

ASIAN DEVELOPMENT BANK

RES:PAK XXX

(REEVALUATION STUDY SERIES NUMBER 26)

REEVALUATION

OF THE

**FOURTH INDUSTRIAL DEVELOPMENT BANK OF PAKISTAN PROJECT
(Loan Nos. 608-PAK[SF] and 609-PAK)**

IN THE

ISLAMIC REPUBLIC OF PAKISTAN

December 1997

EXECUTIVE SUMMARY

Background. Under the Project, the Bank approved two loans in December 1982 of \$20 million each to the Islamic Republic of Pakistan, one drawn from special funds resources (Loan No. 608[SF]), and one drawn from ordinary capital resources (Loan No. 609). The Islamic Republic of Pakistan as the borrower, relented the Bank's loans to the Industrial Development Bank of Pakistan (IDBP) to (i) provide foreign exchange credit to help finance private sector industrial development projects, and (ii) improve IDBP's operational efficiency. The Project subloans were expected to induce \$120 million in investment capital, create some 10,000 jobs, and achieve annual foreign exchange savings of \$10 million. In addition, the Project was expected to (i) diversify and improve the quality of IDBP's loan portfolio, (ii) restore debt-servicing capacity, and (iii) streamline IDBP's organization and procedures.

A Project completion report (PCR) was completed in October 1989 and a Project performance audit report (PPAR) was completed in September 1991. Of the total approved loan amount, \$39.49 million was utilized to assist 69 projects and the balance was canceled. The 69 subloans covered projects in the textiles industry (43 percent by value); engineering (17 percent); paper products (11 percent); food and nonmetallic manufactures (9 percent each); and chemicals (8 percent). The balance was distributed among paper and packaging suppliers, garment manufacturers, light engineering firms, electrical suppliers, and brake-lining and matchmaking manufacturers. Thirty-two of the 64 projects for which data were available were operating at a loss, and eight projects were still under implementation. The average cost overrun among projects was 50 percent, and the average time overrun was 68 percent. The cost overruns were generally due to increases in prices (accentuated by the devaluation of the rupee and implementation delays), while the time overruns were caused mainly by delays in plant construction and the arrival of machinery. From 1989 there was a marked deterioration in the financial performance of IDBP that was attributed to the high turnover of IDBP management and the resulting weakened capacity to appraise new projects and manage its loan portfolio. The PPAR reconfirmed the PCR's assessment, and rated the Project as partly successful.

Reevaluation Findings. The performance of the subborrower projects reveals a worsening situation as reflected in the number of projects not operating, in arrears, and under litigation. Of the 15 projects surveyed for this reevaluation study, only two were operating profitably, nine were operating at a loss, and four had closed down. Three had repaid their foreign currency loans, and eight were insolvent. The expected generation of investment capital, employment, and foreign exchange savings was not achieved. The incidence of project closures and unrecovered debt was too high to be absorbed within the 4 percent interest operating margin specified for the Bank's loans. The performances of the subborrower projects were affected by the instability of operating conditions and markets, changes in the price competitiveness of goods and services, and financing structures that were too highly leveraged and or carried insufficient debt-servicing capacity.

The Government's removal of restrictions on mobilizing deposits in 1985, together with the cessation of long-term credit sources after 1987, caused IDBP to diversify its operations toward short-term lending. Reacting to these changes, IDBP increased its deposit base from PRs215 million in FY1984 (representing 5 percent of total assets) to PRs8,967 million in FY1996 (representing 50 percent of the total assets). At the same time, term lending as a proportion of total assets fell from 85 to 40 percent. Despite the shift in operational emphasis, weaknesses concerning IDBP's operational efficiency, financial performance, and institutional capacity cited in

the PCR and PPAR continued. By the fiscal year ending June 1996, IDBP's after-tax profit to equity ratio fell from 16 percent in FY1990 to 0.5 percent, the current ratio from 1.3 to 0.8, and the arrears to total advances ratio from 16 percent to 52 percent. This worsening financial performance is attributable to inadequacies in the appraisal of projects and legislative processes for IDBP (and all financial institutions) to enforce debt recovery. Prevailing macroeconomic conditions made debt servicing difficult and contributed to IDBP's worsening performance, as did political interventions to approve loans against appraisal dictates.

The Project is reassessed as unsuccessful on the basis of (i) the overall Project outcomes that were markedly less than expected at appraisal, (ii) the poor and worsening subborrower project performances, including the high incidence of closures; and (iii) the nonsustainability of institutional strengthening measures.

Feedback. Reevaluation of the Project after a further six years, demonstrates the inherent risks in project lending, the need for stronger safeguards to be built into debt-servicing and recourse on principal, and the need for more effective debt-recovery systems. The Project design concepts of setting performance targets for IDBP to achieve efficiency improvements, strengthening appraisal and management systems, providing for portfolio diversification, and fixing interest spreads proved useful goals on which to focus results-but were insufficient in themselves to ensure sustainable collectable credit. With the benefit of hindsight, the Bank's assistance should have also focused on improving the operational environment and deregulation of the banking and financial sector.

The Government's current plans reflect a strong resolve and commitment to privatize the banking and financial sector. However, the viability of doing so remains strongly dependent on governance through (i) sound prudential banking regulations backed with appropriate supervisory and enforcement powers; (ii) effective and expedient debt-recovery legislation; and (iii) accounting and audit supervision practices based on international standards. The willingness of private sector investors to take equity and or extend credit to banking and financial institutions will depend upon further Government reforms to improve and enforce financial statement disclosure, debt-recovery, and supervisory controls.

