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Corporate Governance in the Financial Sector of Pakistan

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1. Introduction

The definition of corporate governance differs from country to country. For the case of Continental European countries such as Germany, the term refers to all the stakeholders of a firm while for Anglo-American countries corporate governance focuses on generating a fair return for investors (see Goergen, Manjon and Renneboog, 2005). The corporate governance devices utilized to ensure economic efficiency include among others shareholder monitoring, creditor monitoring, executive remuneration contracts, dividend policy and the regulatory framework of the corporate law regime and the stock exchanges.

The increasing international integration, deregulation and technological development and the resulting challenges are calling for a review of national corporate governance systems. Countries that are in dire need of external financing require stronger and effective corporate governance systems. Pakistan's failure to attract external finance – some of it from foreign investors – may be largely attributed to weak investor protection.

This paper focuses on Pakistan's banking industry given the pivotal role of banks in emerging markets. The paper reviews the recent reforms of corporate governance. It also studies the ownership and control of the 41 Pakistani banks. The paper unveils some interesting, polar patterns in terms of the ownership and control of these banks, which are difficult to associate with La Porta et al.'s (1998) characterization of common-law countries.

The paper is organised as follows. Section 2 reviews the literature on corporate governance with particular emphasis on the literature pertaining to the banking industry. Section 3 outlines corporate governance in Pakistan and Section 4 discusses the recent reforms. Section 5 is the first empirical section. The section analyses the ownership and control of Pakistan's banks and investigates whether there is a link between ownership and control on one side and bad loans on the other side. Section 6 contains the results from a survey on how the recent corporate governance reforms have been implemented by Pakistani banks. Finally, Section 7 concludes.

2. Corporate Governance in the Banking Sector

By examining 49 countries, La Porta et al. (1997) confirm the hypothesis that countries with poor investor protection have smaller capital markets. Their results provide support for the link between the legal environment and economic development. In particular, they find that countries with common law provide better shareholder protection than countries with civil law. Common law is case-based law and it is essentially the judges who make law by setting precedents in court. Civil law is codified law and the role of the judges is limited to interpreting the law texts in court. La Porta

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et al. report that common law countries – that is, countries of English law – provide the highest investor protection, followed by the Scandinavian civil law countries. Civil law countries of French origin provide the worst investor protection. Countries whose law system is based on German civil law are somewhere between the Scandinavian and French law countries.

Shleifer and Vishny (1997) argue that greater investor protection increases investors' willingness to provide financing. In turn, the greater availability of financing will lead to a lower cost of capital. For countries with emerging capital markets, such as Pakistan, corporate governance holds even more significance for both individual companies and the national economy as a whole. Since the quality of corporate governance is an important factor to investors when choosing their investment targets, the introduction of international corporate governance practices in Pakistan may help improve the national investment climate and stimulate economic growth. If corporate governance improves e.g., in the sense of increased investor protection, this will attract more investment and external resources which will strengthen the national economy.

The corporate landscape is changing dramatically all over the world. In developed countries, legal experts, practitioners and policy makers are not only striving to appraise corporate activity in better ways, but are also helping to design rules that are intended to improve the way companies are managed. In these countries, major corporate governance reforms are now under way (see e.g., Goergen, Martynova and Renneboog (2005) for a review of the ongoing reform on takeover regulation in the European Union). Leora and Love (2002) document evidence that, for the case of 14 emerging economies, the quality of corporate governance is important to investors when choosing their investment targets. They find that the quality of corporate governance is highly correlated with market valuation as measured by Tobin's Q. Similarly, if market value is measured by the return on assets (ROA), there is a positive correlation between corporate governance and firm performance.

CLSA (2001) calculate an index with corporate governance rankings (CGR). CLSA provide a CGR for 495 companies from 18 sectors in 25 emerging markets. They also assign rankings to the 25 markets according to factors such as overall market valuation, accounting and stock price performance. The study investigates whether firm level differences in terms of corporate governance have an impact on future performance, market valuation and access to external finance. CLSA (2001) assign Pakistan a weighted score of just 3.1 out of 10 in their ranking; only the Czech Republic (2.8) and Russia (2.1) have a lower score. They find a significant relationship between corporate governance on one side and financial ratios, valuation and share price performance on the other side in emerging markets.

Gompers et al. (2003) study whether variations in firm-specific corporate governance are associated with differences in firm value. Their results are consistent with those of Leora and Love (2002) and CLSA (2001). They use Tobin's Q as a measure of firm value and construct their own corporate governance index. They report a strong positive relationship between their corporate governance index on one side, and stock returns and firm valuation on the other side.

There are scores of studies that touch upon various issues of corporate governance in emerging markets. Nevertheless, corporate governance within the financial sector has as yet not been explored extensively, particularly not for the case of developing economies (Arun and Turner, 2004). Ciancanelli and Gonzalez (2003) document that almost three quarters of the member countries of the International Monetary Fund (IMF) experienced significant episodes of a systemic crisis and associated bank failures due to agency hazards. They further argue that commercial banks differ from other types of firms because of a more intricate structure of information asymmetry arising from the presence of regulation. Further, they show how regulation limits the power of markets to discipline the banks, their owners and managers. They argue that regulation must be seen as an external force, which alters the parameters of governance in banks. They believe that, agency theory is unsuitable for analyzing governance in commercial banks for two reasons. First, the assumptions made by agency theory are not satisfied. In particular, banks are unique in the sense as the principal-agent relationship is subject to regulation. Second, bank regulation, intended to prevent risk, limits the disciplinary power of market forces.

Doidge, Karolyi, and Stulz (2004) develop a model to examine the relationship between country-specific characteristics (such as the financial and economic development and investment opportunities) and the cost and benefits from improving the national corporate governance system. The model outlines the distinguishing features between investor protection granted by the country's legal system and that offered by the firm. They report that a country's economic and financial stability as well as its investment climate are an integral part of its corporate governance environment. They observe that a firm's decision of whether to offer better investor protection than that granted by the legal system is largely dependent on the costs and benefits of doing so. These costs and benefits in turn depend mainly on country-specific characteristics such as economic and financial development and openness. Crespi, Carcia-Cestona and Salas (2003) examine the governance of Spanish banks. They investigate whether poor economic performance triggers corporate governance interventions such as changes to the board of directors and takeovers. They find that bad financial performance triggers corporate governance interventions. However, the type of governance intervention varies with the form of ownership. They distinguish between independent commercial banks, dependent commercial banks (which are wholly owned by another bank), and savings banks. For example, takeovers and the replacement of the chairman are more frequent in badly performing savings banks whereas the replacement of the CEO is more frequent in independent commercial banks.

Barro and Barro (1990), who study a sample of large US commercial banks over the period of 1982-1987, explain CEO dismissals in banks as the result of poor economic performance. Prowse (1995) analyzes a sample of US bank holding companies from 1987 to 1992 to determine how many of these companies used corporate governance interventions. He finds that overall the market-based corporate governance mechanisms in banks are not as efficient at disciplining managers as they are in other firms. In most of the developing countries, banks make up most of the financial sector. Hussain (2005a) reports that banks account for 95% of the financial sector of Pakistan. Arun and Turner (2004) discuss corporate governance in the banking sector of developing economies. They argue that the distinctive characteristics of banks call for regulation to protect depositors' interests. They further suggest that the market value of a banking institution will increase once it introduces corporate governance mechanisms. In particular, improved corporate governance yields better proceeds from the privatization of public sector banks. Arun and Turner also recommend a broader approach to corporate governance for banks to protect the interests of depositors and shareholders alike.

3. Corporate Governance in Pakistan

This section provides an overview of corporate governance in Pakistan. It starts by pointing out some of the characteristics of the Pakistani economy. It then reviews issues pertaining to corporate control and ownership in Pakistan and draws a direct comparison with other emerging markets. Finally, the section introduces the issue of bad loans made by Pakistan's banks.

