Introduction

Since the 1970s, 112 banking crises have occurred in 93 countries, with an additional 51 borderline crises recorded in 46 countries. These episodes of financial distress incur a heavy cost on the governments and taxpayers alike. Often we find that these banking crises resulted due to high levels of nonperforming assets (NPA). The cost of resolving these nonperforming assets can be enormous.

One banking debacle began in Japan in the early 1990s. By 1998, nonperforming loans were estimated at $725 billion (18 percent of Japan's GDP). The Obuchi Plan provided $500 billion (12 percent of GDP) in public funds for loan losses, bank recapitalizations, and depositor protection. These figures do not include the cost of keeping so-called zombie borrowers-companies that continue to exist only because their banks extend further credit.

Nonperforming loans (NPL) are those that in default or are close to default. NPL have been a serious banking disease. They adversely affect the quality of the assets of banks and negatively impact their earnings. Therefore, a riskier loan portfolio combined with lower net income as a result of provisioning for loan losses makes new lending more difficult. The cost of carrying the NPLs on the balance sheet increases the cost of the bank resulting in making the new loans more expensive. Hence, the result is a slower credit growth and a less competitive bank. In addition a high share of NPLs can cause systematic risk and possible fiscal liabilities, affecting investment and economic growth.

The nature of severity of a country's NPA problem generally dictates the resolution strategy adopted. The key factor in the resolution process is the presence of an enabling framework to support asset resolution. In virtually all of the cases the governments have taken the lead in developing a climate for effective asset resolution. Most countries have chosen to establish one or more asset management companies (AMC) to oversee the resolution process. While others countries have chosen to let the originating banks continue to resolve the assets.

This paper looks at the various ways of NPA resolution and then studies the resolution process presently being employed in Pakistan and what measures are needed for the development of an efficient system for NPA resolution.

What is Asset Resolution? Why is it important?

Whenever, the banks have a large stock of NPA and require recapitalization the role of the authorities begins. They are now faced with the task of liquidating the NPA in a timely fashion to provide payment to the creditors. The NPA are a group of distressed assets of the bank. These are assets, which have been impaired due to non-payment by the borrowers.

In order to resolve or reduce these NPA to cash the legal framework for creditor rights and insolvency (including corporate reorganization) and out of court workouts must be developed and implemented. Many corporations and their loans must be restructured before they can be sold.

Large stocks of NPL exact a heavy price. First, they can deepen the severity and duration of financial crisis and complicate macroeconomic management. A large stock of NPA locks up scarce financial capital in nonproductive projects and impedes the resumption of efficient intermediation that is vital for economic recovery.

As institutions weaken as a result of NPL, the flow of credit is reduced creating a credit crunch. Borrowers suddenly find themselves cut off from financing, thus contributing to the slowdown in economic activity.

Without an ability to cleanse the stock of bad loans through liquidation or restructuring, the stock of bad loans will remain, the flow of new nonperforming assets is likely to continue, and economic and ultimately macroeconomic and fiscal stability will remain at risk.

Distressed Debt

Distressed debt investing is "The purchase of debt obligations which are in potential or actual default at a discount to their price in anticipation of reselling those securities over a relatively short period of time at a higher price, generating a profit." Hence, distressed debt investors follow a value investment strategy where they look to exploit informational imperfections. Since distressed debt investing bears high risk investors look for ultra-high rate of return.

Investment in distressed debt involves both acquisition of publicly traded and privately held securities and loans. Initially the main investors in this business were banks, finance companies, private funds and insurance companies. Today, the investors in the distressed debt trading market

include a variety of investment and hedge funds, opportunity funds, vulture funds, and special purpose asset management companies with privately placed funds.

The ability to invest in distressed debt depends first on the creation of an ample supply. Historically, that supply has come into existence when a period of lax lending has been followed by a period of adversity. From time to time, the capital markets will approach a cyclical high in terms of generosity and a low in terms of risk mitigation. Confidence outweighs caution as providers of capital compete to buy securities and make loans. And the way they compete is by accepting less in terms of debt coverage and loan covenants. In other words, they settle for insufficient security. Credit standards are pushed to the point where many borrowers will be unable to service their debt if conditions in the environment deteriorate, as inevitably will become at some point.

When the economic and business worlds are thriving there are few forced or motivated sellers crowding the exits, and thus there are few bargains. But when negatives accumulate in the environment, investors often become unable to hold on and bargains are common. These influences can be seen most clearly in the market for distressed debt, as that is where the extremes of the cycles in corporate creditworthiness and investor psychology are reached.

The distressed debt market started in the early 1980s soon after the international emerging market debt crisis. This crisis resulted in commercial banks and multilateral institutions reducing their exposure on developing countries. This was done by swapping the debt for another and sale of debt. The trading market developed as a result as debtor countries adopted the first debt to equity programs and corporations sought emerging market loans for the purpose of converting them into foreign direct investment.

In December 1987 the Basel Convergence Agreement was made which resulted in an increase in the loan loss reserve and capital adequacy requirements for commercial banks. Thus banks with NPL on their balance sheets became suppliers of loans. These banks were joined by banks wishing to reduce their exposure to particular borrowers or industry sectors became the suppliers of the distressed debt market. This resulted in evolution of opportunities like entering into loan agreements receiving upfront fees and selling the distressed assets to clean the balance sheets thus freeing funds for further loans. The market for distressed assets was first developed in US and as the financial sectors of other countries matured, this market evolved in other areas as well.

In 1990 the US witnessed a recession, a credit crunch, the Gulf War, the melt-down of many of the prominent LBOs of the 1980s, and the government's war on junk bonds. The accumulation

of these events had tangible effects on creditworthiness (for example, the default rate on high yield bonds reached 10 percent) and a very negative effect on debtholders' psyches. Investors were unwilling to hold the securities which brought their prices low. This generated opportunities for bargains in distressed debt. And it was in 1990 when unsecured corporate debt began to be traded like emerging market debt.

Likewise, in 2002 we also saw a recession and credit crunch, this time along with the invasion of Afghanistan, the collapse of the telecom industry, and the disclosure of corporate scandals beginning with Enron and eventually affecting several other companies. The default rate on high yield bonds once again soared past 10 percent, and downturn turned holders of the debt of many former high grade companies into highly motivated sellers. As had been the case in 1990, purchases of distressed debt made in 2002 had the potential to produce ultra-high rates of return.

So are the bargains always this good? No because the helpful influences for most investors are bad for those looking for bargains in distressed debt. In 1996, for example, the economy was strong, business was good, and capital markets were willing to solve overextended companies' financial problems. Investors and creditors were happy. There were no adverse influences and no forced sellers. As a result, there were few chances to buy distressed debt capable of producing the returns investors look for.

In distressed debt, the profit opportunity is cyclical, rising and falling as described above. Potential distressed debt supply is created through the unwise extension of credit and turned into actual supply when conditions deteriorate. But at other times, usually after a round of losses has punished investors and lenders, discipline in credit standards reasserts itself and the supply of potential distressed debt contracts. So the opportunity for distressed debt investing is limited.

And even when conditions are good for distressed debt investing, performance still cannot be accomplished without skillful execution. Judgments have to be made about the survivability, prospects and value of an enterprise in crisis, and about the legal and restructuring process that will reset an indebted company's balance sheet and usually turn many creditors into owners. These judgments have to be made from the outside and often at a time when financial information is insufficient and possibly of questionable validity. Hence, distressed debt investing from time to time provides investment opportunities with great potential, but the outcome will always be dependent on skillful execution.

Distressed Debt Models

Distressed debt investment models can be divided into six categories.

DISTRESSED DEBT INVESTMENT MODELS		
INVESTMENT MODELS	INVESTMENT TYPES	EXPLAINATIONS
TRADING MODEL	Sovereign Distressed Debt	Trading of defaulting and near defaulting countries debt including FCY & LCY bonds, restructured notes & claims.
	Corporate Distressed Debt	Trading of defaulting and near defaulting countries debt including FCY & LCY bonds, bank loans & trade credits.
PASSIVE MODEL	Passive Event Driven	Acquisition of corporate debt to benefit from anticipated corporate event without intending to make that event occur.
	Passive Capital Arbitrage	Acquisition of corporate debt and concurrently taking a position in securities in anticipation of perceived opportunity.
ACTIVE MODEL	Active Blocking	Acquisition of corporate debt in order to block an anticipated event in order to create a more profitable exit.
	Active Facilitating	Acquisition of corporate debt in order to creat an anticipated event in order to create a more profitable exit.
CONTROL MODEL	Control Restructuring	Acquisition of corporate debt in order to achieve controlling interest to profit from instigation of operational turnaround.
	Control Capital Arbitrage	Acquisition of controlling interest in a corporate & taking a position in securities for a perceived arbitrage opportunity.
PORTFOLIO MODEL	Corporate NPL Portfolio	Acquisition of distressed bank loans & underlying securities in order to profit from asset disposals and settlements.
	Real Estate NPL Portfolio	Acquisition of distressed bank loans & underlying real estate in order to profit from asset disposals and rental yields.
	Retail NPL Portfolio	Acquisition of distressed bank retail loans i.e. personal trade debtors in order to profit from asset disposals & settlements.
LENDING MODEL	Distressed Corporate Lending	Provision of controlled lending to distressed corporates on a super senior and fully secured basis.