With further deepening and consolidation of the financial sector, lending margins are likely to narrow and make it difficult for IDBP to remain a viable operation. Based on IDBP's statements of account, IDBP's total share value is worth no more than \$20 million and compares with a present shareholder's equity of around the same. A sale for this amount would still leave some \$360 million outstanding in loan advances, against which the Government carries a contingent liability for guarantees on the deposits and foreign credit lines amounting to about \$255 million. Because of the degree of arrears infection, the cumbersome prospects for debt-recovery through legal recourse, and the limited scale of IDBP's banking operations-intentions to privatize IDBP as a going concern appear unrealistic. A more prudent option would be privatizing through a combination of (i) liquidating loan assets, and (ii) merging IDBP's commercial banking operations with a larger commercial bank.¹

I. BACKGROUND

1. The Industrial Development Bank of Pakistan (IDBP) was established in 1961, primarily to fund industrial enterprises, and to operate as a State-owned bank in accordance with the Government's industrial development policies. Under the State Bank of Pakistan (SBP)

Act 1956 and the Banking Companies Ordinance 1962, IDBP must comply with statutory reserve requirements applying to deposits and other securities, prudential regulations, reporting, and disclosure requirements. Since 1961, IDBP has provided financial assistance to more than 7,000 subborrower projects.

A. Objectives, Scope, and Rationale

2. The Project, for which the Bank approved two loans of \$20 million equivalent each to the Islamic Republic of Pakistan,ⁱⁱ was formulated as part of the Government's Three-year Public Sector Development Program (FY1981-1983),¹ and the Sixth Five-year Plan (FY1984-1988). The loans were to (i) provide IDBP with foreign exchange to help finance private sector industrial development projects, and (ii) improve IDBP's operational efficiency.² Financial and operational covenants in the Bank's loan agreements³ were expected to remedy weaknesses in IDBP's financial structure, and provide IDBP with a reference for continuous self-assessment and improvement.

3. The Bank's Appraisal Mission, which was completed in August 1982, included a review of the Government's policy framework for the industry sector, and a review of the institutional framework and operations of IDBP. The information obtained built on the Bank's previous loan experiences with IDBP (para. 7), and provided a basis for supporting the expansion of private sector-led industrial development. The Project subloans were expected to induce \$120 million in investment capital, create some 10,000 jobs, and achieve annual foreign exchange savings of \$10 million. In addition, the Project was expected to (i) diversify and improve the quality of IDBP's loan portfolio, (ii) reduce the level of its arrears, (iii) restore debt and servicing capacity, (iv) increase the level of loan collections, and (v) streamline IDBP's organization and procedures. The Project was not expected to face any major physical or environmental risks. Subloans to the private sector were expected to be able to reasonably withstand the adverse consequences of recession, delays in project completion, and cost overruns.

¹ The Three-year Public Sector Development Plan resulted from severe resource constraints during the first two years of the Sixth Five-year Plan and the need to review priority allocations for Budget support. Cutbacks in public investment in the industry sector were announced and emphasis was given to promoting expansion in the industry sector through private investment.

² IDBP, being wholly Government owned, conducted its operations in line with the development plans and priorities of the Government. At appraisal, IDBP's mandate to provide long-term credit to small- and medium-sized private sector industries was considered essential to implement the Government's aims and a necessary adjunct to short-term credit facilities offered by the majority of commercial banks.

³ These refer collectively to the two Loan Agreements between the Bank and the Borrower (one for Loan No. 608-PAK[SF] and 609-PAK), and the Project Agreement between the Bank and IDBP.

B. Implementation and Completion

4. By agreement with the Bank, the Government as the borrower, relented the Bank's two loans to IDBP. The proceeds, in turn, were lent to subborrowers in the private sector and for industrial development purposes. The Bank's agreements provided that Bank funds were not to be used for subloans to industrial activities where there was excess production capacity. The interest rate between the Government and IDBP was fixed at 7 percent per annum and the lending rate from IDBP to subborrowers was fixed at 14 percent, inclusive of a foreign exchange risk fee of 3 percent per annum. Loan terms between the Government and IDBP, and IDBP and subborrowers, were set at a maximum 15 years with a grace period up to 3 years. IDBP was permitted to lend up to \$0.5 million (free limit) without Bank approval and up to \$2.0 million with Bank approval.ⁱⁱⁱ Financial and operational performance targets were set including requirements for the Government to (i) ensure that IDBP's debt-service coverage was not less than one by the end of FY1983, (ii) bear the foreign exchange risk in connection with each subloan, and (iii) reschedule debt obligations of IDBP to the Government. IDBP was to (i) monitor the collection performance of its operations for quarterly review by the Bank, and (ii) monitor the economic benefits of subloans for annual review by the Bank. Appraisal of the Project envisaged completion of all subloan disbursements by June 1987, approximately four years from the date of declared loan effectiveness. Commitments under the Bank's loan were completed in June 1986. To accommodate the delays in implementation of subloan projects, the Bank approved an extension on the closing date of subloan disbursements to December 1988.

C. Major Postevaluation Findings

5. A Project completion report (PCR) was completed in October 1989 and a Project performance audit report (PPAR) was completed 23 months later in September 1991. Of the \$40 million approved under the Project, \$39.49 million was disbursed and the balance canceled. A total of 69 projects in the private sector were financed, of which 32 were above the free limit of \$500,000 and accounted for 81 percent of the Bank's total loan assistance. Fifty-two were for new projects and accounted for 72 percent of the utilized assistance.^{iv}

6. The 69 subloans covered projects in the textiles industry (43 percent by value), engineering (17 percent), paper products (11 percent), food and nonmetallic manufactures (9 percent each), and chemicals (8 percent). The balance was distributed among paper and packaging suppliers, garment manufactures, light engineering and construction, electrical suppliers, fabricators of construction equipment, and brake-lining and matchmaking manufacturers. As at 30 June 1990, thirty-two of the 64 projects for which data were available were operating at a loss. Eight projects were still under implementation. The average cost overrun among subborrower projects was 50 percent, and the average time overrun was 68 percent. The cost overruns were generally due to devaluation and increases in prices, which in some cases were accentuated by the effect of the time overruns. The time overruns were caused mainly by delays in plant construction, and in the arrival and installation of machinery.