3.1 The Pakistani economy

Given the recent corporate failures -- such as Enron and WorldCom in the United States, Harris Scarfe, One-Tel, HIH and Ansett in Australia, Parmalat in Italy and Ahold in the Netherlands -- as well as the Asian crisis, there has been a conscious effort to strengthen corporate governance practices in the developed world, but also the developing world. In a similar vein, actors on the Pakistani capital market have started to understand the significance of well-functioning corporate governance mechanisms. Recent corporate scams such as those involving financial cooperatives[1] and forex companies[2] have alarmed the corporate community and public policymakers alike to take corporate governance seriously. The public and private sectors are now aware that the availability of outside funding can no longer be guaranteed unless certain corporate governance standards are adopted and enforced. The increasing globalization further underscores the importance of corporate governance reforms. Weak investor protection in Pakistan has negatively affected overseas financing and domestic savings. Further, Cheema (2003) argues that lean foreign direct investment (FDI) and declining rates of domestic reserves have slowed down national economic growth. Table 1 clearly shows the sluggish and erratic pace of economic growth in Pakistan over the last four decades. Conversely, the other South Asian Economies have experienced a steady rise in the per capita growth during the same period.

Table 2 shows that the flows of FDI into Pakistan have been declining over the last two decades whereas those into India have been increasing. The Securities and Exchange Commission of Pakistan (SECP) has taken the initiative to address these critical

[1]In 1991, four Punjab-based financial cooperatives, known as the Pakistan Cooperative Societies, failed amidst accusations of misappropriation of public monies. Estimates of the misappropriated funds ranged from Rs10 billion to Rs23 billion. Up to 2.3 million accounts were affected.

[2]Recently, many forex firms have been found guilty of engaging in fraudulent activities such as unauthorized foreign exchange transactions and futures trading.

Table 1: South Asian GDP Per Capita Growth Rates

Country	1960's	1970's	1980's	1990's
Pakistan	4.29	2.11	3.82	1.47
India	1.52	0.75	3.70	3.73
Bangladesh	1.40	-0.52	1.98	3.15
Nepal	0.48	-0.32	1.49	2.25
Sri Lanka	2.15	2.63	2.84	3.98

Note: The numbers are expressed in real terms
Source: Cheema (2003)

concerns. Strengthening corporate governance via increased protection of minority shareholders, effective representation of independent non-executive directors on the board of directors and improved auditing and disclosure practices is at the vanguard of the overall reform agenda of the SECP. However, Cheema (2003) cautions the SECP that, without providing clear benefits to the firms, reforms aiming at protecting minority shareholders may end up creating sub-optimal incentives for profit maximization by controlling families. Further, Bari, Cheema and Siddique (2003) and Cheema (2003) report the ownership structure for Pakistan's 40 largest listed companies, which account for over 80% of the total market capitalization (see Table 3). Families are the most important types of shareholders, owning slightly more than half of the top-40 firms. Government and semi-government ownership is the second most important type of ownership. Contrary to the commonly held view, ownership by multinationals is relatively unimportant. If ownership is measured by the percentage of market capitalization owned rather than the percentage of firms owned, the government is the most important type of shareholder, followed by families and lastly multinationals.

Table 2: Foreign Direct Investment Inflows (US$ million)

Country	2001	2002	2003	2004
World	825,925	716,128	632,599	548,146
Developing Economies	217,845	155,528	166,337	233,277
Asia and Oceanis	108,688	92,042	101,424	147,011
South Asia	4,070	4,528	0,331	7,005
China	46,878	52,743	53,505	60,830
India	3,03	3,449	4,269	5,336
Pakistan	383	823	534	952

Source: World Investment Report 2005, UNCTAD

Table 3: Ownership of Pakistan's Top-40 Listed Companies

	% of top 40 companies		% of top 40s market capitalization	
Ownership Type	All	Non-Financial	All	Non-Financial
Family controlled*	52.5	59.0	30.2	29.8
Government	12.5	12.0	36.5	36.8
Semi-government	22.5	14.0	16.3	15.6
Multinational corporations (MNCs)	12.5	15.0	17.0	18.0

Notes: * Family controlled firms are all firms that are neither government controlled nor controlled by a MNC.
Source: Cheema (2003)

3.2 Corporate control and ownership

The Companies Ordinance 1984 and the revised Corporate Governance Code (2002) have made it mandatory for publicly listed companies to disclose their main shareholders. This provision has made it possible to analyse the ownership patterns of Pakistani corporations. Cheema (2003) presents an interesting comparison of ownership concentration and family control in Pakistani firms and firms from other East Asian countries. His findings are summarized in Tables 4 and 5.

Table 4 reveals that, except for Korea, the concentration of ownership in Pakistan is much lower than in the other East Asian countries. Conversely, Table 5 shows that the incidence of family control in Pakistan is much higher than in the other East Asian economies. Further, Cheema (2003) observes that the observed lower ownership concentration in Pakistan is in line with the findings of Lokanathan (1935), Hazari (1966) and Amjad (1982). He also reports that some studies on other South Asian economies such as Bagchi (1999) and Bertrand et al. (2000) support this observation. He argues that this pattern could also be attributed to the quality of data, which does not account for ownership by individuals acting as proxies for the controlling family in Pakistani companies.

Table 4: Ownership Concentration in Asian Corporations

Country	Percentage of Equity Owned by Top Five Shareholders
Pakistan	37.0%
Indonesia	67.5%
Korea	38.5%
Malaysia	58.8%
Philippines	60.2 %
Thailand	56.6 %

Note: The sample size for Pakistan is 32 listed domestic companies. The above Figures have not been adjusted for a possible bias created by proxy holdings.
Source: Cheema (2003)

Table 5: Family Control of Asian Corporations (% of the sample companies)

Percentage of firms with family control between	Pakistan (Textiles)	Pakistan Non-Textiles	Indonesia	Korea	Malaysia	Taiwan	Thailand
10-29%*	92.9 %	88.9 %	67.1 %	67.9 %	57.7 %	65.6 %	50.8 %
30-39%**	85.8 %	55.5 %	58.7 %	20.1 %	45.6 %	18.4 %	54.8 %
>40%***	50.0 %	38.9 %	35.4 %	3.5 %	14.7 %	5.0 %	38.9 %

Source: Cheema and Bari (2003)

As Tables 4 and 5 suggest, in Pakistan the main type of agency problem is not between the management and the shareholders as described in most of the academic literature, but between the large shareholder and the minority shareholders. This agency problem is further exacerbated by weak corporate governance mechanisms, inadequate disclosure and ineffective auditing practices. Correia da Silva, Goergen and Renneboog (2004) describe the ways in which large shareholders can expropriate the minority shareholders. For example, the controlling shareholder may transfer assets from a company, which is only partially owned by him to another company, which he fully owns. He may also give jobs to family members. Grossman and Hart (1988) refer to the benefits derived from the expropriation of minority shareholders as private benefits of control whereas they refer to the benefits shared by all the shareholders as security benefits (e.g. the increase in firm value caused by the monitoring of the management by the large shareholder). Bari, Cheema and Siddique (2003) and Cheema (2003) argue that the expropriation of minority shareholders is a common occurrence in Pakistani companies. Their findings reveal that there is a positive correlation between the concentration of family control and the controlling shareholder's discretion in terms of appropriating personal benefits.[3] Cheema (2003) adds that the separation of ownership from control increases the main shareholder's power over the use and allocation of the firm's capital. Indeed, Bari, Cheema and Siddique (2003) and Cheema (2003) find evidence of cross-shareholdings, interlocked directorships and pyramid structures to secure majority control for private benefits.

Figure 1 shows an example of a pyramid structure. Company A is listed on the stock market. It has a direct shareholder, company B which may be listed or not, which has majority control over company A. In turn, company B is majority controlled by company C. A family that holds a simple majority controls the latter. Given that the family at the top of the pyramid has majority control at each tier of the pyramid, the family is the ultimate shareholder in company A whereas company B is company A's direct shareholder. Effectively, the family has control over company A with a reduced investment of about 13 percent (51% of 51% of 51%).

[3] They do not explicitly test for this link in their study.