The players in current distressed debt business can be divided in three broad categories. First, there are distressed debt traders that are looking for investment opportunities in which they believe the debt obligations are fundamentally under priced and will rebound in value. This type of investor does not seek to control the company. The holding period on an individual security is usually weeks, sometimes days, and the size of a particular position is not directly relevant. This is the most liquid of these investment strategies, and in part for that reason hedge funds are major players in this sector.

Second, there distressed debt investors. These investors look to accumulate significant positions in companies that are likely to go through, or are in, a bankruptcy restructuring process. The goal is to gain a position of influence in that restructuring process in which the value of securities and indeed the nature of the end securities exchanged is negotiated in bankruptcy in order to maximize returns. This complex process necessitates a longer holding period than in a trading

strategy, as well as larger, more concentrated portfolio positions. Private equity funds and hedge funds engage in this type of investment.

Third and possibly the largest category are the financial institutions who become inadvertent investors as the loans held by them become distressed.

Regardless of the different investment strategies, the skills and procedures necessary for successfully investing in the distressed assets are common to participant investors. These investors need to have fundamental valuation and technical skills as well as disciplined asset management capabilities with specialization in non investment grade cash flow valuations.

Invariably, all distressed debt investors under take serious financial, technical and legal due diligence covering both the underlying loan and the borrower. Such due diligence is highly focused on value investing rather than value creation with an aim to capture the value upfront through discounted entry. Value creation is looked at as a side effect of the transaction and is treated as upside only.

Distressed debt investing has over 13 different models and over 32 subcategory processes worldwide, however the underlying investment thesis in all models is based on a 3 step philosophy i.e. buy cheap, unlock value & sell on profit. The trick is to align these steps with the given market dynamics and regulatory frame work of targeted region.

Asset Management Company

An "Asset Management Company" (AMC) is an entity established for the purpose of owning and/or managing assets acquired from troubled or failed financial institutions. It may be either publicly or privately owned bearing a mandate with respect to scope of its activities (sales, corporate restructuring, billing, payment receipt, property management, foreclosure, etc) and the types of assets under its management (banks, loans, real estate, operating companies, equities) for a time span in accordance with the desires of its owners.

When an AMC is publicly owned, it is preferable to refer to it as an asset "resolution/reconstruction" company (ARC). The word "management" tends to divert attention from its true purpose which is to group the NPA from one of more banks, categorize the assets by type (level of default, type of collateral, industry, real estate, furniture and fixtures, etc.) and then package them for sale, either individually or in pools. Assets should be brought to market on a timely basis, without undue disruption to the underlying markets, and in a manner that ensures

the receipt of maximum value. This may require the restructuring of the assets. But, given the importance of unlocking the remaining value of nonperforming assets to economic recovery, the goal of the resolution entity should be clearly focused from the outset on the disposition or liquidation of assets within a medium term framework rather than the indefinite "management" of the stock of NPA for a prolonged period of time.

ARC have been used worldwide, particularly in Asia, to resolve NPL problems, and have had a varying degree of success. The experience of some of the countries having used ARC is given below:

- In 1980s, U.S. used government sponsored ARC - Resolution Trust Corporation (RTC) to overcome thrift crisis. RTC functioned as an effective sales mechanism for disposal of assets.

- In early 1990s Mexico and Sweden successfully used the ARC mechanism to clean and re-privatize/ recapitalize the banks.

- Korea used ARC for acquiring and disposing NPA. The ARC used securitization and joint venture route for investor participation in the assets.

- In Malaysia, a centralized ARC was set up at the instance of Government. Government of Malaysia restructured and consolidated the banking system and also guaranteed the issuance of asset based security (ABS) papers by ARC, which were backed by NPA acquired. The ARC focused on resolution of the assets rather than rapid liquidation to third party investors.

- In Taiwan, the ARC model envisages liquidation of assets through the sale of assets to investors. Government of Taiwan allowed the banks to phase out the losses on such transfer over a period. Besides, the Government also provided several fiscal incentives for transfer to ARC.

- Japan, China, Thailand and Indonesia have also used ARC mechanism during the South-East Asian crisis.

While most countries have chosen the ARC mechanism for resolving the NPL problem other countries have chosen to let the banks resolve this problem. There is no evidence that one solution is preferable to the other. It is clear, however, that to be effective both require a strong enabling framework which includes contract enforceability, induce losses on borrower and owners, and clear, consistent policies as well as commitment to timely sale of the assets.

Operations of ARC

ARC perform due diligence of the target portfolio of assets and then create special purpose vehicles (SPV) which are hollow companies and hold those NPA. This is done to protect the ARC balance sheet from legal attacks by the borrowers. After performing another round of due diligences, all the assets are categorized on the basis of the loan quality, the underlying security etc. and SPV for every category are created separately to hold a single kind of assets. Then a servicer is hired to get value out of those distressed assets. Different kinds of assets require different kind of expertise to deal with them. Normally the servicer is paid an upfront fee of 1% and 10% of the upside while the management gets 2% fee and 70% of the upside.

All ARC typically have three phases of operations which are:

- **Entry:** it involves due diligence of the underlying assets of any NPL and then a discounted entry is made.

SINGLE ASSET SLECTION CRITERIA

PARAMETERS	SCALE	NATURE
Project Sponsor	Genuinely Distressed	Absolute
Project Economics	Restructuring Driven	Relative
Project Management Team	No Major Changes Required	Relative
Project FCFF	Minimum 10% of Debt Stock	Relative
Project Business	No Turn Around Required	Relative
Project Plant	No Major Capex Required	Absolute
Project Upsides	No Reliance on Grow th	Relative
Exit Target	Maximum 5 Years	Absolute
IRR Target	Minimum 30%	Absolute
Cash Multiple Target	Minimum 1.5	Relative
Investment Size	Minimum Rs.500m	Relative
Investment Security	Minimum 1.5 times Investment	Relative

- **Spread:** this phase starts with the deployment of funds and deals with the constant monitoring of the assets performance as against what was originally planned.

SPREAD MONITORING GRID

INVESTMENT CLASS	RATING	INVESTMENT CHARACTERISTICS
AA	Excellent	Performance and Expected Returns Higher than Plan
A	Stable	Performance and Expected Returns at Par w ith Plan
B	Under Performing	Performance and Expected Returns Low er than Plan
BB	At Risk	Performance Significantly Low er than Plan & Capital at Risk
C	Failed	Likely Total or Near Total Investment Loss

- **Exit:** there are several methods available for the exit from the investment; it can be through selling of shares or upright fees etc.

Advantages of ARC vs. Bank Led Resolution Efforts

Centralized Public ARC

- Oversight, governance and management of one agency easier than in case of multiple bank led efforts
- Provides the opportunity for the implementation of standardized treatment of all debtors
- Severs the relationship between the bank and its borrowers and allows banks to focus on returning to profitability and the return of intermediation
- Aggregates loans and collateral from many banks providing focal point for restructuring efforts. Provides economies of scale which may lead to reduced resolution costs through the consolidation of scarce resolution skills and elimination of duplicative systems
- Large number of assets provides better opportunity to structure asset pools to create value

Bank Led Resolution

- May be more difficult to exert political pressure against a number of financial institutions
- Preserves information and knowledge about the borrowing relationship
- Banks can provide additional financing, if required to consummate a restructuring
- Allows for continued, active management of assets
- Provides valuable training and reinforcement of resolution practices within the banks

Asset Sales vs. Corporate Restructuring

Studies have shown that assets left in the hands of the state deteriorate. Thus, the goal of a successful resolution program is to return the NPA to the private sector as quickly as possible. To do this, assets must be sold. The timing and manner of these sales is controversial. In cases where the assets have not been marked to market and the illusion of value persists, the disposition process may be viewed as a dumping of assets. All sales should be conducted through an open and transparent process with all qualified investors provided access to timely and accurate information. Due diligence period should be adequate in length for the complexity of the transaction.