7. There was a marked deterioration in the financial operating performance of IDBP after 1989 in terms of (i) loan portfolio quality, (ii) arrears and collection performance, and (iii) earnings performance. The overall deterioration of IDBP's performance was attributed to the high turnover of IDBP management, which weakened the capacity of IDBP to appraise new projects and manage its portfolio. The PPAR endorsed the PCR's assessment, and rated the Project as partly successful.

D. Need for Reevaluation

8. Appendix 1 provides a framework analysis of the Project objectives, scope, and achievements. The PCR (1989) and PPAR (1991) underscored weaknesses in the operational efficiency, financial performance, and institutional capacity of IDBP, but the evaluations for these were carried out before Project implementation was complete, and before the full impact of other funding assistance, which overlapped IDBP IV and placed more emphasis on institutional strengthening, was fully felt.^v Disbursements and the full impact of assistance for strengthening IDBP's operational performance was not complete until after April 1993, so that the PCR and PPAR judgement about the performance of IDBP and sustainability of operations was premature.

9. Reevaluation of the Project enables the Bank to further examine IDBP's performance and how subborrower projects have fared at a more mature stage. The reevaluation attempts to arrive at firmer conclusions on the long-term performance and sustainability of the Project, and to assess its impact on economic development in the context of which the Project was justified. Special emphasis is given to assessing (i) the subsequent financial and institutional performance of IDBP and the procedures now in place to meet loan collection targets, (ii) the extent to which IDBP has improved its supervisory role to its subborrowers, (iii) the sustainability of the institutional strengthening of IDBP, and (vi) the extent to which Bank support to IDBP and its subborrowers was effective. The reevaluation is based on the findings of a Reevaluation Mission (REM) that visited the Project during July 1996; a review of the Appraisal Report, PCR, and PPAR; a survey conducted in September 1996 of 15 of the 69 subborrower projects, including 6 of 7 examined in 1991 by the PPAR; a follow-up mission in September 1997; discussions with Bank staff, senior officials of IDBP, and other agencies of the Borrower; and interviews with industry experts and recipients of subloans. Copies of the Reevaluation Study (RES) were provided to the Borrower, IDBP, and Bank staff for review and comments. Comments received were taken into consideration in finalizing the Report.

II. REEVALUATION FINDINGS

A. Operating and Financial Performance

1. Operational Setting

10. At appraisal in 1982, Pakistan's primary macroeconomic difficulties were an increasing deficit of import over export trade. The financial system was operated through mandatory controls over the allocation of credit.^{vi} Development finance institutions, including IDBP, were not permitted to raise funds from deposits and depended on allocations of funds from the Government and credit lines from foreign sources. In 1982 the Government initiated Islamization of the financial sector. This meant there would no longer be interest rates specified in domestic lending, but instead there would be negotiated profit-sharing and markup arrangements.⁴ A summary account is given in Appendix 2 of the Government's development plans, resultant economic activity, progress on policy reforms, and external influences affecting the operational environment from appraisal to 1997. In general the industrial, financial, and

⁴ Islamic funding principles do not apply to foreign loans, but have a significant bearing on settlements under litigation and negotiation for recovery. Islamization of the banking sector became effective in 1985.

capital market reforms announced under the Government's development plans were met by faster than expected actions.

11. The Bank's loan as it directly affected the operating and financial performance of IDBP extended from FY1984-1990.⁵ IDBP's loan approvals during this period also included disbursements from 1986 under Development Financing Loan (DFL) II, and DFL III; and from 1982 under the World Bank's industrial investment credit (IIC) loans IIC-1, and IIC-2 (para. 8). IDBP was also the coordinating agency of the Bank's Small-scale Industry Project.⁶ Under the Bank's DFLs and the World Bank's IICs, a loan facility was offered that participating financial institutions could access on a first-come, first-served approach, and on the basis of firm subloan commitments and achievements toward a prescribed set of performance targets.⁷ IDBP utilized \$21.8 million under DFL II and \$33.8 million under DFL III. Apart from a small credit line of less than \$10 million from Belgian sources approved in 1994, IDBP received no further credit approvals for development finance after 1987. Disbursements on credit approvals from the Bank and the World Bank continued until FY1994.⁸

⁵ The Bank's loan was expected to be fully disbursed by 30 June 1985. There were no disbursements in 1983, 17 percent of the Bank's loan was disbursed during 1984, 47 percent during 1985, and 36 percent in 1986. Implementation of most subborrower projects was not complete before 1988, and a few remained under implementation after 1990. The Project subloan terms were commonly of 8-12 years.

⁶ Loan No. 902-PAK: *Small-scale Industry Project*, for \$50 million, approved on 22 September 1988.

⁷ The performance targets included a minimum compliance to qualify as a participant in the loan assistance. Thereafter, and on a projected basis, the performance targets were set to progressively improve the financial and institutional performance of the participating financial institutions.

⁸ IDBP was also a development finance institution participant under DFL IV and IIC-3, but was not able to achieve the performance target levels set to qualify for the drawdown of any loan proceeds.

12. Disbursements under IDBP IV averaged around 21 percent of IDBP's total value of loan approvals, while interest dues from subborrower projects represented around 8 percent of the total income from financing. Although the direct addition to IDBP's loan portfolio was not major, the Bank's loan was an important forerunner to the strengthening process that was extended with subsequent funding support, and for which non-compliance with operating and financial covenants later meant that IDBP would not qualify for funding under DFL IV (page 4, footnote 6).