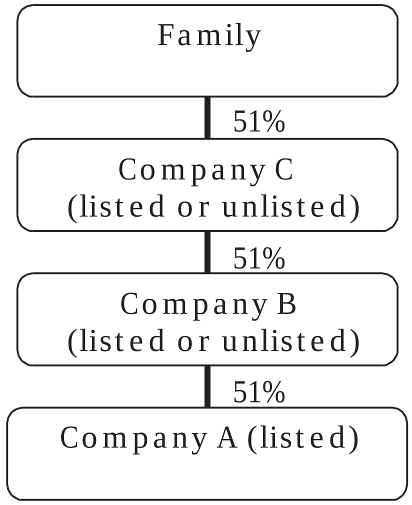

Figure 1: An Example of a Pyramid Structure
Souce: Adapted from correia et al. (2004)

Amjad (1982) confirms the findings by Bari, Cheema and Siddique (2003) and Cheema (2003) and reports extensive interlocking of directorships during the sixties in Pakistan. Data analyzed by Cheema (2003) (see Table 6) reveal that pyramid structures are quite common and much more frequent in Pakistan than in other East Asian economies.

Table 6: Incidence of Pyramiding in Asia

Market	Percentage of sample with pyramiding	Percentage of sample with pyramiding with greater than 10% of ownership
Pakistan (textiles)	66.7%	47.6%
Pakistan (non-textiles)	78.3%	56.5%
Indonesia	66.9%	NA
Korea	42.6%	NA
Malaysia	39.3%	NA
Philippines	40.2%	NA
Thailand	12.7%	NA

Notes: A firm is classed as being controlled via a pyramid if its controlling owner exercises control through at least one publicly limited company. The sample size is 32 companies.
Source: Cheema (2003)

Bari, Cheema and Siddique (2003) report that there is a very low trading volume for the largest 25 listed companies of Pakistan despite the fact that they account for 85% of the overall market turnover. The low turnover – which is mainly due to the high concentration of ownership – inhibits the development of the capital market and the inflow of foreign investment. This statement is strongly supported by the recent collapse of the Karachi Stock Exchange (KSE) in the first and second quarter of 2005 when the KSE-100 share index experienced its largest drop in its entire history by 232.60 points. In order to retain family control, large corporations have been seen to oppose the market reforms, including those on the disclosure and auditing requirements. Further, Bari, Cheema and Siddique (2003) find that the desire to retain family control holds corporations back from financing their projects through the stock market and makes them solely dependent on retained profits. The families' objective of retaining control is an important reason why Pakistan's capital markets are illiquid and inefficient. Cheema (2003) reports that, in 1990, market capitalization as a percentage of GDP was 7.1 percent in Pakistan as compared to 9.8 percent in the other low-income economies. In 2000, the equivalent figures were 10.7 and 23.6 percent.

Although corporate governance reforms may seem inevitable in this kind of environment, they face tough opposition. At times, some of the largest Pakistani listed firms have been threatening the SECP with delisting from the stock market. This will not help the Pakistani capital markets, which have suffered from a stagnating market capitalization over the last decade compared to other low-income economies.

3.3 Non-performing loans

According to the State Bank of Pakistan (2004) study, one of the major problems that the Pakistani banking sector encountered at the end of the 1990s was the huge stock of non-performing loans (NPLs), particularly in the public sector banks. According to the study, these NPLs were eroding the banking sector's profits in a number of ways such as:

- Banks were not earning any income on this huge bad portfolio
- The provisioning against these bad debts further exacerbated the problem
- Banks' resources were mainly engaged in managing their existing portfolios rather than new lending activity

In order to reduce the NPLs, a number of steps have been taken since 2000. These steps include setting up the Corporate and Industrial Restructuring Corporation (CIRC) and the Committee on Revival of Sick Industrial Units (CRSIU), the promulgation of the Financial Institutions (Recovery of Finance) Ordinance, 2001, a vigorous emphasis on banks' adequate provisioning of NPLs and an enhanced focus on the privatization of the nationalised financial institutions. According to the State Bank study, these measures have already started bearing fruit.

According to the same study by the SBP, favourable macroeconomic factors (GDP growth, inflation, interest rates, exchange rates, terms of trade, etc) along with the multi-pronged policy have resulted in bringing down the NLPs as a proportion of total assets and advances. According to the study, there are statistically significant differences in terms of NLPs between the different types of banks. For example, the ratio of NPLs to assets is 5.3 percent higher (on average) ratio for public sector commercial banks than for foreign banks. Finally, the study also claims that the ratio of NPLs over advances has been significantly reduced in the 2003 financial year as compared to the 1997 financial year.

4. Corporate Governance Reforms in Pakistan

One of the rationales behind the recent corporate governance reforms aimed at Pakistan's financial sector is to minimize risk. As mentioned above, banks in Pakistan account for 95 percent of the financial sector and hence their good health is essential to ensure sustained economic growth and the development of Pakistan (Hussain, 2004). However, banks in Pakistan have been catering largely for the needs of the government. The government has been pressurizing banks to meet its financial needs, and to issue loans to corporations benefiting from favouritism. As a result, banks have ended up with bad loans and financing has not been channelled to the most efficient firms in the economy.

Hussain (2005a) describes the banking sector over the past decades. The government used the banks' deposits to finance its fiscal deficit. Lending to the government was considered to be safe and profitable. Moreover, the government owned most of the banks and their employees had little incentive to work hard and absenteeism was high. The banking sector was characterized by low levels of competition, unnecessary bureaucracy, overstaffing, loss-making branches and poor customer service. Further, favouritism at the time of lending resulted in huge amounts of debt defaulting subsequently. The corporate tax rate in the banking sector was 58 percent compared to only 35 percent in other sectors. As a result there was a continuous trend for lending rates to increase at the detriment of depositors who earned lower and lower returns.

Over the last decade, the banking sector has been undergoing a tremendous transformation, which has been recognized by the IMF and the World Bank. IMF (2005) observes that credit to the private sector has been increasingly steady over the last few years. It further reports that credit to the corporate sector has been generally stable and is declining in the case of public sector owned enterprises. The Financial Sector Assessment Report (2004) distinguishes between domestic private financial institutions and foreign financial institutions. According to the Report, domestic private financial institutions have attracted almost 86 percent of credit by end of the 2004 financial year compared to 67.2 percent at the end of 2000. The government has undertaken some of the much-needed corporate governance reforms, such as the privatization of banks, the appointment of individuals of standing and integrity as chief executive officers (CEOs) and changes to the boards of directors. Hussain (2005b) believes that good corporate governance is vital for bringing about improvements in the internal controls and the organizational culture. A summary of achievements and initiatives taken by the government is outlined below (Hussain 2005b):

- Regulation defining the responsibilities of the board of directors.
- Applicants for the posts of CEO, other board members and key executives have to fulfil certain criteria.
- Banks have to adhere to minimum (quarterly and annual) disclosure requirements.
- Family representation on the boards has been limited to 25 percent of the seats and the remaining directors have to be independent non-executives and not related to the controlling family.

- Stockbrokers and all others who may suffer from conflicts of interests are barred from getting involved in the management and oversight of banks.
- A ‘Handbook on Corporate Governance’ for banks/development financial institutions (DFIs) containing international best practice and State Bank of Pakistan (SBP) guidelines on the subject have been compiled, published and disseminated. The Handbook also refers to OECD practices and the Cadbury (1992) code. The main objective of publishing this document is to reinforce the significance of corporate governance as an effective business tool for bankers, auditors and the general public. Members of banks/DFIs were organized to train them.
- An institute namely, Pakistan Institute of Corporate Governance has been established in Karachi and the SBP is among its founder members.
- Corporate governance requirements for banks/DFIs are continually reviewed to keep them in line with internationally recognized best practice.
- External audit firms are screened, categorized and rated for the purpose of auditing financial institutions. Whenever they are found deficient, they are delisted or even black-listed.

SBP claims that these steps have resulted in better market discipline and conduct, improved risk management, better-qualified board members and CEOs, and better self-regulation. To set good examples, the regulatory agencies such as SBP and SECP have themselves subjected to higher standards of disclosure and transparency. Hussain (2005a) reports that both the SBP and SECP have undertaken a number of measures, including an open consultative process and the dissemination of information. As part of its accountability strategy, SBP now issues an annual corporate performance report. A semi-annual monetary policy statement discloses SBP’s stand on monetary policy. The following sections look in more detail at some of the recent improvements in corporate governance in Pakistan.