One difficult decision in asset resolution is determining the proper timing of sales. Should the pool of assets be sold today or can it generate a higher return if sold later? Early asset sales are necessary to determine the clearing price of the assets. Due to the uncertainties regarding the process, the nature of the assets and the investor's ability to achieve an acceptable rate of return, this price will, of necessity, be low. But once investors are seen to be making money, competition will enter the market and prices will rise.

To a certain extent, the timing, composition, and structure of asset sales will be driven by the market's appetite. Asset resolution companies need to think of themselves as marketing firms and to be client driven. They need to regularly survey market participants to determine what they are interested in and then attempt to meet these needs by properly packing their assets.

The temptation is great to hold assets in an attempt to create value, particularly through corporate restructuring. Corporate restructuring is absolutely necessary but the question remains "Is it better done by the public or private sector?" There is little evidence to support an ARC claim to enhanced value through restructuring. Hence, they should be sold to and restructured by the private sector, where the incentives for resolution, including restructuring, are better.

In those cases where restructuring is deemed appropriate, great care must be taken to ensure that the restructuring is done on commercial terms and results in an economically viable corporate entity. The restructuring process is generally lengthy and contentious as losses will have to be apportioned amongst the owners and creditors and a change in ownership and management would take place. Hence, there is temptation to engage in "cosmetic" restructuring.

When restructuring is conducted, the ARC should develop and publish a set of core principals guiding the restructuring process. These should incorporate the principles for informal workouts discussed earlier and provide for the ARC to accept the decisions of a majority of similarly situated private sector creditors.

In cases where the legal and insolvency regimes are weak, ARC have been granted special or extra-judicial powers. Generally, these involve an expedited process for reducing claims to judgments and confiscating assets. Additional safeguards should be provided to guard against potential abuse including provisions for a limited lifespan for use of the powers.

Structure of NPL in Pakistan

Like other developing countries Pakistan also faced a serious NPL problem. All the major banks and financial institutions in country were state owned till when they were privatized a few years back. Even now, the largest commercial bank in the country and all the major development financial institutions (DFI) are state owned. These state owned institutions were plagued with the NPL disease and constituted the major chunk of NPL in the country. State owned banks alone contributed Rs.153 billion towards the NPL market.

The NPL showed a rising trend in the 1990s because of lack of effective financial regulations and strategies to deal with both defaulted loans and defaulters. This condition has changed during the last several years because the government has taken an active interest in resolving this problem through new regulations and measures and with the privatization of nationalized banks.

Pakistan had a debt market of Rs.2045 billion in 2003 comprising of the following segments:

PAKISTAN DEBT MARKET		
CATEGORIES	AMOUNT	PERCENTAGE
Banking Debt	1083.0	53.0%
Government Debt	895.8	43.8%
Semi Government Debt	40.2	2.0%
Corporate Debt	25.8	1.3%
TOTAL	2044.8	100.0%

The Pakistani banking debt is the category which would present opportunities for distressed debt investing. With the recent expansion in credit due to low interest rates the banking debt would have increased substantially (recent figures not available).

Pakistani state owned commercial banks and other financial institutions held the major pool of NPA. The following table shows the categories of banks and the amount of NPL.

AMOUNT & PECENTAGE OF NPL IN FINANCIAL INSTITUTIONS			
	1990	1995	2000
Nationalized Banks	39.0	89.3	153.0
Private Banks	-	2.4	13.6
Foreign Banks	2.1	3.2	7.0
All Banks	41.1	94.9	173.6
DFI	22.8	39.6	83.4
HFC	0.6	4.3	9.3
Others	1.6	3.7	3.0
NBFIs	25.0	47.7	97.8

It is visible from the table that the NPL held with the nationalized banks have been increasing over the period 1990-2000. In the following table the NPL stock held by nationalized banks has decreased. This is because of measures adopted by the government including the privatization of state owned banks.

The banking debt is further distributed in the following manner along with corresponding bad debts in 2003:

PAKISTAN BAD DEBT MARKET			
INSTITUTIONS	DEBT STOCK	BAD DEBT	BD/DS %
Nationalized Banks	434.4	120.6	27.8%
Privatized Banks	145.8	28.8	19.8%
Private Banks	180.6	20.4	11.3%
Foreign Banks	136.2	7.8	5.7%
Specialized Banks	127.2	72.0	56.6%
Development Banks	58.8	37.8	64.3%
TOTAL	1083	287.4	26.5%

The NPLs of both commercial and specialized banks rose to Rs.184 billion at end-March 2007 from Rs.173 billion at end-December 2006 – a rise of Rs.11 billion in just three months. The World Bank estimates Pakistani banking sector to have NPLs worth $3 billion. This figure corresponds to the March 2007 NPL figure. This latest figure has substantially reduced from Rs.287 billion some years back due to the cleaning of the balance sheets of the banks through the process of write-off of NPLs, sale of NPAs and recovery of NPLs.

The stock of non-performing loans net of provisioning also increased to Rs.47 billion from Rs.36.5 billion. And as a result, the ratio of net NPL to net loans climbed to two per cent from 1.5 per cent. Over this period, the gross NPL of commercial banks rose to Rs.142.8 billion from Rs.134.5 billion, and that of specialized banks increased to Rs.41.3 billion from about Rs.38.7 billion.

It has been observed that when the private sector credit grows strongly in a particular year, the stock NPL shows a build up in the following year. Due to lenient credit policies of banks during 2006 it is expected that NPLs would increase further in 2007.

According to one recent report government banks and financial institutions have written off loans totaling over Rs.33 billion ($540 million) during the last three years. The report to the Senate conveyed that an amount of Rs.5.66 billion was written off in 2003, Rs.10.42 billion in 2004, Rs.9.908 billion in 2005 and Rs.7.15 billion in 2006.

The industrial sector remained the major beneficiary, getting loans amounting to Rs.25.82 billion written off. In 2006 alone, the loan write-offs and other forms of financial relief by the five largest banks (NBP, HBL, MCB, UBL, and ABL) to textile companies aggregate to over Rs.6 billion.

In addition, loans to the tune of Rs.3.21 billion and Rs.2.83 billion obtained by trading and agricultural sectors were also written off during the period. One report claims that the write off by ZTBL during FY 2006 was Rs.22 billion. The bank wrote off Rs.16.7 billion in March 2006 and Rs.5.2 billion in December 2005.

Earlier, the loans written off in 1985-1988 were of Rs.16.6 billion. This figure is quite misleading as Rs.87 billion worth of loans were written off and publicly disclosed by Prime Minister Moeen Qureshi.

Back in 1999 Finance Minister told the Senate that loans worth over Rs.30.6 billion had been written off or part of these rescheduled. In the same year Dr A. R. Kamal, chief economist of the Pakistan Planning Commission, said that the structural deficiencies and political influence in writing off huge loans had resulted in bad debts exceeding Rs.300 billion.

During 1999-2003 loans written off amounted to Rs.23.5 billion. And in the period from 2004-2006 the loans written off amounted to Rs.33 billion. This shows an increasing trend.

One thing is clear from the information presented above – Pakistan has been suffering from a severe NPL problem. The actual figures are always more than the published ones for the reason that many loans are politically motivated and these amounts are only disclosed when an opposing party comes into power.

Characteristics of NPLs in Pakistan

The composition and inherent characteristics of NPLs can vary significantly between and within the countries and cultures. These variations include:

- economic segments and sub-segments are most affected (real estate, manufacturing, services),
- key geographical concentrations
- competitive characteristics
- obsolescence issues
- management quality
- the regulatory environment

Thus it is important to understand the key characteristics of Pakistan's NPLs and this will provide an insight into the resolution of these distressed assets.

The NPLs in Pakistan constitute the following characteristics:
a) Concentrated in the large-scale manufacturing sector with a few exceptions (e.g., trading and construction). The worst affected sector is the large-scale manufacturing sector with key concentrations in textiles, cement, and sugar and public sector companies. The small and medium-sized enterprise (SME) sector in Pakistan is not seriously impacted. The reason behind this is high leverage/under-capitalization in the large-scale manufacturing sector and debt aversion/low leverage in the SME sector.

b) Concentrated in the public sector banks and financial institutions. Few years back nearly 90% of the country's NPLs were concentrated in state owned banks and financial institutions. The ratio of net NPLs to net loans in the private sector and the foreign banks has rarely exceeded single digits.

c) "Zero Equity" projects in Pakistan and augmented the problem of NPLs. In the 1980s and 1990s, liberal project finance (lax in due diligence by the banks), collusive lending, poor corporate governance and bureaucratic regulators led to NPLs. In this period, hundreds of

projects were set up where the paid-up capital of the company was nominal. This under-capitalization and high gearing become the norm and many of these projects could not withstand even a minor business downturn.