13. Between FY1983 and FY1990, annual growth of the gross domestic product (GDP) averaged more than 6 percent until FY1988, then slowed amidst tightening monetary constraints. Interest rates on term lending increased from 14 percent to 20 percent, and the rupee devalued against the dollar from PRs9.9 to PRs21.4. These factors variously affected IDBP's operations, so that while the Bank's foreign credit lines helped IDBP expand its lending to the industry sector, the economic recession after FY1988, together with increased interest rates on borrowings, strained the debt-servicing capacity of subborrower projects.⁹ For banking operations, the high interest structure was favorable for mobilizing savings deposits, and for lending on a short-term basis to highly liquid businesses and or for projects that involved a high proportion of equity. For most subborrower projects, the severity of devaluation caused significant overruns on appraised costs. The capacity of the banking sector and private sector businesses to absorb the impacts of market conditions varied. Nationalized commercial banks, whose exposure to project lending was less than 20 percent of their loan portfolios, were least affected. For the development finance institutions, including IDBP, that were created with a mandate to meet long-term financing needs, the impact was more acute. And for those private sector projects that were dependent on project revenues for debt servicing, the impact was generally severe.¹⁰

14. After 1990, the recessionary effects of the cotton virus extended to 1993, before showing evidence of recovery. GDP growth increased to 5.2 percent in FY1995, but slowed to 3.1 percent in FY1997. Overall, the increase in economic activity was relatively weak taking into account the annual population increase of around 2.8 percent. Interest rates continued on an upward trend through to June 1987,¹¹ and the rupee devalued against the dollar, from PRs21.4 in FY1990 to PRs38.6 in FY1997. Reflecting the changes in economic circumstances, including the promise of no further banking lines of credit from traditional sources, IDBP made a switch in operational emphasis toward short-term funding. IDBP's capacity to do so followed the Government's lifting of restrictions on mobilizing deposits in 1985 (paras. 21 and 27).

2. Performance of Subborrower Projects

⁹ The nominal interest rate on subloans was fixed at 14 percent. However, the cost of finance from other sources for domestic and working capital was variable and increased to around 20 percent. The increased costs could not be passed on to export competitive industries, and consequently rendered some subborrower projects inviable.

¹⁰ Loans from domestic sources typically represented between 60 to 80 percent of a subborrower's total project cost. In addition, the high cost of funding, was directed toward competitive industries for which the servicing capacity of projects was limited. As a consequence, lending was viable only where substantial subborrower equity or recourse to nonproject debt servicing was available. Most projects were funded with less than 20 percent equity.

¹¹ When the first of a series of small downward adjustments on funding provided by State Bank of Pakistan were announced.

15. At the time of the PPAR, the operational performance of 64 of the 69 projects for which data were available indicated that 32 were operating at a loss, including 8 projects still under implementation. Despite the disappointing profitability, the value of arrears to the total loan amount outstanding on these projects was only 6.4 percent. Of the seven select projects surveyed for the PPAR, three were operating profitably, two were still under implementation but not in financial difficulty, and two were operating at a loss. Three projects were in arrears on repayments.

16. Although the data available for the RES is not fully consistent with the records available at the time of the PPAR, it indicates a worsening trend. Of the 69 project loans, 35 (51 percent) were in significant arrears, and the arrears component of the Bank's foreign currency subloans as a ratio of the foreign currency loan amount outstanding had increased to 56 percent.^{vii} Of the 15 projects surveyed for the RES (including six of the seven surveyed for the PPAR), only two were operating profitably, nine were operating at a loss, four had closed down, and three had repaid their foreign currency loans. Eight of the 15 projects surveyed were insolvent. Of the six projects surveyed for the PPAR, only one was operating profitably, and four were insolvent, in arrears, and under litigation. Appendix 3 provides further details of the operating status of subborrower projects.

3. Performance of IDBP

17. IDBP's efforts at diversifying its term-lending portfolio across industries were generally sustained (Table 1). Diversification across provinces also improved, with purposeful efforts to provide an increased amount of lending to less developed areas.^{viii}

Table 1. Distribution of Outstanding Term Advances

Industry	1982	1990	1996
	%	%	%
Textiles	44	21	27
Food Products	5	16	14
Chemicals	30	7	13
Engineering	2	6	8
Nonmetallic Manufactures	2	9	8
Paper Products	1	6	5
Electrical	1	3	4
Other/Miscellaneous	15	32	21
TOTAL	100	100	100

18. The number of development loans appraised and approved increased from around 235 at appraisal in 1982 to 420 in 1987, before falling to 20 in FY1996.¹² The average size of the project loans approved was PRs2.4 million (\$183,000) in FY1983, PRs9.77 million (\$406,000) in FY1991, and PRs13.7 million (\$360,000) in FY1996.

19. From FY1983-1990, IDBP expanded its total asset base 3.1 times from PRs3,349 million. The increase in total assets, which reflected an average annual increase of 17.6 percent, was sourced mainly from additional borrowings and deposits, with the latter substituting for reduced foreign borrowings from 1989. Increased after-tax profits also contributed to IDBP's asset base, as did a small infusion of equity capital (PRs0.57 million) in 1985. Correspondingly, IDBP's after-tax profits climbed from PRs34 million in FY1983 to a high of PRs97 million in FY1990, and thereafter progressively declined to PRs4.3 million in FY1996.¹³

20. Relative to IDBP's equity base, after-tax profit varied around 14 percent until FY1990 before following a declining trend to 0.5 percent in FY1996. The current ratio declined from 3.2 in FY1983 to 0.8 in FY1996. The decline in absolute profit after FY1990 was in part attributable to the sensitivity of IDBP's lending exposure to increases in the statutory minimum liquidity ratio.

¹² There were five foreign currency loans approved in FY1995 and none in FY1996.

¹³ PRs49 million in FY1995.