4.1 Investor Protection

Pakistan guarantees basic shareholder rights. Indeed, the legal framework for the rights of the shareholders is well founded in Pakistan under the available law and regulations such as the Code of Corporate Governance and the Company Ordinance 1984. Custody of securities has always been a matter of concern for investors in Pakistan. This concern affected the development of the securities market. Under the Central Depository Company of Pakistan’s (CDC) arrangements, investors may secure the custody of their securities by opening accounts with CDC to secure transactions and securities.

A company is obliged to provide any information requested by one of its shareholders. The election of directors takes place under cumulative voting that allows minority shareholders to cast all of their votes for a single candidate. The directors can be dismissed through a shareholder resolution. According to the amendment in Companies Ordinance 1984 (160A), the court can invalidate proceedings of a general meeting on petition by members carrying not less than ten percent of the voting power in the company. Similarly according to amendment 179, the court can declare the election of directors invalid if application (within thirty days of the election) is made by members holding not less than twenty percent of the voting power in the company. The approval of the shareholders is required for any changes to the articles of association, increases to the authorized capital, and sales of major corporate assets. Shareholders can participate in the annual general meeting (AGM). However, some companies still do not hold an AGM. Some hold their AGM in odd and obscure places such as Fortabbas or Bahawalnagar[4] so that the shareholders are unable to attend the meeting. The law does not allow for postal or electronic voting. This makes the whole process of electing the board difficult and cumbersome, particular for small shareholders.

4.2 Disclosure Requirements

With the introduction of the Code of Corporate Governance in 2002 and the amendments to the Company Ordinance 1984 (most of them made in 1999), the disclosure of financial data has generally improved in quality. Companies often follow the given time limits under the new Corporate Governance Code (see below). It is mandatory for the company to disclose any of its shareholders controlling 10 percent or more of the votes in the Directors' Report, prepared under section 236 of the Companies Ordinance 1984. However, it may still be difficult for outsiders to understand a firm's ownership and control structure in the presence of pyramids, cross-shareholdings, etc. Hence, the SECP has issued guidelines asking firms to issue more information on transactions between connected parties. The auditors have to certify that the firm has followed the required valuation practices properly when determining the transfer price.

4.3 The Code of Corporate Governance

In March 2002, the SECP issued the Code of Corporate Governance (the Code).[5] The Code is a code of best practice and all listed companies have to include a statement in their annual report as to the level of compliance with the best practices detailed in the Code. This statement must be reviewed and certified by the company's auditors.

[4]These areas lack proper communication, transportation and accommodation making it difficult for the shareholders to travel to the AGM.

[5]The Code can be downloaded from the website of the European Corporate Governance Institute (ECGI) at http://www.ecgi.org/codes/all_codes.php.

[6]The Code defines an independent director as 'a director who is not connected with the listed company or its promoters or directors on the basis of family relationship and who does not have any other relationship, whether pecuniary or otherwise, with the listed company, its associated companies, directors, executives or related parties. The test of independence principally emanates from the fact whether such person can be reasonably perceived as being able to exercise independent business judgment without being subservient to any apparent form of interference.'

The Code specifies best practice in terms of:

- the composition and the duties of the board of directors;
- the appointment, qualification requirements and the responsibilities of the chief financial officer (CFO) and the company secretary;
- corporate and financial reporting including the disclosure of directors' interests and trades;
- the required free float at the time of the flotation;
- takeovers;
- the need for an audit committee and its duties;
- internal auditing;
- the external auditors

Board of directors – The Code recommends that the boards of listed companies include independent non-executive directors,[6] including representatives of the minority shareholders. Companies are asked to send proxy forms to all the shareholders at the request of a minority shareholder standing as a candidate for the election of the directors. The board should also have at least one independent director representing the institutional shareholders. The Code also recommends that directors should be appointed for a term of three years and should not hold more than ten directorships at a time. The Code defines that the main responsibility of the directors is to carry out their fiduciary duties in the best interest of the company.
Further, it suggests that firms should issue a statement of ethics and business practices, and review and circulate it every year. The statement should be signed by the directors and the employees. Finally, the board is expected to meet at least once during each financial quarter and to decide on any significant issues affecting the firm.
The CFO, company secretary and head of internal auditing – The CEO with the approval of the board appoints the CFO, company secretary as well as the head of internal audit. Both the CFO and company secretary have to fulfil certain minimum qualifications such as being chartered accountants and have to attend the meetings of the board of directors.
Corporate and financial reporting – The Code stipulates the best practice in terms of financial reporting and insider trading. The Code recommends that directors who acquire or sell shares directly or indirectly in their company have to notify the company secretary immediately. The details of the transaction (price, number of shares, type of share certificates and the nature of the transaction) have to be disclosed to the company secretary within four days of the transaction. Although the Code does not explicitly recommend trading bans around price-sensitive events (e.g. the announcement of the interim or final results), it nevertheless states that for companies that have voluntary trading bans in place the directors have to respect these. Finally, the auditors of the company and their direct relatives are not allowed to hold any shares in the company.[7]
Free float at the flotation – The minimum free float at the initial public offering (IPO)

[7]See Fidrmuc, Goergen and Renneboog (2006) for a comparison of UK and US regulation on insider trading and differences in reporting requirements.

should be at least 20 percent of the firm's equity or 100 million Rupees (Rs., about £0.9m or US$1.7m), whichever is higher. However, exceptions to this rule may be granted by the stock exchange with the approval of the SECP.

Takeovers – There is one important provision in the Code on takeovers. Strictly speaking, the Code uses the more general term of 'divesture'. In the case of a divesture of at least 75 percent of the shares of the company at a price higher than the market price of the shares at the time of the divesture, the directors should only approve the operation if a written tender offering the same price has been made to the minority shareholders. If the tender offer is made at a lower price, then the company will require the approval of the SECP.

Audit committee – Every listed firm should have an audit committee with three members, including the chairman of the company. The majority of its members should be non-executive directors and the committee's chairman should be a non-executive. The committee should meet at least once during each quarter of the financial year. The CFO, the head of internal auditing and a representative of the firm should also attend the meetings.

Internal auditing – There should be an internal auditing procedure within each listed firm and internal audit reports should be sent to the external auditors. The head of internal auditing should have access to the chairman of the audit committee.

Despite initially low levels of compliance, the Code has now started gaining ground. Increasingly better compliance with the Code by the firms is witnessed due to the efforts of the SECP. A few multinational companies, banks, and family-controlled corporations are taking the lead. They have started to adopt more transparent and effective corporate governance structures. General awareness of corporate governance issues is increasing via training programmes and credit rating initiatives. With the objective to engender sound corporate governance practices and provide an environment facilitating the implementation of the Code, the SECP has established the Pakistan Institute of Corporate Governance.

4.4 Reforms Affecting the Financial Sector

The most daunting challenges facing Pakistan's financial sector come from the Basle II Accord. The increased transparency provided by Basle II will provide a clear direction for all stakeholders concerned. Consumers and corporate clients will benefit from more timely and accurately assessed lending decisions leading to increased customer satisfaction and loyalty in a highly competitive market. Recognizing the significance of the financial sector in terms of developing the economy, Pakistan has undertaken some crucial reforms to improve its efficiency and service delivery capacity. Hussain (2005b) summarizes some of the major measures taken by the government. We highlight the most important ones here.

Privatization of National Commercial Banks (NCBs) – With the nationalization of local banks and the expansion of public sector financial institutions, the financial set up underwent a substantial change during the early 1970s in Pakistan. The government strongly felt the need to create new mechanisms of social protection and dovetail the fruits of financial prosperity to the grassroots level, as the private sector was not conforming to the standards of social responsibility. This was indeed a distant echo of recognizing the importance of corporate governance systems. Available evidence, however, suggests that this could not deliver the desired results (SBP 2004). It rather led to financial and institutional inefficiency, 'crowding out' of the private sector, low quality assets and above all mistrust in the public sector. Lack of consistency and continuity in public policies and the public sector's weak capacity to manage these financial institutions are largely responsible for this failure. Policy makers soon felt the need for rethinking the nationalization paradigm. Therefore, the 1990s saw a shift in the government's policy in terms of the public role of the financial sector of Pakistan.

