Securities and Exchange Commission of Pakistan
NIC Building, 63 Jinnah Avenue, Blue Area, Islamabad - 44000, Pakistan
www.secp.gov.pk

Securities and Exchange Commission of Pakistan

Newsletter SECP Perspective

Winter Edition 2014

www.secp.gov.pk

INSIDE

Insurance rights of air crash victims

By Sabahat Ul Ain and Faraz Uddin Amjad

In the last 67 years there have been 36 passenger airplane crashes in Pakistan. Sabahat Ul Ain and Faraz Uddin Amjad bring you a cut-to-the-rhythm awareness commentary written in the milieu of insurance and compensation rights available to the legal heirs of the victims of air crash incidents

How it feels to lose a dear one in an air crash is something a devastated relative or heir could only describe and is beyond words to express. However, agony is compounded when aggrieved families have to face the financial problems because of losing an earning member of family. Their economic impact can be lessened provided the payment of compensation by the airline and other authorities is made justly and promptly. Unfortunately, once the mourning is over, the aggrieved family has to go through a maze of situations to obtain the compensation amount. Even if the heirs receive the compensation, sometimes it is not in accordance with the social and economic worth as well as the earning capacity of the crash victim. Also at times, the liable party makes every possible effort to escape by paying the minimum possible amount. Giving all this, it is exceedingly important for everyone who travels by air to be well aware of their rights under the relevant laws in case of such calamity and also make their family and heirs aware of this factual knowledge.

The most recent passenger airplane crashes in Pakistan, being the two private airliners, occurred in 2010 and 2012, killing all passengers and the

crew. The crash of a private passenger carrier on July 28, 2010, in the Margalla hills of Islamabad, claimed 152 lives while the payment of compensation to the families of the crash victims initially remained a dilemma because of conflicting amounts prescribed by the laws and authorities. The basic compensation—Rs0.5 million per passenger as mandated by the civil aviation laws at the time—was paid. However, the competent courts decided this compensation to be paid to an additional amount of Rs5 million per passenger. A further additional amount of Rs50,000 per passenger was paid to the legal heirs of the victims for legal documentation and services. In case of the flight crew, a compensation of Rs1 million was paid per crew member by the airline.

All these compensations were made by the local insurer and its reinsurers. It was also learnt that the airline was held liable to pay for the DNA test of the dead bodies of passengers for identification purposes which was billed by the local hospital to the tune of Rs4 million. Though, immediately after the broadcast of the sorrowful news of the air crash, the reinsurers and the international insurance brokers along with their legal advisers were on the ground for settlement of the legal claims.

Considering the severity and frequency of such incidents, it has recently been made mandatory under the Carriage by Air Act, 2012 for the carrier (airplane) to maintain insurance coverage of all liabilities which may arise in case of any unfortunate event causing injury or death of the passenger. Such coverage, as required to be kept by the airline company falls under aviation class of insurance.

One would be interested to note that the aviation insurance was first underwritten by the Lloyd's of London in 1911 and was formalized when Warsaw Convention, 1929, came into place, as it clearly stated the terms, conditions and limitations of liability of the airline carrier in event of a disaster. Realizing the need of industry specialist, an association of eight European aviation insurance companies was formed in the name of International Union of Aviation Insurers (IUAI). However, even today the Lloyds of London continue to hold the position of the

Newsletter
SECP Perspective
Winter Edition 2014

largest underwriters of aviation risk. Most of the airline risks originating from Pakistan are placed in the Lloyds and the London market, whereas these risks are placed by leading international expert brokers with the highly proficient reinsurers and the underwriting syndicates who possess the capacity to take such large risks. The placement of these risks is also carefully monitored by the Securities and Exchange Commission of Pakistan (SECP) at the time of approving this facultative reinsurance arrangement by the local insurers. The aviation risks are usually so colossal that no single insurer has the muscle to carry it on its own. It is normally backed by various reinsurers having financial strength and reputable record in the field of aviation insurance. Business ethics imply that no one should be required to go to court to get compensation amount, instead, the insurer should willingly pay the rightful amount to the legal heirs. The dilemmas of past can be attributed to a lack of standard statute in this respect, but the excuse is not submitted in present time when a local law is in place which clearly defines the liability of carrier with respect to domestic as well as international travelling.