Table 2: Operating Performance and Financial Highlights: Industrial Development Bank of Pakistan^a

Item	1982	1983	1985	1987	1989	1991	1993	1995	1996
Operational									
Project Loan Disbursements (PRs billion)	0.211	0.398	0.539	0.974	0.965	1.408	1.167	0.310	0.201
No. of Project Loans Approved									
- Foreign Exchange	32	37	53	70	22	11	5	2	nil
- Local Currency	127	199	211	350	212	133	102	28	20
Balance Sheet Accounts (PRs billion)									
Total Assets	3.028	3.349	4.378	7.192	9.842	12.865	16.796	18.103	17.882
Current Assets	0.159	0.414	1.693	3.106	4.032	7.489	11.376	7.924	7.973
Term Loans	2.586	2.864	3.138	5.079	6.154	7.063	6.913	8.190	7.169
- Loan Arrears	0.816	0.931	0.734	0.953	0.905	1.269	2.238	4.326	5.975
Shareholders' Equity	0.196	0.228	0.333	0.460	0.585	0.715	0.834	0.912	0.894
- Paid-up Capital	0.100	0.100	0.157	0.157	0.157	0.157	0.157	0.157	0.157
Income Statement Accounts (PRs billion)									
Total Operating Income	0.227	0.261	0.450	0.729	1.074	1.378	1.975	2.305	2.263
Total Operating Expenses	0.210	0.220	0.397	0.638	0.939	1.226	1.822	2.195	2.246
Profit Before Tax	0.017	0.041	0.053	0.091	0.135	0.152	0.153	0.110	0.161
Profit After Tax	0.006	0.034	0.048	0.056	0.080	0.077	0.061	0.049	0.004
Ratios (%)									
Shareholders Equity/Total Assets	6.5	6.8	7.6	6.4	5.9	5.6	5.0	5.0	5.0
Arrears/Total term loans	31.6	32.5	23.3	18.8	14.7	24.3	32.4	52.8	83.3
Term Loans/Total Assets	85.4	85.5	71.7	70.6	62.5	54.9	41.2	45.2	40.1
Arrears/Total Assets	27.0	27.8	16.8	13.3	9.2	9.9	13.3	23.9	33.4
Profit Before Tax/Total Income	7.5	15.7	11.8	12.5	12.6	11.0	7.8	4.8	7.1
Profit Before Tax/Shareholders Equity	8.7	18.0	15.9	19.8	23.1	21.3	18.4	12.1	18.00
Profit After Tax/Shareholders Equity	3.1	14.9	14.4	12.1	13.7	10.8	7.3	5.4	0.5
Term Liabilities/Equity (ratio no.)	13.2	12.6	9.4	11.0	10.5	9.9	8.3	9.0	8.0

n.a. – not available

^a Results are for the year ending 30 June.

21. The switch in operational emphasis toward short-term funding, saw IDBP's deposits accelerate 16.5 times from FY1983 to PRs1,903 million in FY1990, and thereafter increase to PRs8,967 million by FY1996 (paras. 14 and 27).¹⁴ Correspondingly, short-term lending activities as a proportion of IDBP's total assets increased from 3.3 percent in FY1983 to 12 percent in FY1990, to 33 percent in FY1996. Term loans as a proportion of total assets fell over the entire period from 85 to 40 percent. Although the overall trend since FY1990 in IDBP's asset growth, deposit base, and debt/equity and debt-service ratios represent positive performance elements, profit levels declined in both absolute and relative magnitude,¹⁵ and the current ratio declined to less than one. See Table 2 for a summary of IDBP's financial performance and Appendix 4 for further details.¹⁶

¹⁴ Facilitating the growth in deposits, IDBP's deposit rate was set so as to be more attractive than available from SBP. Depositors were also provided a guarantee as additional security from the Government.

¹⁵ As measured by the ratios for after-tax profit to shareholders' equity and after-tax profit to income receivables.

¹⁶ IDBP's statement of accounts prepared on an income accrual basis tends to overvalue assets, equity, and profit performance. Provision for bad loans is on the basis of actual settlement rather than in anticipation.

22. At appraisal, IDBP's arrears of PRs931 million represented approximately 32 percent of IDBP's total loan portfolio, similar to that recorded at appraisal in 1975 for IDBP III. But while IDBP's arrears to total loan portfolio ratio had not improved, there was greater recognition of the need to make provision for doubtful debts against income. Also, the system of appraising subborrower projects was strengthened and promised success with recoveries following measures taken by the Government.¹⁷ For IDBP IV, the Bank extended the sole financial covenant under IDBP III¹⁸ to include a provision requiring IDBP's debt-service ratio not to fall below one. The Bank's DFL loans extended the financial covenants further to include performance targets on profit performance and cash collections on loan dues.¹⁹

23. From FY1983-1990, IDBP's arrears to total loan portfolio declined from 32 to 16 percent (Appendix 5). Cash collections on current dues improved from 68 percent in FY1983 to 81 percent in FY1988, fell to 49 percent in FY1989, improved to 85 percent in FY1991, and thereafter followed a declining trend to less than 30 percent in FY1996 (para. 35). By FY1996, the ratio of arrears to total loans had increased to 52 percent,²⁰ and it was clear that IDBP's earlier improved performance could not be sustained. Reflecting concerns for the mounting arrears position of IDBP and other institutions, at the beginning of 1997 SBP announced a special scheme for the recovery of overdue loans. The scheme, which is based on the age of overdue loans, offers heavy discounts on interest accruals and penalties for time-based repayments. The scheme was reported to have drawn a favorable response from about 430 of 1,300 IDBP subborrowers. Together with recent IDBP measures, recoveries of principal and interest were reported by management to be 37 percent more in FY1997 than FY1996.

¹⁷ In 1980, the Government promulgated rules governing judicial procedures to accelerate court proceedings. Initial experiences seemed encouraging; of 73 cases filed by IDBP, 28 were settled by June 1980. There was some evidence of the new procedures slowing down at appraisal. However, it was generally acknowledged that resolution through the special courts was taking less than a year compared with ten years under regular civil courts.

¹⁸ This required IDBP to operate within a debt/equity ceiling of 5:1, also extended for the Bank's fourth loan.

¹⁹ Under DFL III, IDBP was required to maintain a net profit to equity ratio of 12 percent, achieve cash collections of not less than 20 percent compounded annually from FY1988, improve its cash collections on total dues from 58 percent in FY1988, and make progressive reductions on its principal infection ratio from 34 percent.