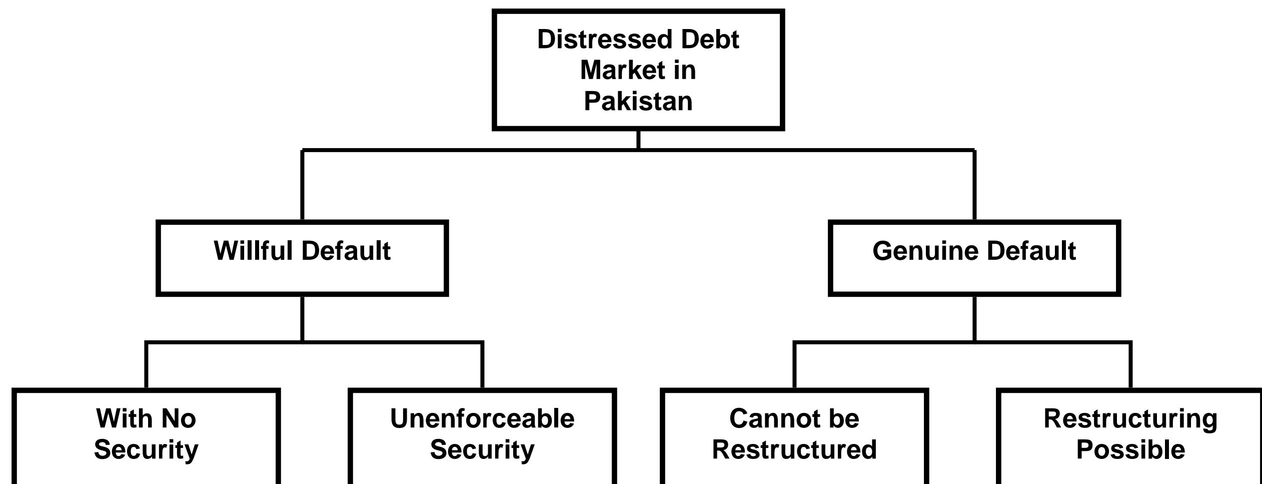
d) While there are several well-established and well-managed business groups, around a third of the NPLs came from new entrants into industry with diverse backgrounds (e.g., agriculturists, bureaucrats, senior military officials, and judges). These entrepreneurs did not have the skills to run an efficient enterprise and also most of these defaulters are very influential and thus hinder the efforts for the NPL resolution.

e) Over-capacity/lack of competitive advantage are the major factors that lead to the genuine default of the businesses and are responsible for a large portion of NPLs. Certain large industrial segments have significant over-capacity, which only a sustained period of high economic growth can cure e.g., the cement industry has functioned at less than two-thirds capacity utilization for over a decade. There are other industrial segments that lack competitive advantage and should not have been set up in the first place e.g., sugar, where the average yields for most mills is 7%. Thus such projects that cannot utilize their full capacity are at a competitive disadvantage are very likely to default.

f) Politically motivated loans also led to the creation of NPLs. The senior management of public sector banks and other financial institutions would be selected by politicians and/or military officials for considerations other than professional competence. These individuals were often asked to repay political patronage by making loans that were designed not to be repaid. These were NPLs at birth. This culture of obtaining loans through coercion was a major cause of the high amounts of NPLs in the public sector banks.

Distressed Debt Market in Pakistan

Pakistan had NPLs amounting to Rs.184 billion in early 2007 which has witnessed significant reduction in the past few years. It is divided into 4 categories on the basis of the underlying securities



Willful Default – No Underlying Security

This segment of bad debt market represents debt stock which exists only on papers and has no assets on ground. A major portion of this segment is a derivative of political loans where the borrowers are powerful individuals with strong political and/or non-political connections in high up bureaucracy. They were granted loans by DFIs and commercial banks either without proper due diligence or without proper security documentation. They can pay back their debt but are not willing to do so and as the underlying security has no value thus nothing can be done for the recovery of such loans. Most of the DFIs like ICP, NDFC and BEL have significant amount of exposures in this category.

Willful Default – Unenforceable Security

This segments of bad debt market represents debt stock which can be restructured but the owners of the project are unwilling to have them restructured mainly due to tax reasons. Almost entire exposure in this category is owned by willful defaulters. In most cases borrowers are strong land lords with pledged assets in their ownership areas, where security enforcement is almost a non-option. Most of the projects in this category are agriculture based. This segment is more prevalent in public commercial banks.

Genuine Default – Cannot be Restructured

This segment of bad debt market represents debt stock where projects have become non-performing due to changes in the macro economic variables including but not limiting to changes in government policies, withdrawal of subsidies, international dumping, demand or supply shift of economics etc. This is the real problem sector and these projects cannot be restructured within the existing economic environment. Most of these cases are genuine defaulters which should have been written off long time back.

Genuine Default – Restructuring Options Available

This segment of bad debt market represents debt stock where the projects became non-performing due to genuine reason, owners are willing to rescue and the project can be restructured. Most of the cases in this category require simple working capital induced restructurings with long term debt adjustments. This category has mainly suffered due to ever-greening by banks without addressing the core underlying issues. This is the category that not only presents exciting opportunities for a distressed debt player but also has tremendous untapped developmental value in terms of macro economic goals.

NPA Classification Standards in Pakistan

CLASSIFICATION & PROVISIONING OF SHORT/MEDIUM & LONG TERM FINANCING FACILITIES			
CLASSIFICATION	**DETERMINANT**	**TREATMENT OF INCOME**	**PROVISIONS TO BE MADE**
SUBSTANDARD	Where interest or principal is overdue by 90 days or more from the due date.	Unrealized interest to be kept in Suspense Account and not to be credited to Income Account except when realized in cash.	Provision of 25% of the difference between OPB and FSV plus RV of liquid assets realizable.
DOUBTFUL	Where interest or principal is overdue by 180 days or more from the due date.	As Above	Provision of 50% of the difference between OPB and FSV plus RV of liquid assets realizable.
LOSS	Where interest or principal is overdue by 1 year or more from the due date.	As Above	Provision of 100% of the difference between OPB and FSV plus RV of liquid assets realizable.

These provisioning standards were introduced through a SBP circular on November 1, 2005. There were four classifications for the nonperforming debt which were reduced to three under this circular. The following table shows the classifications which existed before this circular was enforced.

CLASSIFICATION & PROVISIONING OF SHORT TERM FINANCING FACILITIES			
CLASSIFICATION	**DETERMINANT**	**TREATMENT OF INCOME**	**PROVISIONS TO BE MADE**
OAEM	Where interest or principal is overdue by 90 days or more from the due date.	Unrealized interest to be kept in Suspense Account and not to be credited to Income Account except when realized in cash.	No provision is required
SUBSTANDARD	Where interest or principal is overdue by 180 days or more from the due date.	As Above	Provision of 25% of the difference between OPB and FSV plus RV of liquid assets realizable.
DOUBTFUL	Where interest or principal is overdue by 1 year or more from the due date.	As Above	Provision of 50% of the difference between OPB and FSV plus RV of liquid assets realizable.
LOSS	Where interest or principal is overdue by 2 years or more from the due date.	As Above	Provision of 100% of the difference between OPB and FSV plus RV of liquid assets realizable.

Some of the important sub-guidelines are discussed below:

- Liquid assets mean realizable amount of bank deposits, certificates of deposit, government securities, shares of listed companies, NIT units, certificates of mutual funds, gold ornaments, inventories pledged to banks or NBFIs with possession with 'perfected lien' duly supported with flawless documentation.

- Classified loans or advances that have been guaranteed by the Federal Government would not require provisioning, however, mark-up or interest on such accounts shall be taken to suspense account instead of income account.

- In addition to the above time based criteria, subjective evaluation of performing and non-performing credit portfolio shall be made for risk assessment and where considered necessary the category of classification determined on the basis of time based criteria shall be further downgraded. Such evaluation shall be carried out on the basis of adequacy of security inclusive of its realizable value, cash flow of borrower, his operation in the account, documentation covering advances and credit worthiness of the borrower, etc.