The aviation insurance entails various liabilities in its domain. The liabilities arising in the event of an unfortunate air crash usually include public liability, i.e. damage caused to properties of third party such as houses, cars, crops, airport facilities or another aircraft struck in the collision. Passenger liability insurance compensates for injury or death of passenger in the aircraft accident. Both these types may be combined into a single overall limit per accident providing more flexibility in claim payment. The main area of concern for airlines remains the passenger liability as it is the requirement of international conventions and laws of many countries, including Pakistan or where the Pakistani-origin airlines operate. The insurance company pays to the victims the amount to compensate for loss

incurred due to plane accident and at times, the matter may be taken to the courts if settlement is not reached between the claimant and the insurer. It has been learnt in the case of the July 2010 crash, while the insurer and the reinsurers have compensated most of the claims, some of the remaining compensation or claim amounts have been deposited with the courts due to the inconclusiveness or disagreement on the succession issue or declaration of the heirs. In the past, the airline operators pointed out that they had been receiving multiple claims from different family members of one single passenger because of which it has become difficult to identify the genuine legal heir. This gives a delaying rationale for non-payment of compensation. The excuse stems from the ignorance of the family of the crash victim about the standard procedure for making claim.

International statutes for carriage by air prescribe different amounts and conditions for compensating the heirs of crash victim and in some instances, the provisions of these conventions may overlap. For instance, the 1929 Warsaw Convention holds carrier liable to pay amount equivalent to

125,000 Swiss francs in event of passenger death. The limit was later raised to 250,000 Swiss francs through the amendment made at the Hague in 1955. However, in case where damage is not caused due to negligence of carrier or any of its agents, the amount claimed cannot exceed 5,000 Swiss francs. The subsequent Montreal Convention of 1999 states that heirs must be given 100,000 special drawing rights (SDRs), the rupee equivalent of which exceeds Rs10 million per passenger. The local law (Carriage by Air, 2012) states that in case of overlap of provisions of these conventions, the latest one shall prevail. It is pertinent to mention that the 1999 Montreal Convention is applicable only to international flights.

Before the recent promulgation of the 2012 Carriage by Air Act, the determination of compensation amount was controversial because of multiple international statutes and varying practices of foreign countries with respect to these laws. The promulgation of this act has by far eliminated this anomaly with respect to domestic travelling as the reasonable compensation amount is prescribed for the bereaved families. The law stipulates that in the event of death of the passenger during domestic travel, carrier is liable to pay to the heirs the minimum prescribed amount, irrespective of the fact that which party is at fault. At present, the amount so prescribed is Rs5 million. The heir may claim even a higher amount in accordance with the loss incurred and earning capacity of the deceased, if the airline carrier is proven guilty.

Sometimes, the irony is the implementation issues of the law because of airlines' desire for least possible compensation amount helped by the ignorance of the claimants about their rights. Empirical observation shows, with some exceptions, that in case of such event, the airline usually plays the role of a silent spectator so as to protect its business relationship with the insurer instead of informing and facilitating the passenger's heirs in obtaining the rightful compensation amount, where the former's innate interest is the recovery of loss of its aircraft hull.

The sixth schedule of the 2012 Carriage by Air Act stipulates in

detail the liability of the carrier in the event of death of passenger and the procedure of claiming the compensation amount. Also, it clearly specifies the criteria for establishment of heir-ship, i.e. the succession certificate from the court stating the proportion in which compensation amount will be distributed among all legal heirs.

The 2012 airplane crashed near Rawalpindi claimed 127 precious lives, including those of six crew members.

While one must always yearn for tranquillity and well-being, it is the onus on everyone to be aware of their rights in case of any air travel casualty. Peace to all!

[1] For more than four centuries, Lloyd's of London (also known simply as Lloyd's) has been an insurance market located in London's primary financial district, the City of London. It serves as a partially mutualized marketplace where multiple financial backers, known as underwriters, or "members", both individuals (traditionally known as "names") and corporations, come together to pool and spread risk. It is a corporate body governed by the Lloyd's Act of 1871 and subsequent acts of the Parliament of the United Kingdom. See http://www.lloyds.com/lloyds/about-us/what-is-lloyds/the-lloyds-market for more details.

Sabahat ul Ain is a management executive at the SECP. She is a public administration graduate and a junior associate of the Institute of Bankers Pakistan. She is also doing her MBA from IBA, Karachi.