There was a massive privatization operation of the banking sector during 1991 to 2004. Public sector ownership was reduced to about 20 percent in 2004 from almost 100 percent in 1991 (Hussain 2005b). In order to expand its investor base, some 23.5 percent of the shares of the National Bank of Pakistan were sold in a public offer, targeting especially small investors. Presently, only one bank is still owned by the public sector: according to its 2004 accounts, 75 percent of the shares of the NBP are held by the State Bank of Pakistan (SBP). However, the privatization of nationalized commercial banks has necessitated a new set of regulations and responsibilities both for the public and private sector alike. There is a need for a well-conceived set of prudential regulations and their successful implementation. Good corporate governance is crucial to ensure the effective supervision of the banks. Therefore, the SBP has set standards for the appointment of the boards of directors, chief executives and senior management of the banks.

Capital Strengthening – In order to build a solid base for the financial sector, the capital requirements of the banking sector have been increased from Rs 500 million (approx. US$8 million and £5 million) to Rs 1 billion. The Government has increased the minimum capital requirement to Rs. 2 billion (US$ 35 million) effective from December 31st, 2005 however the SBP is planning to increase it to US$100 million by the end of 2009. This has enhanced the capacity of the banking sector to confront unpredicted economic jolts. The requirement has also triggered many mergers of smaller and weaker banks, further strengthening the banking sector.

Capital Adequacy Ratio (CAR) – This is the capital expressed as a percentage of the risk weighted assets. While the minimum requirement for the banking industry is about 8 percent, currently CAR is at about 11 percent. CAR ensures that the banks not only use the depositors' money to undertake risky investments but that they also put their shareholders' money at stake. In fact, a high CAR forces the banks to make cautious and prudent decisions while allocating resources.

Liberalization of Foreign Exchange Regime – The foreign exchange regime has been liberalized and foreign exchange companies have been established. Foreign investors are now allowed to bring in or remove their financial resources at any time. Similarly, Pakistani corporations are now allowed to get their hands on foreign resources.

Legal Reforms – The Financial Institutions (Recovery of Finances) Ordinance came into force in 2001. The Ordinance provides for the belated recovery of defaulted amounts. The Ordinance allows the right of foreclosure and sale of mortgaged property with or without intervention of court. The Banking Laws Reforms Commission has been established to update and consolidate the banking laws and draft new laws such as bankruptcy law.

Micro Financing – An effective and buoyant micro finance mechanism is vital for broad-based economic sustainability and development at all level. Therefore, the Pakistani government has eased down the licensing and regulatory conditions for financial institutions to guarantee widespread and easy access to small borrowers, particularly in rural areas. Contrary to restrictions on commercial banks, these micro-credit financial institutions can be established at district, provincial and national levels under different capital requirements. In the private sector, Khushali Bank and the First Microfinance Bank have already started working under this new regulatory regime. Khushali Bank has a customer base of about 125,000 persons, who live in the poorer districts. Its rate of recovery of loans is above 95 percent (Hussain 2005b). The government has set up a Small and Medium Enterprise (SME) Bank to provide headship in developing new lending instruments such as programme loans and new credit appraisal. The SME Bank does not require any collateral. The loans are approved on the basis of asset conversion cycle and cash flow generation. It is expected that these new instruments and practices will be dovetailed and adopted by other banks in the country.

Taxation – To develop the corporate market, the government has reduced the corporate tax rate on banks from 58 percent to 41 percent during the last four years. The government is planning to bring it further down to 35 percent by 2007. This will, in turn, help to decrease further the spread between the deposit and lending rates, which has already come down to between 3.5 to 4.5 percent.

Credit Rating – The government has made it mandatory for all banks to obtain a credit rating. This has facilitated the customers in making informed decisions as to the investment of their capital. The SBP publicizes these ratings for the general public and the Chambers of Commerce and Trade Organization. Such public disclosure allows depositors to choose between various banks.

Risk Management – The SBP has adopted the following two monitoring systems to improve the supervision of the financial sector:

> CAMELS-S[8] – an on-site inspection framework, which gauges the capital adequacy, asset quality, management soundness, earnings and profitability, liquidity, sensitivity to market risks, and systems and controls.
> CAELS[9] – An offsite surveillance framework, which gauges the capital adequacy, asset quality, management soundness, earnings and profitability, liquidity and sensitivity to market risks.

Islamic Banking – The SBP defines Islamic banking as 'banking in consonance with the ethos and value system of Islam and governed, in addition to the conventional

[8]CAMELS-S stands for capital adequacy (C), asset quality (A), management soundness (M), earnings and profitability (E), liquidity (L), sensitivity (S) to market risks, and systems and controls (S).

[9]CAELS – stands for capital adequacy (C), asset quality (A), earnings and profitability (E), liquidity (L) and sensitivity (S) to market risks.

good governance and risk management rules, by the principles laid down by Islamic Shariah'.[10] Owing to their belief against interest-based (so called riba-based) banking, a sizable portion of Pakistanis have always felt disinclined to present day commercial banking. To mobilize and encourage economic and commercial activity in this fraction of the society, the government has introduced Islamic Banking. This Islamic Banking system is working along with its competitor, conventional banking. The Islamic Banking system largely targets individuals (and their businesses) from the amiddle and lower classes. The latter now have the option to engage in trading and businesses and avail of loans from Islamic banks as per the Islamic injunctions.

5. Ownership and Bad Loans

Our analysis of ownership and bad loans covers the whole population of listed[11] Pakistani commercial banks and investment banks, with the exception of two banks (P.D.G House and Trust Brokerage) for which annual reports could not be obtained. The latest data regarding ownership, non-performing loans, ratios such as non-performing loans as a percentage of total assets, bad debts written off directly and provisions for doubtful receivables were collected from the audited accounts[12] of each bank (the list of the banks can be found in Appendix A.1). Shareholders are classified as individuals, financial institutions (banks, DFIs, non-bank financial institutions (NBFIs)), foreign investors, investment companies, provincial government, modarabas[13] mutual funds, charitable trusts, associated companies (sponsors) and the free float. Similar to most other countries in the world, decisions, which substantially change the nature of the company – such as alterations to the articles of association -- have to be approved by a super-majority of three-quarters of all the members or the class of members affected by such a change.[14]

5.1 Ownership and control

Table 7 reports that the average largest stake held in the sample of 41 commercial and investment banks is 34.1 percent. The average second, third and fourth largest stakes are 14.8, 14.6 and 12.4 percent, respectively. The figures suggest that on average the largest shareholder faces powerful minority shareholders.

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[10]The State Bank of Pakistan website provides a whole range of information on Islamic Banking. See for details.

[11]The banks are listed on the stock exchanges of Lahore, Karachi and Islamabad.

[12]Among the various banks considered, the relevant financial information was obtained from the 2005 accounts for Alfalah Bank, Bank Al-Habib, Metropolitan Bank and National Bank of Pakistan. For Crescent Bank and Investec Securities, the financial data relate to 2003. For the remainder of the sample, financial data are for 2004.

[13]This is an Islamic form of banking, whose partners contribute only capital and the others only work (entrepreneurship). See Vogel and Hayes (1998) for more details.

[14]See Article 28 of the Companies Ordinance 1984.

Table 7: Ownership concentration in all listed Pakistani banks

Average holding (%) by	Average	Median	Minimum	Maximum
Largest shareholder	34.1	27.8	10.0	80.3
Second largest shareholder	14.8	12.6	4.8	32.9
Third largest shareholder	14.6	10.5	10.0	25.5
Fourth largest shareholder	12.4	12.4	10.4	14.4

Note: The ownership data are based on 41 listed Pakistani commercial and investment banks.
Source: Annual Audited Reports 2003 and 2004.