- The rescheduling and restructuring of NPLs shall not change the status of classification of a loan or advance unless the terms and conditions of rescheduling or restructuring are fully met for a period of at least one year (excluding grace period, if any) from the date of such rescheduling or restructuring. Accordingly, banks and NBFIs are directed to ensure that

status of classification as well as provisioning is not changed in relevant reports to the State Bank merely because of the fact that a loan has been restructured or rescheduled. However, while reporting to the CIB, such loans/advances may be shown as "rescheduled or restructured" instead of "default".

Banks and NBFIs will continue to classify their loans or advances portfolio and make provision there against in accordance with the time based criteria prescribed above. However, where a bank or NBFI wishes to avail of the benefit of collaterals held against loans or advances they can consider the realizable value of assets mortgaged and pledged for deduction from the outstanding principal amount of loan and advances against which such assets are mortgaged and pledged, before making any provisions. The realizable value shall be the value that could currently be obtained by selling the mortgaged and pledged asset in a forced or distressed sale conditions. Accordingly, banks and NBFIs shall take into account only forced sale value into consideration while determining the required provisions. Loans and advances against which securities are not available, or which have not been valued according to these guidelines and verified by the external auditors, shall continue to be classified and provided for according to the time-based criteria.

Liquid Assets

Valuation of Liquid Assets, excluding pledged stocks shall be determined by the bank itself and verified by the external auditors. However, in the case of pledged shares of listed companies values should be taken at market value as per active list of Stock Exchange on the balance sheet date.

Pledged Stocks

In case of pledged stocks of perishable and non-perishable goods, forced sale value should be provided by valuers, which should not be more than six months old, at each balance sheet date. The goods should be perfectly pledged, the operation of the godowns should be in the control of the bank and regular valid insurance and other documents should be available. In case of perishable goods the valuer should also give the approximate date when these are expected to be of no value.

Investments and other Assets

Subjective evaluation of investment portfolio and other assets shall be carried out by the bank and NBFI. Classification of such assets and provision required there against shall be determined keeping in view the risk involved and the requirements of the International Accounting Standards.

Timing of Creating Provisions

Banks and NBFIs shall review, at least on a quarterly basis, the collectibles of their loans and advances portfolio and shall properly document the evaluations so made. Shortfall in provisioning, if any, determined as a result of the quarterly assessment shall be provided for immediately in their books of accounts by the banks and NBFIs.

Verification by the Auditors

The external auditors as a part of their annual audits of banks and NBFIs shall verify that all requirements of Prudential Regulations in classification of assets and determination of provisions required there against have been complied with. The State Bank shall also check the adequacy of provisioning during on-site inspection.

Problems with these standards

The major problem in these provisioning standards existed in the OAEM category. This category required keeping the unrealized profits of such loans in suspense account while no provisioning was required to be done. This enabled banks carry out the ever greening of their financials; artificially portraying a better position. The balance sheets of the banks overstated the quantum of quality assets as NPAs falling into the OAEM category were not been provisioned for. The leverage that loans which were overdue by 90 days did not require any provision gave an incentive to the banks that whenever a loan was about to be categorized as substandard it was restructured and brought into the OAEM classification.

Apart from hindering the balance sheets from showing the true picture, this practice also resulted in increasing the NPL amounts. Whenever a loan is restructured, the overdue interest is added to the outstanding principal and treated as the new principal amount in return for giving more time to the borrower. There is no limit on the time period for which the loans can be restructured and thus the banks would restructure their loans periodically. Due to restructuring loans banks recorded more and more unrealized profits while increasing the outstanding amount which was never to be recovered.

The removal of the OAEM classification resulted in greater transparency in the NPLs held by the banks. OAEM category was misused frequently and this contributed towards the aggravation of the NPL problem. The government realized this and removed this category from the provisioning standards.

Treatment for Loss Category Loans

The SBP developed a set of guidelines for writing off of irrecoverable loans/advance and issued this circular 29 on October 15, 2002. This circular was aimed at enabling banks to deal with the loans in loss category, which had been outstanding on the books and for which the probability of recovery is negligible. These revised guidelines would facilitate the banks in clearing their stock of irrecoverable debt. The benefits of this approach are that the balance sheets of the banks will be strengthened and NPL drag portion in the lending rate will be reduced.

These instructions did not affect the legal right of financial institutions to recover the written-off loans if they wanted to pursue them legally. For the purpose of write offs arising as a result of settlement of the irrecoverable loans, these guidelines divide these loans in three categories

Category A

Loans having outstanding amount up to Rs.0.5 million fall into this category. For writing off these loans, the management should obtain a resolution from Board of Directors empowering it or its committee to write-off such loans on case-to-case basis without going for litigation. However, bank/NBFI should formulate internal policy/guidelines spelling out the criteria for write-off of these loans.

Category B

Loans having outstanding amount of more than Rs.0.5 million and up to Rs.2.5 million fall in this category. It has three further sub categories

Criteria	**Amount to be recovered**
Forced Sale Value (evaluated by the bank /NBFI) of the security is more than the outstanding amount.	75% or more of the outstanding should be recovered in cash.
Forced Sale Value (evaluated by the bank / NBFI) of the security is less than the outstanding amount.	A sum equal to Forced Sale Value (evaluated by the bank / NBFI) should be recovered in cash.
Where no tangible security is available.	Efforts should be made to recover maximum possible amount.

Category C

This category comprises of loans having outstanding amount of more than Rs.2.5 million. It also has three sub categories

Criteria	Amount to be recovered
Forced Sale Value of the security is more than the outstanding amount.	75% or more of the outstanding should be recovered in cash.
Forced Sale Value of the security is less than the outstanding amount.	A sum equal to Forced Sale Value should be recovered in cash.
Where no tangible security is available.	Efforts should be made to recover maximum possible amount.
Forced Sale Value should be determined by an independent professional valuer who should be listed on the panel of valuers maintained by the Pakistan Banks' Association (PBA)	

Apart from the above guidelines on the write off, the authorities also provided some sub guidelines to the above ones in order to clarify and regulate the entire process of write offs.

- Before allowing write-off, all liquid assets including FDRs, Government Securities, and Share Certificates etc held under lien and pledged goods should be realized and sale proceeds should be appropriated towards the reduction of outstanding liability of the borrower.
- The latest valuation of properties/stocks held as security having value of Rs.2.5 million and above indicating their present market value as well as their forced sale value duly assessed by a surveyor/ architect, on the approved panel of Pakistan Banks' Association (PBA), should be produced before the approving authority.
- In case the bank is not in a position to recover even 75% of Forced Sale Value of the security due to any reason, the Board of Directors/designated authority may allow relaxation by recording reasons/justifications thereof.
- Outstanding Loans include the amount of principal and interest / mark-up and other per forced charges charged to the borrower's account or mark-up receivable account. Further, outstanding amount should be arrived at after deduction of liquid assets. However, in case of decreed cases, the decrial amount and the mark-up allowed by the Court will be treated as outstanding amount for the purpose of this Scheme.
- The settlement in above categories shall be made only on the basis of cash recovery. The borrower has to make at least 10% cash down payment of settled amount at the time of signing of agreement and remaining amount may be paid in installments at least on quarterly basis within a maximum period of 3 years from the date of signing of agreement. Under the

above arrangements the borrower will only be eligible for write-off after repayment of entire agreed amount. In case of non-adherence of terms of agreement, the borrower will not be eligible for any concession.

- The Banks/NBFIs are further advised to vigorously pursue those delinquent borrowers who fail to avail of the Scheme within the stipulated time period by processing the cases under the provisions of law. To this end an effective in-house system for recovery of defaulted loans should be developed at Head Office level, which should be charged with the responsibilities of taking all the requisite legal measures/proceedings.
- The circular instructs that disputes between the borrower and the Bank/DFI will be resolved through "SBP Committee". The decision of the Committee shall be binding on the concerned parties.

In subsequent circulars the SBP provided further clarifications which are:

- The loan originally classified as "Loss", but was declassified due to subsequent rescheduling/ restructuring and reclassified in original "Loss Category" (due to breach of agreement or any other reason) shall be eligible for write-off. For the purpose of determining the period of 3 years "Loss Category", the same will be calculated from the date on which the loan was originally/ initially classified as loss.
- Forced Sale Value (FSV) of the mortgaged assets will be valid for two years from the date on which valuation was made by the Bank/ PBA's approved panel of valuators for settlement under SBP guidelines.
- Incentives to borrowers can be given by banks/DFIs on immediate repayment of settlement amount in lump sum instead of repayment in 3 years as stipulated in subject SBP guidelines.
- Borrowers who have availed the option of a settlement under this circular may be eligible for fresh financing.