²⁰ Total arrears as a proportion of total term loans increased to 83 percent, but the measure includes arrears on nonterm advances that were insignificant at appraisal. Some 20 percent of IDBP's nonterm advances were reported to the REM as being in arrears.

B. Socioeconomic Aspects of Subborrower Projects

24. The Bank's funding assistance although predominantly disbursed to the textile industry, included a wide differentiation of activities covering weaving; knitting; cloth manufacture; dyeing and printing; and glove, apparel, and garment making. Other industry activities included cement making, leather shoemaking, packaging, auto parts, paper production, cable manufactures, rubber and latex processing, sugar production, and small engineering manufactures for fittings, fasteners, and zippers. Fifty-two of the 69 subborrower loans were for new projects. Many of these were based on developing a market source as an alternative to importing, e.g., gloves, plastics, and tires, and several supported the introduction of imported technologies e.g., glass medical vials, brake linings, and electric cable manufacture. The availability of foreign exchange funding for the import of machinery assisted export-based operations maintain competitiveness, and develop value-added operations in leather, garment, and apparel making. Based on the 15 projects surveyed for the RES, it is estimated that the Project generated export revenues of approximately \$9 million and additional direct employment for some 4,300 persons. The expected foreign exchange savings and employment impacts from the Project were therefore not achieved (para. 3).

C. Institutional Development

25. At the time of the Bank's appraisal, IDBP was involved in preparing a strategy statement specifying its intention to improve its appraisal and supervision standards, pursue a program for arrears recovery and the rehabilitation of sick industrial projects, diversify its portfolio, and promote new projects in the less-developed areas. An active and sustained pursuit of these goals followed. By 1985 an effective monitoring and supervision system was in operation. Project loans were classified into one of four categories: those problem-free, with temporary difficulties, with major problems, and under litigation. These categories were used to determine the frequency of visits and type of follow-up actions taken. The system appears to have worked well with notable improvements in collections until 1988, after which frequent changes of management and senior banking officers contributed to a deteriorating performance.

26. Between 1982 and 1996, IDBP's operations expanded from 12 to 19 branches. The number of professional staff engaged doubled from around 240 at appraisal to 500 in 1990, and is currently about 530. The increase in staff numbers was needed to (i) expand the branch network for the purpose of mobilizing deposits, and (ii) diversify IDBP's activities into commercial and merchant-banking services. Until 1985, lending operations were steered through Government controls over credit allocation, lending, and borrowing rates (Appendix 2). Because nearly all operational assets (save some interbank commercial deposits) were sourced from credit lines extended by the SBP and foreign sponsors, assessing IDBP's performance was essentially a measure of financial accountability and of evaluating the effectiveness of project appraisals. Operating efficiency was measured in terms of progress on disbursements, compliance with loan covenants, and the achievement of acceptable profit returns. In this, management's role was limited to following the Government's industrial development policies, approving credit for projects, and overseeing accounts and staff operations.

27. In 1985, with the adoption of Islamic modes of financing (para. 10), and the liberalization of Government controls on deposit taking, IDBP was given scope to diversify its operations from project lending. Mounting pressure to do so came from the Bank and World Bank reviews of IDBP operations. Initially, IDBP focused on building its deposit base. By FY1990, IDBP's deposit base, which represented 18 percent of total assets, enabled IDBP to also expand lending for working capital purposes, and to use any surplus liquidity in money market operations

and export financing. After 1989, the cessation of traditional funding sources for term finance caused IDBP to intensify its short-term lending activities. A successful foreign exchange deposit scheme started in 1991 allowed IDBP to expand into import financing. As its deposit base further expanded, IDBP expanded into merchant and investment banking activities, including leasing, treasury investments (bonds and securities), equity participation, and underwriting. At the end FY1996, IDBP's commercial and merchant-banking activities accounted for 44 percent of its income-earning assets compared with 4 percent at appraisal, and new income-generating operations were almost entirely focused toward short-term financing and services. Loan advances outstanding in IDBP's portfolio numbered around 1,300, with a total asset value of PRs14.9 billion (\$360 million).^{ix}

D. Environmental Impacts and Control

28. The Bank's loan covenants required that loans to subborrowers be conditional upon the subborrowers complying with all the environmental rules and regulations of Pakistan. Subloan agreements between the participating financial institutions and subborrowers reflected the Bank's environmental loan covenants, and the REM's visits to subborrower project sites found no obvious breach.

E. Sustainability

29. The sustainability of IDBP's operations and its diversification into commercial banking are dependent on the (i) quality of its balance sheet, (ii) effectiveness of mechanisms introduced to aid the recovery on subborrower loans, (iii) expertise and banking experience available to lead the bank's operations, and (iv) capacity to compete on a viable basis with larger commercial banks.

30. Uncertainty over the quality of IDBP's accounts, perceived weaknesses in the quality of IDBP's loan portfolio, limitations of the Governments recently enacted Recoveries Ordinance (1997), constraints on staff emolument incentives, and the limited scale of commercial operations raise doubts as to the sustainability of IDBP's banking operations. Prudent macroeconomic management and stable conditions are also key to the sustainability of operations as a continuation of existing economic trends could further impede the pace and extent of financial development and the mobilization of domestic capital and direct foreign investment. The need for management autonomy free from political intervention is also evident.

III. KEY ISSUES FOR THE FUTURE

31. Several interrelated issues emerge from the reevaluation of IDBP IV. These include (i) macroeconomic constraints affecting the viability and sustainability of project funding, (ii) privatization and the impact of future financial deepening, and (iii) loan recovery and the lack of effective recovery procedures.

A. Project Design/Macroeconomic Constraints

32. While the overall rationale for the Project was to provide IDBP with foreign exchange to help finance private sector industrial development projects, macroeconomic conditions after 1988 were generally not conducive to making viable project investments. The combined impact of rising interest rates (on rupee funding) and the devaluation of the rupee caused many project costs to double. Recessionary impacts that slowed economic activity and the domestic demand for project goods and services further undermined the capacity of subborrowers to service their loan debts. These factors point to the need for project design to take into account the operating environment and ensure that objectives for the industry sector in this case, are both financially viable and attainable through credit support. They also point to the need to ensure that credit appraisals take into account the impact of adverse variations in economic conditions.