In order to proceed we divide the banks along the median largest stake of 27.8 percent. The table documents the diversity in terms of the control of Pakistani banks. Panel A of Table 8 includes the 20 banks whose largest shareholder has a stake of more than 27.8 percent. The average stake held by the largest shareholder is just above the simple majority. The second largest shareholder is relatively unimportant and holds less than half of the stake held by the largest shareholder.

Table 8: Banks with above median and below median ownership by their largest shareholder

Panel A: Above median ownership by largest shareholder				
Average stake held by the	Average	Median	Minimum	Maximum
Largest shareholder	51.5	49.9	29.7	80.3
Second largest shareholder	18.3	14.4	10.0	32.9
Third largest shareholder	–	–	–	–
Fourth largest shareholder	–	–	–	–
Panel B: Below median ownership by largest shareholder				
Average stake held by the	Average	Median	Minimum	Maximum
Largest shareholder	16.7	16.0	10.0	26.0
Second largest shareholder	12.2	12.0	4.8	17.4
Third largest shareholder	11.9	10.3	10.0	17.0
Fourth largest shareholder	–	–	–	–

Note: The ownership data are based on 41 listed Pakistani commercial and investment banks. Panel A covers the 20 banks with above median ownership and Panel B covers the 21 banks with below median ownership by the largest shareholder. Disclosed stakes falling below the disclosure threshold of 10% are excluded from the table.

Source: Annual Audited Accounts

Panel B covers the remaining 21 banks whose largest shareholder owns a stake equal to the median stake of 27.8 percent or less. On average, the largest shareholder holds slightly less than 17 percent of the votes. The second and third largest shareholders are relatively important and the largest will need their support to obtain a majority of votes at the AGM. The patterns unveiled by Table 8 are very interesting as they document the high diversity of control in Pakistani banks. Some Pakistani banks

Table 9: Detailed ownership for the banks with above median ownership by their largest shareholder

	largest share-holder (%)		largest shareholder (%)
Arif-Habib Securities	58.9	Arif Habib Family (CEO, Mr. Arif Habib)	16
The Bank of Punjab	51.6	Provincial Government	–
Atlas Commercial Bank Limited	32.6	Shirazi Family	–
Faysal Bank	44.9	Shamil Bank of Bahrain E.C.	–
Muslim Commercial Bank	29.7	Pension/Provident Fund	26.6
National Bank of Pakistan	75.2	State Bank of Pakistan	–
Jahangir Siddqui & Company Limited	41.1	Jahangir Siddiqui Family	–
Javed Omar Vohra&Company Limited	80.1	Vohra Family (husband and wife both carrying more than 10% of shares)	–
Jah. Siddiqui Investment Bank	62.4	Jahangir Siddiqui & Co. Limited	10.1
NDLC-IFIC	70	Temasek Holdings Sigapore through indirect Bugis Investment Pte. Limited	–
PICIC Commercial Bank Limited	60	Pakistan Industrial Credit & Investment Corporation Limited	12.4
Prime Commercial Bank	46.6	Arab Asian International Holding Company E.C. Bahrain	12.9
Saudipak Commercial Bank Limited	54	Saudipak Industrial and Agricultural Investment Company (Pvt) Limited	–
Union Bank	51.2	Director (Mr.Abdullah Mohammad Abdullah Basodan)	–
Escorts Investment Bank	39	M/s ESSEM Power (Pvt) Limited	10.9
Askari Commercial Bank Limited	39.7	Directors/ Chief Executive	10.4
United Bank Limited	48.7	State Bank of Pakistan	25.5
Allied Bank Limited	36.5	Directors (Mukhtar Family)	32.9
Meezan Bank Limited	32	Pakistan Kuwait Investment Company (Pvt) Limited	25.9
Jahangir Siddiqui Capital Securities	75	M/s Jahangir Siddiqui Co. Limited	

Note: The ownership data was collected for 41 listed commercial and investment Pakistani banks. The table covers the banks in the sample whose largest shareholder holds a stake exceeding the median of 27.8%. Disclosed stakes below the disclosure threshold of 10% are excluded from the table.

Source: Annual Accounts

(those from Panel A of Table 8) conform to the patterns observed in Continental Europe where most listed firms have a majority shareholder who does not tend to face blocking minorities. Others (those from Panel B) have ownership and control more in line with Anglo-American firms which need a coalition of several shareholders to obtain majority control.

Table 9 focuses on the 20 banks from Panel A of Table 8 whose largest shareholder has virtually uncontested control. One of these banks is Javed Omer Vohra & Company Limited. It has a total of 10,000,000 shares outstanding. Two of its shareholders -- Mr. Javed Omer Vohra and Ms. Fozia Parveen Vohra -- jointly hold 7,999,175 shares, roughly 80 percent of the bank's shares. Other shareholders such as NIT and ICP – holding jointly 8.52 percent – and financial institutions – holding jointly 0.42 percent – are not in a position to form a blocking majority of their own.

Arif Habib Securities Limited is a typical example of a bank with above median ownership held by its largest shareholder. Its detailed ownership is reported in Table 10. Members of the Habib family hold together roughly 75 percent of the bank's shares. Mr Arif Habib, the chief executive of the company, owns alone 58.9 percent of the shares. The Habib family do not face a single large minority shareholder.

Table 10: Ownership of Arif Habib Securities

Categories of shareholders	%
NIT& ICP	<0.0
Mr. Arif Habib, Chief Executive	58.9
Mrs. Zetun Arif, wife of Mr. Arif Habib	16.0
Other family members	0.2
Individuals	18.5
Leasing, Investment & other joint stock companies	6.4
Total	100

Source: Annual Accounts 2004

Table 11 shows the ownership of the banks whose largest shareholder holds 27.8 percent of the shares or less. The largest shareholder in these banks does not have uncontested control and faces other large shareholders. A typical case is that of Crescent Commercial Bank Limited whose detailed ownership is reported in Table 12. As the table shows, the largest shareholder – Mashreq Bank – holds about 13 percent compared to the second and third largest shareholders who jointly hold 20 percent.

Table 11: Detailed ownership for the banks with below ownership by their largest shareholder

Bank	Stake held by largest share-holder (%)	Type of largest shareholder	Stake held by second largest shareholder (%)
Asset Investment Bank Limited	10	National Leasing Corporation	4.8
Alfalah Bank Limited	16.7	Family	10.2
Bank Al- Habib	17.5	National Investment Trust	11.5
MyBank Limited (formerly Bolan Bank Limited)	17.8	Individual (Mr Iqbal Ahmed)	17
Crescent Commercial Bank Limited	13.3	Mashreq Bank PSC	10
Crescent Standard Investment Bank Limited	13.4	National Bank of Pakistan	11.3
First Dawood Investment Bank Limited	16.6	State Life Insurance Corporation	12.9
First International Investment Bank Limited	14.5	American Express Limited	10.8
Investec Securities Limited	No shareholder holding more than 10% of shares	–	–
Islamic Investment Bank Limited	15.4	Sphere Finance Holding Limited	–
KASB Bank Limited	13.6	Mr. Nasir Ali Shah Bukhari (Bukhari Family)	–
Metropolitan Bank	19.6	National Bank of Pakistan, Trustee Department	–
Orix Investment Bank Limited	20	Orix Corporation	15
Soneri Bank Limited	23.4	NIT & ICP	–
Network Microfinance Bank Limited	15.5	Network Leasing Employees Share Trust	9.9
AMZ Ventures	13	Sponsors/Promoters	–
International Housing Finance	14.9	Crescent Leasing Corporation	12.5
PICIC (Pakistan Industrial Credit & Investment Corporation Limited)	21	State Life Insurance Corporation of Pakistan	17.4
First National Equities	17.4	First Pakistan Securities Limited	–
Al-Mal Securities Service Limited	26	Mr. Shazad Ali (Director)	–
Security Investment Bank Limited	14.2	Amina Bano	12.3

Note: The ownership data was collected for 41 listed commercial and investment Pakistani banks. The table covers the banks in the sample whose largest shareholder holds a stake equal to or below the median of 27.8%. Disclosed stakes below the disclosure threshold of 10% are excluded from the table.