Faraz Uddin Amjad is a joint director at the SECP. He did his MBA from IBA, Karachi, and a position holder in LLB from Karachi University. He is also certified from the Chartered Insurance Institute, UK.

Newsletter
SECP Perspective
Winter Edition 2014

Making Pakistan an investment destination

By Shaukat M. Malik Khichi, CPA

It is sad to note that the agents of the Five Eyes, an intelligence network of the US, the UK, Canada, Australia and New Zealand, founded in secret in 1946 after the second world war, and whose chat room documents were leaked by Edward Snowden, the US intelligence whistleblower, and subsequently published in *The New York Times*, are reported sharing tricks of the trade in terms of software used while tracking a Pakistani terrorist group. It would be ideal if these developed economies were tracking Pakistan's stock market instead of a terrorist group.

The collateral damage of such news to Pakistan as an investment destination is huge. Perception is a human trait that is very important to the decision-making process. Perceptions invariably affect our judgments about entities, individuals, and even countries. Sometimes perception turns out to be stronger than reality.

For example, would you like to visit a country where you are confronted by armed policemen at checkpoints training their guns at you, police barriers creating traffic jams causing unnecessary delaysand frustration, or if you are afraid that someone might kidnap you or cut off your head, snatch your mobile and wallet in broad day light with no one to protect you; would you like to be driving down the road with a van approaching you in your lane after having jumped the red light on a busy highway with no policeman in sight? The answer is *no* and we are only talking about visiting.

Such countries are best avoided by investors and tourists alike, and this is exactly the advice being proffered around the world by security analysts. Pakistan far from becoming a possible investment destination has become synonymous with all things terrorism. The infusion of extremist religion during the Afghan war has given Pakistan the gift of the Taliban, whose outlook is incompatible with today's civilized society and acceptable human behavior. The hopes of millions of young people are being sacrificed at the altar of terrorism. Happiness has been extinguished by limited employment opportunity and each new bombing or killing adds to the negative perception about a country that should have so much going for it, due to its extraordinary geographic location and a tech savvy, and keen young population.

There is no denying that we are indeed handicapped by the war on terror next door in Afghanistan, but that is no excuse for not putting our house in order. Even after the US withdrawal, Afghanistan will remain unstable, but that does not mean we should allow the situation next door to continue destroying our economy and our way of life. Through a few small steps,we can help counter the support system for terrorists inside Pakistan, and can very quickly change the world's perceptionof Pakistan both at home and abroad as a safe investment destination, with many unmet needs.

Here are some of the measures that should be considered:

Counter-terrorism strategy: The federal government needs to come up with a comprehensive counter-terrorism strategy with a sense of urgency, to prevent continuing damage to our reputation as a worthy investment destination.

Political activism: Political leaders must start a movement at the local level to root out extremists and criminals wherever they may reside. Process can be initiated through neighborhood cleaning and improvement campaigns at shopkeeper/street level. Associations can be formed, and citizens' watch added to their agenda. Furthermore, laws already in place for regulating public broadcast for religious and political purposes must be properly enforced by local authorities to prevent their use in spreading hatred between communities. Economic reward of a peaceful environment can be extraordinary both for the politician's in terms of votes and the local business community.

Victims of terrorism: Victims both civilian and military must be recognized by political leadership to bring home the damage caused by extremists in the name of religion. Legislation to dispense immediate justice and appropriate punishment to extremists should be drafted. Terrorists and criminals have managed to get away using loopholes in our legal system. Anyone supporting or abetting terrorist activities should be held responsible for terrorism.

Organizations supporting terrorism: The government should show zero tolerance for such organizations, notwithstanding who they are, by simply shutting them down. They are indeed enemies of the state who want to destroy our future.

Funding sources: Economic distress caused by terrorists should be redirected at them by targeting funding from home or abroad to any organization sympathetic to terrorists through common goals or shared ideology. Our banking and money exchange system can be used to target rogue transfers and or conversion of funds.

Text messages: Mobile phone companies should be encouraged to provide free text messaging to our law enforcement agencies to bring home short crisp messages condemning extremists that can reach millions in seconds.