Corporate and industrial Restructuring Corporation

The above scheme offered some benefits to the borrower by allowing the write off but there were still large amounts of NPLs with the banks. Most of the NPLs of those corporations and borrowers that fell under the category of genuine default required some other measures to deal with them. Thus a company was needed that could restructure and rehabilitate those distressed companies.

The major load of NPLs was concentrated in the public sector banks. The government had decided to privatize these banks to improve their operations and to reduce the political influence. These banks could not be privatized generating maximum value unless the balance sheets of the banks had been cleared of the accumulated stocks of NPLs. Thus for the purpose of restructuring and clearing the balance sheets of the banks, the government created an asset resolution/ reconstruction company named Corporate and Industrial Restructuring Company (CIRC).

Government of Pakistan passed the Corporate and Industrial Restructuring Ordinance in 2000. It was passed with the aim to make provisions for the acquisition, restructuring, rehabilitation, management, disposition and realization of NPLs and other assets of various banks and financial institutions. CIRC was established under this ordinance to assist banks in rehabilitating the distressed enterprises, clearing up their balance sheets and to make them ready for privatization by removing the NPAs.

A "Restructuring Corporation Fund" was established to fulfill the financial needs of the newly established restructuring corporation and was granted the power to seek assistance and information from any department of the Federal Government or a Provincial Government, local authority, financial institution, law enforcement agencies etc to render such assistance or furnish such information as it may reasonably require. The corporation was entitled all the rights and remedies available to the banks, financial institutions and corporations. The bonds issued by CIRC were backed by the security of Government of Pakistan to ensure the confidence of the business parties.

CIRC was granted the powers to purchase, takeover, own, hold, sell, lease, arrange finance for, manage, dispose of, reorganize, restructure, and rehabilitate the distressed assets. CIRC could enter into any settlement or contract, realize, mortgage, hypothecate, control, and manage any loan, finance, advance, commitment, lease installment, sale contract or other activity relating to the NPAs. CIRC could initiate, take, continue, resist, implement and perform any and all

activities for the recovery of NPAs including filing suits and appeals and to enter into settlements, through the courts or outside.

CIRC is just like an asset management or assets reconstruction company with the only difference that it was setup by the government. All the banks and financial institutions were ordered by the law to transfer their NPLs to the company. The increasing cost of those NPLs to the banks made banks willing to transfer the NPAs to the CIRC.

CIRC was expected to make a significant contribution it terms of eliminating the large stock of NPLs in the public sector banks. It was also expected that since it operated under a strong enabling law, it would be able to extract better value from distressed assets than the banks operating under the auction process through the courts. It was also expected to complete its mandated tasks with considerable speed. Hence, it has a sunset clause built into its enabling law whereby it was to be wound-up six years after commencing operations by September 2006.

CIRC helped clean balance sheets of six banks (HBL, UBL, NDFC, IDBP, NBP and ABL) for the purpose of privatization and helped in the revival of about 100 industrial companies and facilitated additional investment of over Rs.2 billion by new entrepreneurs, which led to generation of over 30,000 employment opportunities in the country. Of these four banks had been privatized. During its operations the CIRC disposed of 151 NPAs resulting in a surplus of over Rs.1 billion for the government of Pakistan. Additionally, 252 NPAs having gross debt value of Rs.45.9 billion were also restructured and rescheduled through the corporation's intermediation at the end of referring banks and DFIs.

CIRC resumed its work in the minimal start-up time after its creation. It completed repayment of government loan of Rs.145 million along with mark-up before its final maturity. The CIRC made the gross recoveries of Rs.5.381 billion and created gross surplus of Rs.1.102 billion for government through disposal actions of assets.

Unfortunately, CIRC was not able to live up to the expectations owing to a variety of factors. These include the poor quality of staff, lack of expertise, bureaucratic procedures and absence of procedures for corporate rehabilitation. After about half of its mandated life, the data of progress did not show much inspiring results. 722 cases (of distressed assets/companies) were referred to CIRC by banks with NPLs of $ 2.1 billion in initial three years. CIRC returned 387 cases back to the parent banks with NPLs of $1 billion. The main reason for returning a case is that the underlying asset/company is operational and can be revived by the banks themselves. CIRC has sold 77 units for $ 46 million, and the underlying NPLs settled as a result of these sales were

$200 million or around 4% of the country's NPLs. In terms of value maximization, initial data suggests that the banks have been able to extract better values from distressed assets either through aggressive settlements with borrowers or through the auction process. CIRC was expected to do a considerable job in terms of rehabilitating the distressed companies but it merely became an auction house for the NPLs.

The main objectives of CIRC were:

1. Playing a pivotal role for Pakistan's financial sector restructuring.
2. Acquisition and Resolution of NPAs from financial institutions.
3. Management and arrangement of sales of NPAs of Government owned Banks.

Amendment in CIRC Ordinance 2004

The federal government tabled a bill on March 5, 2004 to allow all nationalized, privatized and private commercial banks to use CIRC to clean up their balance sheets. This bill amended the Non-performing Assets and Rehabilitation of Industrial Undertakings (Legal Proceedings) Ordinance 2000 (LVIII of 2000), and was known as Non-performing Assets and Rehabilitation of Industrial Undertakings (Legal Proceedings) (amendment) Act 2004.

The Non-performing Assets and Rehabilitation of Industrial Undertakings (Legal Proceedings) Ordinance 2000 limited the operations of CIRC to the financial institutions in which Government of Pakistan's equity holding was more than or equal to 85 percent and were mentioned in the schedule of the CIRC Ordinance. The main problem with this was that the criterion of Government of Pakistan's equity holding excludes the financial institutions such as Allied Bank Limited (ABL), United Bank Limited (UBL) and National Bank of Pakistan (NBP) in which the equity of the government has now dropped below the laid down percentage. Thus these institutions were unable to avail the services of CIRC to clean up their balance sheets.

Thus in order to broaden the CIRC entry criteria to accommodate all or any financial institution operating in Pakistan particularly NBP, ABL, and UBL, the ordinance was amended to simplify the process of entry of financial institutions into the CIRC program while keeping due control over any discretionary entries because of the requirement of the recommendations of the State Bank of Pakistan and the desire of the financial institution. Because of this amendment all nationalized, privatized and private banks would be able to use CIRC for their balance sheet cleaning.

Completion of the tenure of CIRC

CIRC was established with an inbuilt clause that it will have a life of six years and will terminate in September 2006. Now by the law the company has ceased to exist. The government is considering two options now that CIRC's term has expired i.e. transfer of CIRC inventory of NPAs to a government owned financial institution (National Bank of Pakistan) or privatization of the company. The benefits of each option are discussed below

Transfer of CIRC inventory to a government owned financial institution

- One benefit of this is that the government stands the potential surplus on the sales of the NPAs. Since the NPAs were acquired at fairly discounted prices and if disposed off properly they can generate handsome amount of money. Thus the government can avail this opportunity by transferring the assets of CIRC to one of its own institutions.
- Smooth transfer of portfolio will be another benefit. As CIRC is a government owned entity, the transfer of assets to another government owned entity will not involve any third party. In this case the existing infrastructure of financial institutions for handling this portfolio will be helpful.
- The major disadvantage would be reloading the government-owned financial institutions with bad portfolio. This would impose a heavy financial burden on the government as it would have to bear the cost of rehabilitation of the NPAs. Since the government will deal with these NPAs in a bureaucratic way their resolution would be slow.
- Another government owned financial institution will not have the strength that was given to CIRC. CIRC was given strong powers and legal cover e.g. special benches to dispose off the NPAs through an ordinance. Another institution cannot perform such activities unless it is registered to do so. Thus some legal provisions would be required to enable the institution to handle the portfolio of NPAs.

Privatization of CIRC

- This option would be in line with the government policy to promote private sector initiatives and government would be relieved of any direct or indirect cost of handling those NPAs.
- The disadvantage would be that government backs the bonds issued by CIRC. If CIRC is bought by a private investor then the government would be guaranteeing the debt of the private investor.

- The CIRC avails the benefit of special benches of high court to deal with the recovery and legal proceedings of NPLs. If privatized, the legal process will have to be amended to confer such benefits to the private investor.
- The private investor would be required under the privatization process to purchase all residual distressed NPAs held presently by CIRC.
- The sunset clause does not pertain to the private investor.

All the foreign examples show that initially the government owned Asset Reconstruction Company introduces the distressed debt resolution model in the country. Later the government invites private investors in the sector to introduce competition and effective resolution of NPLs. Hence, the successful models for resolving the NPL problem involve Public-Private Partnership where the private investors will invest in the sector and the government would provide the enabling framework to aid the asset reconstruction companies in their work.