Source: Annual Accounts

Table 12: Ownership of Crescent Commercial Bank Limited

Mashreq Bank PSC	13.3
Doha Bank	10.0
National Bank of Pakistan, Trustee Dept.	10.0
The Crescent Textile Mills Limited	7.1
Crescent Steel and Allied Products Limited	2.9

Source: Annual Accounts 2004

5.2. Nature of control

Table 13 reports that financial institutions are the most frequent types of shareholders followed by families. They are the largest shareholder in 18 and 15 of the banks, respectively. For the case of the second largest shareholder, families are the most frequent type of shareholders (12 banks), followed by financial institutions (10 banks).

Table 13: Average total ownership by type of shareholder
(number of firms with that type of shareholder)

	Families	Financial Institutions	Foreigners	Other Companies	Provincial Government	Others
Largest shareholder	14.1% (15)	12.7% (18)	4.8% (5)	–	1.3% (1)	0.1% (1)
Second largest shareholder	3.8% (12)	3.5% (10)	1.3% (2)	–	–	–

Notes: The ownership data is based on the 41 listed Pakistani commercial and investment banks. The averages are calculated across the entire sample and not just the firms with that particular type of ownership. Source: Annual Reports

An important observation regarding the shareholding patterns of banks which emerges from our analysis is that NIT (National Investment Trust) and ICP (Investment Corporation of Pakistan) happen to be shareholders in five out of the 41 the banks.

5.3 Bad Loans

As shown in Table 14, the amount of non-performing loans (in million rupees) dropped in 2004 compared to 2003 by 1.9 percent. Similarly, the non-performing advances as a percentage of total advances decreased in 2004 by 2 percent. To analyse whether there is a link between ownership and bad loans, we analyze the bad loans for the group of banks with above sample-median ownership by their largest shareholder and those with below median ownership.

Table 14: Amount of non-performing loans

	2003	2004
Amount of non-performing advances (sum) million	88,710.6	87,067.2
Non-performing advances as a percentage of total advances (average)	15.6	13.6
Non-performing advances as a percentage of total assets (average)	9.2	9.4

Source: Annual Reports

Table 15 shows that there is a difference in the amount of non-performing advances between the two groups of banks. For the banks with above median ownership by their largest shareholder (Panel A), the amount of non-performing loans is considerably higher. Conversely, the ratios of non-performing loans as a percentage of total advances and as a percentage of total assets are smaller than those of the banks with below median ownership by their largest shareholder (Panel B). However, the Mann-Whitney ranks sum test for the difference between two means is not significant.

Table 15: Bad loans by ownership of the largest shareholder

	2003	**2004**
Panel A: Banks with the largest shareholder holding more than 27.8%		
Amount of non-performing advances(sum) million	78,759.3	76,241.2
Non-performing advances as a percentage of total advances (average)	9.6	6.9
Non-performing advances as a percentage of total assets (average)	5.2	4.1
Panel B: Banks with the largest shareholder holding 27.8% or less		
Amount of non-performing advances(Sum) million	99,51.4	10,825.8
Non-performing advances as a percentage of total advances (average)	24.9	23.3
Non-performing advances as a percentage of total assets (average)	15.3	17.1

Notes: Panel A covers the 20 banks whose largest shareholder has above median ownership. Panel B covers the 21 banks whose largest shareholder has median or below median ownership.

Source: Audited Financial Statements

6. Survey Results

A questionnaire (which is reproduced in Appendix A.2) was prepared on the basis of the broad recommendations made by the Corporate Governance Code (see Section 4). The objective was to determine the extent to which the Pakistani banks (included in the sample) have followed the Code's recommendations. The questionnaires were administered via telephone interviews. Additional data were collected from the financial statements for the years 2003, 2004 and 2005.

Overall, the levels of compliance varied substantially from recommendation to recommendation. For example, 77.5 percent of the respondents have independent non-executive directors on their board. The sample banks which do not have independent non-executive directors on their board consist of Investec Securities Limited (the report does not mention any shareholder carrying 10% or more shares) and Network Microfinance Bank Limited. However, only 12.5 percent of the banks have representatives of the minority shareholders on the board. Sixteen out of the 20 banks with a large shareholder holding an above median stake indicate that they do not have representatives of the minority shareholders. The only banks within this category that have minority shareholders are Askari Bank, Escorts Investment Bank, Saudipak Commercial Bank and Bank of Punjab. Surprisingly, 18 out of the 21 banks whose largest shareholder has below median ownership do not have representatives of the minority shareholders either. Only 35 percent of the banks have independent directors, representing institutional shareholders: for the banks with an above-median largest shareholder, 13 out of 20 banks state that they do not have such representatives while 14 out of the 21 banks with a below-median largest shareholder are in the same situation. All of the banks have some ownership by institutional investors. Only four banks from the entire sample have a chairman who is an independent non-executive. Hence, overall, the large majority of banks fail to comply with the recommendations of the Code in terms of the composition and the characteristics of the board of directors.

In line with the Code, all the banks have a statement of ethics and business practices but none of the banks review their statement on a regular basis. This response does not conform to the recommendation of the Code, which stipulates that the statement must be reviewed and certified by the company's auditors.

The boards of Pakistani banks meet between 4 and 8 times a year. However, most of the banks which meet at least 6 times a year have above median ownership by their largest shareholder. In most banks, both the chief financial officer (CFO) and company secretary have degrees in accounting, business or economics. Nevertheless, the minimum qualification is below that of a chartered accountant as stipulated by the Code of Governance. All the respondents reveal that they have imposed trading bans on the directors around price-sensitive events. Similarly, Bettis et al. (2000) report that for the case of the US, a large fraction of firms impose insider-trading restrictions on their directors and officers that in many cases also include trading bans which go beyond what is imposed by federal regulation. Further, none of the banks report that their auditors or the auditors' direct relatives hold shares in the banks they audit. All the banks have an audit committee, which in most cases comprises 3 members. In 70 percent of the banks, the chairman of the audit committee is a non-executive. Roughly

83 percent of the banks' audit committee meets once every quarter. The CFO of all the banks attends most of the meetings of the audit committee, but not all of them as recommended by the Code. Similarly, all the banks have an internal auditing procedure and the head of the internal auditing has access to the chairman of the audit committee. Out of the total sample, only 8 banks disclose information regarding the issue whether the head of the internal auditing attends the audit committee meeting or not. For only 12 banks, the chairman of the audit committee is a non-executive.

Despite initially low levels of compliance, the Code of Corporate Governance is now gradually gaining ground. The increased levels of compliance are likely to be the result of the SECP's efforts to promote the Code.

7. Policy Implications

Hussain (2005) observes that Pakistan's financial sector needs to be further developed and integrated into the global economy. This observation poses a critical challenge for the policy makers. The recent reforms have resulted in an expansion of the financial sector; such development has resulted in an increased coverage of population segments. The resulting economies of scale and scope provide clear benefits to banks, yet the development calls for the utmost care, agility and ability to exploit every single opportunity. Banks need to adopt rational approaches in their lending and forecasting policies which has been a clear challenge in the past. Further, the introduction of the Basel II regime may expose Pakistan's banking sector to a number of additional challenges.

Although the banks' financial structure has been revamped, the legal system requires further improvements for an enabling business environment in the country. While the regulatory regime has been strengthened and the monitoring capability of the regulators has improved, the enforcement of regulations remains a real concern. Policy makers need to devise non-intrusive mechanisms to ensure implementation of these rules and regulations; otherwise the benefits from the reforms will not materialize. Initiatives have been undertaken to introduce internationally recognized best corporate governance practices such as those relating to board structure and the independence of non-executive directors. Audit and accounting standards have been brought to the level of the International Accounting and Auditing Standards. The Corporate Governance Code (2002) is a step in the right direction, yet levels of compliance to the Code remain a challenge. Given the crucial role of the financial sector in the national economy, it needs to be made aware that it should lead in terms of high levels of compliance to the Code. A better corporate governance environment will not only encourage Pakistani nationals and corporates to make investments within the country, but also attract foreign investors.