B. Privatization and Financial Deepening

33. The arguments for privatizing IDBP have been made by those who (i) attach value to IDBP's banking license and its years of experience, (ii) believe privatization is the panacea for management autonomy and improved operational efficiencies, and (iii) view privatization through the share market as an alternative to replacing traditional credit sources. While all arguments carry merit, the appropriateness of privatization ultimately depends on (i) the scale and viability of IDBP's banking operations, (ii) depositor reaction to removing the Government's guarantee on deposits, (iii) management capability, (iv) ultimate liability for unrecovered debt on credit lines, and (v) the costs of dealing with redundant staff.

34. These considerations apart, IDBP's capacity to change its focus from term to short-term lending and to provide proactive and competitive financial services remains constrained by cumbersome processes; weaknesses in operational and management information systems; and a lack of debt instruments, in-house experts, and management to support such. With further deepening of the sector, interest rate spreads and negotiated markups are likely to be squeezed. These factors need to be addressed alongside the scale of output needed if IDBP is to remain a viable operation. At book value, and on the basis of IDBP's earnings result for FY1995, IDBP's total share value is worth between \$8 million and \$20 million. However, from the Government's perspective, which has a vested interest tied to guarantees on deposits and foreign credit lines worth some \$255 million, a combination of liquidating IDBP's loan assets and merging the commercial banking operations with one of the nationalized commercial banks might be preferable to trying to sell IDBP as a going concern.^x

C. Arrears/Loan Recovery

35. The arrears to total loan portfolio ratio^{xi} was the main mechanism for assessing operational performance. This indicator of loan recovery, however, is subject to anomalies that

arise with irregular project loan disbursements, lags in the rescheduling of loan repayment due to delays in project implementation, and markup arrangements on loans that ultimately bear no relationship to final settlements. As such, the results and interpretation of trends from this measure can be misleading. One consequence is that despite the ratio being at least 30-40 percent every year from the mid-1970s, IDBP has remained solvent without any infusion of capital.²¹ The ratio moved from 16 percent in 1990 to 52 percent at the end of June 1996. Closer examination of the sums making up the arrears to total loan ratio reveals that the ratio is sensitive to (i) variations in the continuity of loan disbursements, (ii) time lags between rescheduling and recoveries, and (iii) interest rate levels. The drying up of new credit lines to IDBP after 1987 had a significant bearing on the deteriorating arrears ratio.²²

36. Notwithstanding the need for care in interpreting variations in the arrears ratio, the inadequacy of debt-recovery mechanisms and the need for improved and less lengthy legal procedures was noted in various reviews by the Bank since the 1970s. The Government for its part has responded,²³ but the measures introduced have proved at best temporarily effective. The most recent Recoveries Ordinance (1997) that aims to expedite recovery procedures on loan litigations is limited to cases under PRs30 million. While this ordinance promises to reduce the backlog of cases, recovery procedures for cases over PRs30 million were left for recovery through the High Court in a slow-moving process that is unlikely to significantly benefit IDBP or the overall operational environment. Regardless of the size of the debt outstanding, debt-recovery procedures through litigation take too long and impair the willingness of institutional investors and funds managers to make placements with commercial lenders. This problem is recognized in English jurisdictions under receivership law that empowers banks to appoint a receiver²⁴ to manage the operations of a subborrower in persistent default. The system, allows lenders to recall loans and appoint a receiver with 24 hours notice. The receiver is given total autonomy to manage and operate the business/enterprise until loans are repaid and/or arrangements satisfactory to the lender are agreed to. In the extreme, lenders may sell the business and or such assets of the business to satisfy loan recovery. The subborrowers may end receivership and regain control of their enterprise by repaying the lender's loans and recoverable dues. The system of receivership, while providing more protection to lenders, expedites recovery procedures, shifts the onus on investors to take more responsibility for successful project implementation, and reduces the lending risk.

²¹ There was a conversion of subordinated debt amounting to PRs0.57 million in 1985.

²² From 1990 the falloff in loan approvals, while aided by strong loan recoveries after 1994 in low-age loans, caused at least a 5 percent annual increase in the arrears ratio, i.e., without any neglect or falloff in attention.

²³ Measures include (i) a Recoveries Ordinance in 1979 that created special courts to deal exclusively with litigation cases (later deemed invalid); (ii) directives in 1980 to all nationalized commercial banks not to lend to defaulters of IDBP (and other development finance institutions); (iii) the establishment in 1982 of a Committee on Sick Industrial Units, and subsequent Industrial Rehabilitation Committee; (iv) a second Recoveries Ordinance in 1991 to establish special banking tribunals to expedite the recovery of loans based on Islamic principles; (v) the establishment in 1992 of a Credit Bureau to monitor and report on borrower records of debt servicing; and (vi) a third Recoveries Ordinance in 1997 aimed at expediting the recovery through special banking courts of debts under litigation under PRs30 million.

²⁴ Refer to Receivership law under English jurisdictions.

IV. CONCLUSIONS

A. Overall Assessment

37. While the Bank's foreign credit lines helped the Government and IDBP expand lending to private industry, weaknesses concerning the long-term viability of subborrower projects and IDBP as cited in the PCR and PPAR continued to prevail, and despite sustained involvement and further funding assistance from the Bank, World Bank, and bilateral sources.

38. The performance of subborrower projects, since the PPAR (1991), shows a worsening trend as reflected in the incidence of closures, the increased number of projects under litigation, and the need for reschedulings. Approximately one half of the 69 projects are insolvent and one quarter are no longer operating. The expected investment generation, foreign exchange savings, and employment impacts from the Project were not achieved, and because the incidence of project closures and unrecovered debt are too high to be absorbed within the 4 percent interest operating margin allowed under the Project, the financial investment return on IDBP's loan advances is negative. With respect to the performance of IDBP, the Project's design concept of setting performance targets for IDBP to achieve efficiency improvements met with improving success, but after 1991 the sustainability of earlier achievements could not be maintained.