Business Thesis for Distressed Debt Investor

Distressed debt investing is still a new concept in Pakistan market though there is a general understanding of the business concept along with the legal and regulatory framework. The Pakistan market with estimated $3 billion bad debt portfolio presents enormous opportunity for distressed asset resolution business. The first entrants will benefit from the luxury of cherry picking due to the absence of competition in the market. This means that the initial participant will not have to purchase the bad debt in wholesale.

The banks in the country have the somewhat bitter but relieving experience of dealing with CIRC. CIRC had purchased the NPLs from the banks at discounted prices. As payment for these NPLs the banks were issued 3 year bonds backed by the guarantee of Government of Pakistan. This caused a lot of resentment among the management of banks. Although they were glad of getting rid of the NPLs but thought that the payment terms were quite unfavorable.

The proposed plan for entry is ***"Private entry in Pakistan distressed debt market through a combination of asset management vehicle and close ended fund with primary purpose of acquiring super selected Doubtful Category loans from banks at discount with primary methodology of Actively Controlled Restructuring in order to instigate turnarounds and earn profits from a combination of secured debt and substantial sweat equity arising from unpassed discount payments and mature flipping."***

The investment thesis for the proposed asset reconstruction company (ARC) is given below:

Buy Cheap

The ARC will be targeting the doubtful category loans on bank books where 50% provisioning is already carried out. Purchase will be will be made for the remaining 50% outstanding principal balance (OPB) with the targeted discount of 50%, paying effectively 25 paisa per rupee of gross OPB.

The purchase will specifically target debt stock in which the targeted holding of the ARC will be greater than 75%.

Unlock Value

Value will be unlocked mainly by reducing the debt stock of the target company by half. This reduction in debt will be through write-off and equity conversion. This would enable the company to service its debt while the investor would get a position of the board of the company

thus being able to influence the policies of the company. This equity share could be sold off later through the stock markets. However, this has not been factored into the base economics of the deal. Any profit arising out of the sale of this equity will be considered an upside.

In most cases reducing the debt of the target project will not provide a rehabilitating solution in the absence of working capital. Therefore, short term credit line will be availed for this purpose. If the project is unable to obtain credit, than the ARC will guarantee the line till the project becomes creditworthy.

Sell on Profit

The target purchase price of 25 paisa per rupee will be booked on project as 50 paisa per rupee on a 4 years tenor giving a multiple of 2 in the base case. The 50% benefit to the project will come in the form of half write-off and half equity conversion. The value derived from the sale of equity will be treated as an upside.

Every effort will be made to flip the debt as soon as the project shows signs of rehabilitation thereby maintaining the cash multiple and increasing the IRR. The loans will be interest free and convertible so that in case of default the investment can be recovered to forced sale of assets.

Target Market

The target market for the ARC will consist of non performing loans held in banks. Within the NPLs the ARC will target those loans where the borrower has defaulted due to genuine causes and where restructuring options for the project are available. The major causes of genuine default are as follows:

- Time Over Runs
- Cost Over Runs
- National Policy Adjustment
- International Policy Adjustment
- Size Drag of Economics
- Quality Shift of the Market

In the above factors shift in the project economics result in genuine problems requiring complicated financial/operational solutions. These can lead to increasing financial costs resulting in default. Additional funds cannot be borrowed from the financial institutions due to regulatory inability of banks to lend to distressed borrowers. This result in a vicious cycle in which the distressed project requires additional funds to alleviates its circumstance while the lenders demand repayment of their debt.

Potential Competition

Distressed debt investment opportunities are currently being looked at by a number of local as well as foreign institutions/investors. Local institutions lack the required expertise and understanding of this business. Foreign players are looking credible local partners for potential joint ventures. Most of the players are waiting for the first distressed debt transaction to go through before they decide to enter the market.

Scope of Operations

- **Outright Acquisition:** This involves the purchase of distressed assets from a holder. Typically the assets are sold at a discount to the book value and must realize the loss. The sellers generally not sell the distressed assets unless they are motivated to bear the loss on the sale. This usually happens if the seller is very distressed and cash hungry or where the loss will be covered by the government. This strategy offers the highest returns on investments to the investors.

- **Fee Based Management:** This entails a distressed asset manager entering into a management contract (usually on agency basis) with the holder for management and resolution of distressed debt. The manager typically earns a free for the resolution of the portfolio but does not commit funds. Such contacts are perceived to be expensive and the interests of the holder and manager are non-aligned.

- **Partial Acquisition:** This is an increasingly popular solution in which seller participate in the upside of recoveries while the manager is kept fully aligned. This strategy involves the distressed asset manager acquiring a small interest in the portfolio he is managing. This aligns the interests of the holder and manager while providing for immediate cash flows from the resolution of the distressed assets. The manager can also earn a return higher than the base as well as achieving an attractive return for the investor.

Outright acquisitions would be the most preferable strategy to use in the Pakistan market. This is because the industry is in its infancy where banks are only concerned about cleaning their balance sheets. Fee based management would not do well in Pakistan for there is no incentive for the manager to resolve the distressed assets and additional costs will be incurred. In case of partial acquisitions the banks in Pakistan would not be interested in holding on to the distressed debt and would rather receive cash upfront.

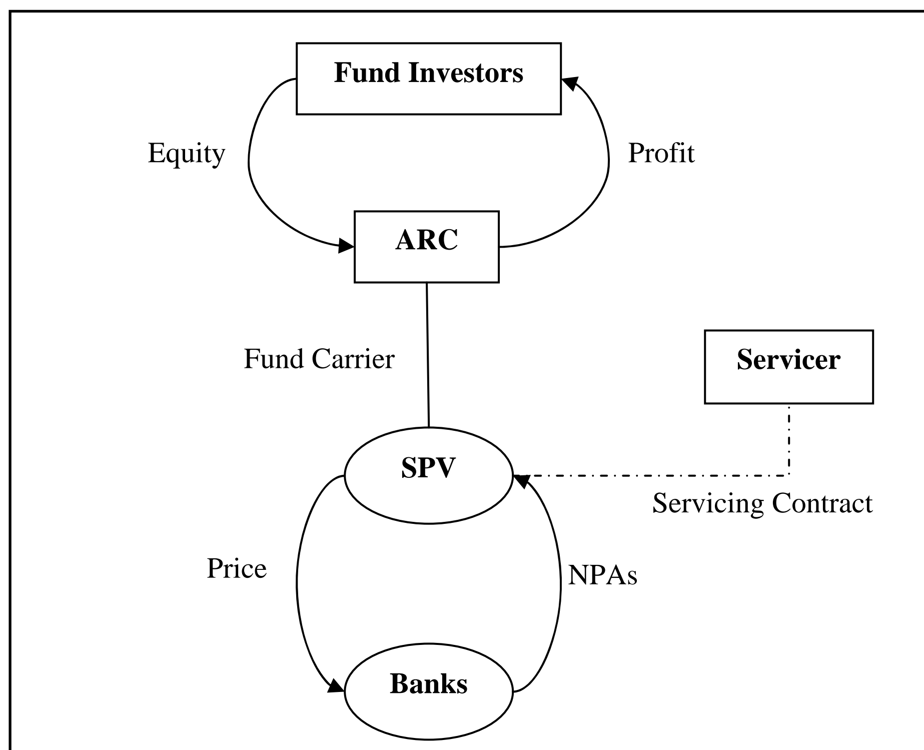
Business Structure

The distressed debt business can be divided into three main components. The business would be carried out by the synergy of these essential components which are as follows.

Asset Reconstruction Company: The asset reconstruction company would be registered as an asset management company. In addition, asset management and investment advisory licenses would be obtained to carry out the distressed asset resolution business. This is the component where the functions of deal origination, transaction structuring and fund deployment will be carried out. The ARC will represent a fund raising platform and will be used for parking the equities in the underlying investment. ARC will charge 3% management fee plus 25% of the super profit which are over and above the agreed returns to fund holders.

Special Purpose Vehicle (SPV): The SPV will be a shell entity which will represent the balance sheet where the funds will be placed along with the securities. Different SPVs will created for different funds.

Financial Servicer: The servicing company which will be used to monitor the deployed funds with the responsibilities of collections from debtors, payment to fund investors, litigations in cases of default and exiting from investments. The servicing company will work under the ARC on a contract basis by earning 1% management fee and 10% of the super profit which are over and above the agreed returns to fund holders.



