 billion or about 2 percent of total loans outstanding and about 8 percent of all non-performing loans have been written-off or charges waived. As against this, the banks have recovered Rs. 124 billion in the same period or 58 percent of 1999 outstanding stock of NPLs. The amounts which have been written-off thus represent the cumulative total of the decretal judgments awarded by the Courts of Law, the discounts at which loans were acquired by CIRC, the implementation of the decisions of CRSIU, general amnesty schemes to calamity affected small borrowers and the decisions taken by the Banks' Boards on merit of each case. Contrary to popular perception as many as 262,209 small borrowers benefited from these write-offs and got relief of Rs. 7.6 billion.

The State Bank of Pakistan has provided another avenue to the banks under BPD Circular No. 29. It is estimated that Rs.25-30 billion of defaulted loans will be written-off under this scheme during the next three years. Thus, as long as banks are in the business of making loans and taking risks, the write-offs will continue to take place. As long as they are made in a transparent manner and according to given policies, there should be no cause of concern. This will, as a matter of fact, help revive some of the closed businesses and strengthen the balance sheets of the banks.

TABLE I

Impact of Write-offs on Banks' Balance Sheets

(Rs. in billion)

		Oct 1999 to Dec 1999	2000	2001	2002
I.	Amounts written-off or waived	0.467	4.480	5.662	9.642
II.	Total Non-Performing Loans (NPLs)	211	282	274	266
III.	Total advances from banks/DFIs	902	1,025	1,107	1,069
IV.	Amounts written-off as % of total NPLs	0.22	1.58	2.06	3.62
V.	Amounts written-off as % of total advances	0.05	0.43	0.51	0.90

TABLE II

Beneficiaries of the Banks' Write-offs/Waivers

1999 - March 2003

(Rs. in million)

Banks	**No. of Small Borrowers (below Rs. 0.5 million)**	**Amount written-off/waived**	**No. of Borrowers (above Rs. 0.5 m)**	**Amount written-off/waived**
NBP	32,519	994	564	6,876
HBL	13,577	483	794	1,137
ZTBL	188,197	5,042	34	1,746
SME	27,916	1,112	16	30
TOTAL	**262,209**	**7,630**	**1,408**	**9,789**