39. The overall worsening performance of the subborrower projects was affected by the instability of operating conditions and markets, changes in the price competitiveness of goods and services, and financing structures that were too highly leveraged and or carried insufficient debt-servicing capacity. IDBP's worsening performance is primarily attributable to inadequacies in the appraisal of subborrower projects to cover the risks associated with term lending, and inadequate legislation and due process for IDBP (and all financial institutions) to enforce recovery. The unsustainable operating environment, marked by the recessionary impact of a cotton virus between 1991 and 1994, and an unprecedented escalation in interest rates, made debt servicing on projects difficult and contributed to IDBP's worsening performance. Management interventions in loan approval applications against appraisal dictates was also a factor.

40. In consideration of the significantly less than expected Project outcomes projected at appraisal, and (i) the low operational achievements from supported projects, (ii) the unacceptably high incidence of closures among subborrower projects, (iii) the worsening operational and financial performance of IDBP, and (iv) the nonsustainability of institutional strengthening measures, IDBP IV is reassessed as unsuccessful.

B. Lessons Learned

41. Reevaluation of IDBP IV six years after the performance audit demonstrates the inherent risks in project lending, the need for stronger operating safeguards to be built into debt-servicing and recourse on principal, and the need for more effective debt-recovery systems. The Project design concepts of setting performance targets, strengthening appraisal and management systems, providing for portfolio diversification, and fixing interest spreads proved useful goals on which to focus results-but were insufficient in themselves to ensure sustainable collectable credit. Bank assistance should have also focused on improving the operational environment and deregulation of the banking and financial sector.

C. Followup

42. The Government's current plans reflect a strong resolve and commitment to privatize the banking and financial sector. However, the viability of doing so remains strongly dependent on governance through (i) sound prudential banking regulations backed with appropriate supervisory and enforcement powers; (ii) effective and expedient debt-recovery legislation; and (iii) accounting and audit supervision practices based on international standards. The willingness of private sector investors to take equity and or extend credit to banking and financial institutions will depend upon further Government reforms related to improving and enforcing financial disclosure, debt-recovery, and supervisory controls.

43. The audited accounts of IDBP for FY1996 reflect a long deterioration in financial performance. The results together with weaknesses in accounting practices (page 8, footnote 3) raises solvency concerns. With further deepening and consolidation of the financial sector, the banking sector's lending margins are likely to narrow and make it difficult for IDBP to remain a viable operation. Given the degree of arrears infection, the cumbersome prospects for debt recovery through legal recourse, and the limited scale of IDBP's banking operations-intentions to privatize IDBP as a going concern appear unrealistic (para. 34). It appears that IDBP will either have to be liquidated or merged into another financial institution.

IDBP management believes that, based on the present rate of progress on recovery, IDBP can continue functioning as a going concern and play a leading role in the financial sector.

ii. Loan No. 608-PAK(SF), *Fourth Industrial Development Bank of Pakistan Project* (IDBP IV), for \$20 million, approved on 7 December 1982 and Loan No. 609-PAK for \$20 million, approved on 7 December 1982.

It was expected that about 50 percent of the loan proceeds would require prior approval of the Bank.

iv. IDBP was a recipient of three previous credit lines from the Bank, all aimed at providing foreign exchange for the purpose of meeting the long-term funding requirements of small- to medium- size industries in the private sector. The loans totaling \$50 million included Loan No. 006-PAK:*First IDBP*, for \$10 million, approved on 12 December 1968; Loan No. 053-PAK:*Second IDBP*, for \$15 million, approved on 22 December 1970; and Loan No. 256-PAK:*Third IDBP*, for \$25 million, approved on 23 December 1975. These loans are respectively referenced IDBP I, IDBP II, and IDBP III. IDBP I and II were postevaluated together and rated generally successful. On the basis of the mixed performance of IDBP and subborrower projects under review, IDBP III was rated partly successful.

v. Overlapping the impact of IDBP IV were Loan Nos. 776-PAK and 775-PAK(SF):*Second Development Financing Loan Project* (DFL II), for \$100 million, approved on 19 December 1985; Loan Nos. 878-PAK and 879-PAK(SF):*DFL III*, for \$200 million, approved on 17 December 1987; and Loan No. 996-PAK: DFL IV for \$250 million, approved on 12 December 1989; and the World Bank's, *IDBP Credit* 1186-PAK, for \$30 million, approved on 3 November 1981; and *First Industrial Investment Credit* (IIC-1), Loan 2380/Credit 1439-PAK, for \$100 million, approved on 2 February 1984; *IIC-2*, for \$150 million, approved on 7 January 1986; and *IIC-3*, for \$150 million approved on 31 January 1989. Assistance under DFL II, III, and IV; and IIC-1, IIC-2, and IIC-3 also extended to other financial institutions.

vi. Credit expansion was set by formulas reflecting expansion requirements of the economy and with adjustments for special development areas and projects.

vii. Twenty-four (35 percent) of the 69 projects had repaid their foreign currency component by 30 June 1996.

viii. While 65 percent of IDBP's total term lending at appraisal was directed to Punjab Province, this fell to 55 percent by the end of FY1990 and thereafter held around the same level. There was a corresponding increase in the share to Sind Province from 20 percent to 25 percent, and a 5 percent increase in share to the North West Frontier Province and Balochistan Province.

ix. Of which approximately 88 percent were denominated in rupee loans, and 46 percent represented on-

lending from State Bank of Pakistan and credit sources.

IDBP management considers current restructuring and rehabilitation measures will enable IDBP to continue operating as a going concern and to play a leading role in the financial sector.

More specifically, the ratio of arrears divided by the sum of the outstanding loan principal plus arrears.