Organizational Structure of ARC

An AMC by law is not allowed to make any investment with the purpose of having the effect of changing the management or obtaining control over the company. As the work of the ARC will require a controlling interest in the companies being financed, an exemption from this law will have to be obtained.

Board of Directors: The ARC will have a board of directors. The directors of the board will represent the fund investors. The board will have a chairman and the managing director of the ARC will also be a part of the board.

Investment Committee: The ARC will have an investment committee with executive powers to recommend investments to the board of directors. Only the investment committee recommended investments will be taken to the board for approval. The investment committee will have the powers to reject any deal.

Management: The ARC will be managed by the managing director. The MD will be appointed by the board and will have powers of hiring and firing the staff. The management would be responsible for the operations of the ARC.

Reconstruction Fund

Financing for the reconstruction fund can not be arranged from general public (as in case of public limited companies) but a kind of hedge fund can be created by investing companies or partners. Once the fund gives profitable results, it can be taken public. Since, there is very little understanding of the business in Pakistan so getting general public to fund it would be difficult.

The fund would be geared towards maximizing the current income to the extent consistent with preservation and deployment of capital and maintenance of liquidity. Investments shall comprise of both short term and medium term secured exposures with the objective of achieving an earning multiplier of 2 over a maximum period of 5 years.

The fund will bear the features of a close ended fund with the objectives to invest and exploit opportunities in the distressed debt sector. The fund will be deployed to cater to the restructuring needs of non-performing assets providing an external source of funds other than the banks.

Investment made by funds will be based upon 100% take out philosophy, giving the funds exclusive and sole rights over the entire asset stock of targeted project as well as preferential rights over entire cash flows.

The fund deployment strategy will be based on the classical model of distressed debt whereby the entry with an aim of capturing value upfront in the form of deep discount. The funds would be utilized in cherry picked distressed business with strong fundamentals and genuine inability to payback their debt. In addition, in line with the business model funds would move from project to lenders and not the other way round.

Funds deployed in companies would be fully secured with a first charge on the present and future assets of the company. As a rule of thumb the underlying security should be 1.25 times or more of the outstanding exposure.

The fund would be invested based on the cash multiple target for a period of 3-5 years. As a thumb rule 50% provisioned outstanding principal balances would be targeted.

The fund investors are issued Security Receipts with fixed, floating or pegged coupon rates with line with the market. The redemption of the receipts would take place at a predetermined time.

Investment & Operating Process

The investment process as discussed earlier is a 3 step model:

1. Entry
2. Spread
3. Exit

This 3 step model describes the basic distressed debt investment philosophy – discounted entry, enhance spread by unlocking value, timely exit. These steps are easier said than done. Distressed debt investing requires meticulous planning and skillful execution.

The entry process will require thorough due diligence on the part of the buyer. This due diligence will assist the investor in determining the debt which has the potential to the recover through timely restructuring and operational turnaround. The spread phase starts with the deployment of funds. This phase pertain to the control and monitoring of the underlying investment by the Financial Servicer. This phase will always be focused on early exit from both debt and equity which will be one of the integral functions of the financial servicer. The exit phase will be initiated by the financial servicer whereby the investor would liquidate its debt and equity holdings in the company.

The operating process of the ARC is divided in 5 stages:

1. Pre-prospecting stage: This stage will revolve around deal sourcing and high level scrutiny. It will involve marketing, discussions with sponsor, information sourcing and discussions. It would also decide whether the investment proposal under scrutiny is a go or no go area.

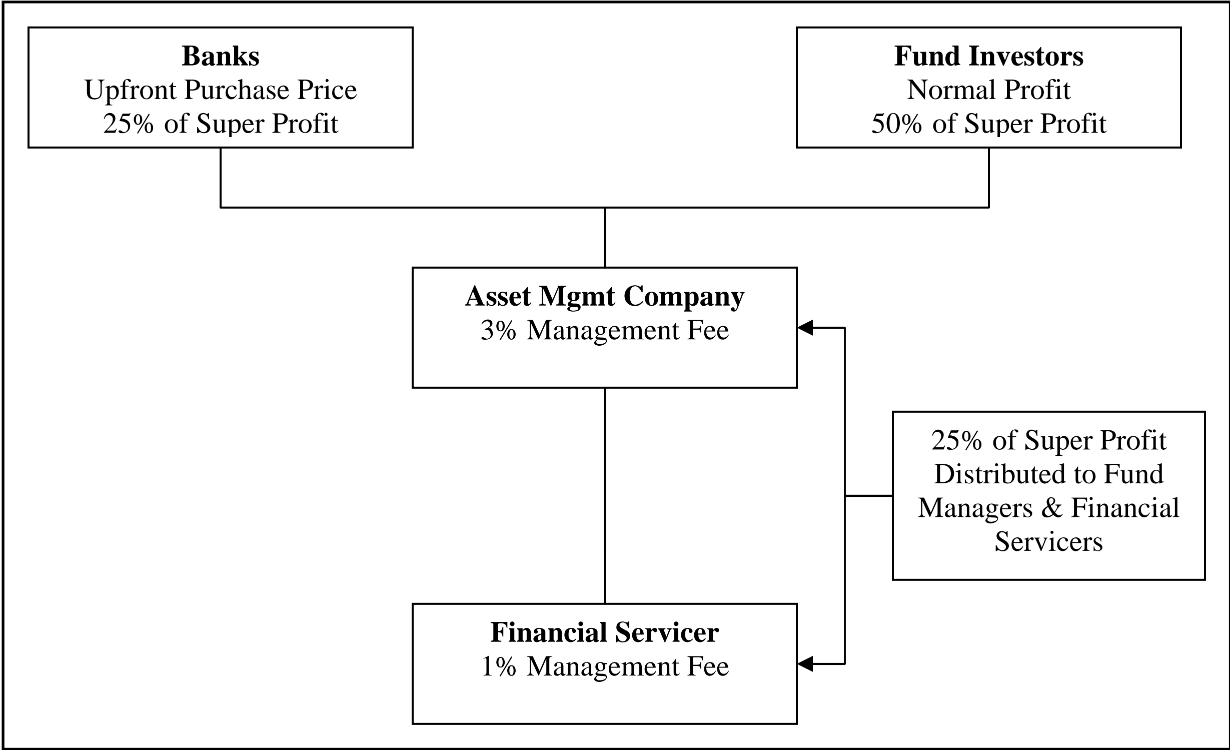
2. Prospecting stage: The prospecting stage will initiate the due diligence process with a view to understand the business dynamics and deal structure. In will involve strategic, financial, technical, legal as well as commercial due diligence.

3. Screening stage: This stage will reinforce the prospecting stage through external due diligence carried out by independent specialists. This process will provide an external view on the financial, technical and legal aspects of the deal. During this stage the process of negotiations with the sponsors and related parties would begin.

4. Mapping stage: By this stage we have arrived at the actual deal structuring. This stage will involve building of a business & investment thesis of the deal, structuring the transaction, and finalization of negotiations with the sponsors and related parties.

5. Investing stage: This stage will involve the actual deal execution. During this stage all the legal documents would the purchase of NPA would be completed and signed. Moreover, the transaction would be handed over to the financial servicer in this stage.

Distribution of Income



Normal profit is the minimum earning multiplier committed to the fund investors. Normal profits go to fund investors only. Fund manager do not get any thing.

Banks would get 25% of super profit. Remaining 75% profit is distributed to fund managers and fund investors. Fund managers charge would get 25% of the super profit while fund investors get the balance 50%.

Conclusion

Distressed debt business is a high risk business worldwide and offers high returns. Most of the active players in the market prefer to acquire a majority stake of a portfolio at a substantial discount.

The Pakistan market offers enormous potential to this business. Any investor who enters the market now will benefit from the first movers advantage. They would be able to cherry pick the distressed assets instead of buying them wholesale. With the implementation of Basel II banks would be required to keep capital adequate to the risk that they carry on their balance sheets. A riskier portfolio would mean a higher capital requirement. Hence, banks are further likely to clean their balance sheets in the future.

In addition, any investor who enters the market would first have to buy CIRC. This is essential to give the investor the legal protection needed to carry out the distressed asset resolution business. With the purchase of CIRC the investor would gain the privileges which no other investor can hope to gain unless SECP introduces laws for distressed debt and provides similar benefits to all investors. This is not likely to happen in the immediate future.

The distressed market provides a lucrative yet challenging opportunity to tackle Pakistan's NPL problem. All it requires is a firm commitment on the part of the government which is willing to support investors and provide the enabling framework for NPA resolution and patient and dedicated investors who are willing to turnaround businesses and restructure loans to build sustainable businesses for long term gains.