8. Conclusion

La Porta et al. (1998) assign Pakistan, a common-law country, a maximum score of 5 for their anti-director rights index. Pakistan should therefore be a country with good investor protection attracting large amounts of investments. However, the reality could not be more different. Pakistan has been lagging behind other, comparable Asian economies in terms of incoming foreign direct investment as well as GDP-per-capita growth. Given the crucial role that the finance industry plays in promoting and sustaining economic growth in emerging markets, this paper focuses on Pakistan's banks.

The paper reviews some of the recent reforms of corporate governance, such as the introduction of the Corporate Governance Code (2002). It also comments on reforms that target the banking industry such as the privatization of financial institutions and the strengthening of its financial structure.

The paper also unveils some interesting patterns in terms of the control and ownership structure of Pakistani banks. While about half of the Pakistani banks have concentrated control, similar to that of Continental European firms, others have a relatively high dispersion of ownership more in line with that of Anglo-American firms. This mix of opposing control structures creates a challenging environment for reformers of company law and corporate governance.

Further, a detailed questionnaire-based survey shows that compliance with the Code tends to be high in terms of the recommendations that have less far reaching consequences for the controlling shareholders and/or the management of the banks. However, most banks are more reticent to follow the recommendations which increase the voice of minority shareholders, such as institutional shareholders.

To conclude, Pakistan has made major steps in improving the governance of its corporations in general and that of banks in particular. However, more efforts need to be made in terms of improving levels of compliance with the Code. Given its crucial role in promoting and sustaining economic development, Pakistan's banking industry needs to be aware of its role as a leader in high corporate governance standards.

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Appendix A.1

Listed Commercial Banks and Investment Banks	Share price (Pak. Rupee) as of 12 May 2006
1. Asset Investment Bank Limited	3.0
2. AlFalah Bank Limited	53.95
3. Bank Al-Habib	64.8
4. Arif-Habib Securities Limited	606
5. Atlas Commercial Bank Limited	57
6. The Bank of Punjab	92.9
7. MyBank Limited (formerly Bolan Bank Limited)	20.55
8. Crescent commercial bank limited	11.5
9. Crescent Standard Investment Bank Limited	4.50
10. Faysal Bank	72.6
11. First Dawood Investment Bank Limited	25.0
12. First International Investment Bank Limited	17.3
13. Investec Securities Limited	3.2
14. Islamic Investment Bank Limited	5.0
15. Jahingir Siddique&Company Limited	201.5
16. Jahangir Investment Bank Siddiqui	85.75
17. Javed Omer Vohra&Company Limited	41.2
18. KASB (Khadum Ali Shah Bukhari)	15.5
19. MCB (Muslim Commercial Bank)	252
20. Metropolitan Bank	76
21. NBP (National Bank of Pakistan)	275.7
22. NDLC-IFIC (NIB Limited)	24.55
23. Orix Investment bank Pakistan Limited	27.3
24. PICIC	34.2
25. Prime Commercial Bank	25.6
26. Saudipak Commercial Bank Limited	16.45
27. Soneri Bank	44.95
28. Union Bank	83.75
29. Network Microfinance Bank Limited	8.0
30. Escorts Investment bank	18.95
31. Al-Mal Securities and Services Limited	6.50
32. Security Investment Bank Limited	13.25
33. Allied Bank Limited	108.4
34. AMZ Ventures	6.1
35. International Housing Finance	7.4
36. Jahangir Ali Siddiqui Capital Securities	202
37. Askari Commercial Bank Limited	91.4
38. United Bank Limited	155.5
39. First Nat. Equity	51.1
40. Meezan Bank	30
41. PICIC Bank	28.50

Source: Published Share Price from Dawn Newspaper dated May12, 2006.

Appendix A.2

Board of Directors		Percentage of banks complying with the recommendation	
1. Does your board include independent non-executive directors? (An independent director is defined as a director who is not connected with the listed company or its promoters or directors on the basis of family relationship and who does not have any other relationship, whether pecuniary or otherwise, with the listed company, its associated companies, directors, executives or related parties. The test of independence principally emanates from the fact whether such person can be reasonably perceived as being able to exercise independent business judgment without being subservient to any apparent form of interference.)	Yes / No	77.5%	
2. Do you have representatives of your minority shareholders on the board?	Yes / No	12.5%	
3. If you have institutional shareholders, do they have an independent director representing their interests?	Yes / No / Not applicable	35%	
4. What is the term, i.e. the number of years before having to be re-elected, for board members?		Almost all sample banks except one have term of 3 years before having being re-elected for board members.	
5. Is your chairman an independent non-executive?	Yes / No	Yes (10%)	
6. Does your company have a statement on ethics and business practices?	Yes / No	All firms have the statement with exception of one firm.	
7. If you have a statement on ethics and business practices, how often is the statement reviewed by your company?		Not at all (All firms' response)	
8. How frequently does your board meet?		Every Quarter	32.5%
		5 times	27.5%
		6 times	10%
		7 times	5%
		8 times	2.5%
		9 times	2.5%
		10 times	2.5%

The Chief Financial Officer (CFO) and Company Secretary		
1. how frequently?	Yes / No	All firms responded 'Yes' to query No.1 but 17.5% of banks said that CFO does not attend all meetings.
2. What are your CFO's qualifications (e.g. is s/he a chartered accountant)?		All of them have degrees in accounting, economics and business administration but they vary such as ACMA, B.Com etc. All of them are not chartered accountants
3. Does your company secretary attend the board meetings? If yes, how frequently?	Yes / No	All banks answered Yes to part 1, however 87.5% of banks disclosed that company secretary attends all meetings.
4. What are your company secretary's qualifications (e.g. is s/he a chartered accountant)?		All of them have accounting, economics and business administration background such as CA, MA, MBA, ACMA etc. Only two of them have bachelors only.
Insider trading		
1. Do your directors inform the company secretary each time they buy or sell shares in the company?	Yes / No	Yes (in case of buying shares) but 12.5% respondents said 'No' in case of directors informing them while selling shares.
2. Does your company impose trading bans on the directors around price-sensitive events (such as an earnings announcement? If yes, please provide details.	Yes / No	Yes (all respondents)
3. Do your auditors or their direct relatives hold shares in your company?	Yes / No	No (all respondents)

The Audit Committee			
1. Does your company have an audit committee?	Yes / No	Yes (all)	
2. How many members does it have?		2	5%
		3	72.5%
		4	20%
		5	2.5%
3. Do its members include the company chairman?	Yes / No	No (55%)	
4. How many of its members are non-executives?		None	7.5%
		2	22.5%
		3	57.5%
		4	10%
5. Is the chairman of the audit committee a non-executive?	Yes / No	Yes (70%), No (30%)	
6. How often does the audit committee meet?		3 times	2.5%
		Once every quarter	82.5%
		6 times	2.5%
		8 times	5%
7. Does the CFO attend its meetings?	Yes / No	All respondents said 'Yes' to CFO attending its meeting but 20% replied 'not all'.	
8. Does the head of internal auditing attend its meetings?	Yes / No	Only 20% said 'Yes'.	
Internal Auditing			
1. Does your company have an internal auditing procedure?	Yes / No	All respondents said 'Yes'.	
2. Does the head of internal auditing have access to the chairman of the audit committee?	Yes / No	All respondents said 'Yes'	

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Abstract

La Porta et al. (1998) assign Pakistan, a common-law country, the maximum score of 5 for their anti-director rights index. Pakistan should therefore be a country with good investor protection attracting large amounts of investments. However, the reality could not be more different. Pakistan has been lagging behind other, comparable Asian economies in terms of incoming foreign direct investment as well as GDP-per-capita growth. This paper focuses on the Pakistani banking sector. The paper analyses the banks' ownership and control structure. It finds that Pakistan has its own idiosyncrasies, which are difficult to associate with La Porta et al.'s characterisation of corporate governance and in*vestor protection* in common-law countries. The paper also reviews the recent reforms of corporate governance.

Keywords: corporate governance, corporate control, banks, Pakistan, emerging markets, investor protection

JEL codes: G21, G28, G30

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