Media: Television, especially PTV, should broadcast short meaningful messages against terrorism and its evil effects. The media must be trained to protect Pakistan's image from damage caused by unnecessary sensationalism. The TV hosts should make a serious effort to deprive the apologists for terrorism of their theological justifications. For this purpose, they should invite tolerant scholars to debate supporters of terrorism. The media should not become a vehicle for conspiracy theories, which tend to provide justification to terrorist organizations. In order to achieve these objectives, journalists' critical thinking skills and fact-checking capacity need to be improved.

Diplomatic community: It is important to share steps being taken for fighting terrorism with our guests from abroad; they are indeed the eyes and ears of investors, who may be contemplating visiting Pakistan by assuring them that it is safe to visit.

Afghan refugee camps: It is time these refugees were returned to Afghanistan, notwithstanding humanitarian pleas by the United Nations. These camps provide safe havens for terrorists and the cost of keeping them open is simply too great for Pakistan's economy. Pakistan's hospitality should not be exploited. Imagine the fate of a Pakistani refugee camp on the outskirts of Kabul. They would be robbed and killed overnight.

Rehabilitation of militants: Like Saudi Arabia, we need to have a de-radicalizationprogram for youngsters who get misguided by terrorists. This program was launched in Swat, but it needs to be extended to other parts of the country.

Rule of law: Ordinary law-abiding citizens/residents should have confidence in our police force to protect them from criminals. Police must be trained and properly funded. We should be able to go out for a walk at night without fear.

These are just some of the measures that can be taken to counter the menace of terrorism. We must make Pakistan attractive to the prospective investor no matter which country they are from. And, when we say attractive to a prospective investor, this includes tourists, who should feel comfortable and safe visiting Pakistan.

This is the second part of an article on making Pakistan an investment destination. The writer is a Certified Public Accountant (CPA), US equivalent of a Chartered Accountant. He works as a consultant in the SECP's Strategy Development and External Relations Department. The views expressed in this article are those of the writer and do not necessarily represent the SECP's position.

The past, present and future of SECP

Muhammad Rabnawaz Awan

The Securities and Exchange Commission of Pakistan (SECP) had been operational for nearly three decade and it faced numerous challenges in its evolutionary process. It overcame those challenges by instituting reforms to its constitution, management and operations.

Scores of influential developments have shaped over the SECP's 33-year history. The scope of the authority of the SECP has also been extensively widened since its creation. Without a doubt, much has changed at the Commission. What has not changed is the SECP's role as the capital markets' regulator and, in particular, its duty to enforce the regulations.

The history of the SECP began formally in 1970. The Securities and Exchange Authority of Pakistan (SEAP), a precursor to the Corporate Law Authority, was set up in November 1970, with the approval of the President of Pakistan under Section 28 of the Ordinance.

The Corporate Law Authority came into existence on March 10, 1981. It was the merger of the SEAP, Registrar of Companies and the Monopoly Control Authority (MCA).

The process of restructuring the CLA was initiated in 1997 under the Capital Market Development Plan of the Asian Development Bank (ADB). A Securities and Exchange Commission of Pakistan Act was passed by the Parliament and promulgated in December 1997. In pursuance of this Act, the SECP, having autonomous status, became operational on January 1 1999. The Act gave the organization the administrative authority and financial independence to carry out the reform program of Pakistan's capital market.

The responsibilities of the SECP were expanded in 2002. In order to provide for holistic and consolidated regulation of the non-banking financial sector, regulatory authority over the leasing and insurance sectors was transferred to the SECP. The regulatory agenda was further expanded by amending the Companies Ordinance, 1984, through the Companies (Amendment) Ordinance, 2002, under which the concept of non-banking finance companies (NBFCs) was introduced. As such, the NBFC regime covered activities pertaining to investment finance services, leasing, housing finance services, venture capital investment, discounting services, investment advisory services and asset management services were transferred to the SECP. Most of these entities were previously regulated by the State Bank of Pakistan.

In 2003, the regulation of Voluntary Pension Schemes (VPS) and Real Estate Investment Trusts (RIETs) were also entrusted to the SECP. The significant reforms taken by the SECP for the development of capital market and the insurance industry include (i) new mechanism for determination, collection and determination of CGT (ii) introduction of ETFs and Index Option (iii) implementation of Anti-Money Laundering (AML) Regime (iv) operationalization of e-services portal for online registration and fast-track registration services, a company may be registered just within four hours (v) for insurance companies, sound and prudent management regulations have been introduced. Besides, solvency and Takaful Rules have also been notified.

During the financial year 2010-11, a record corporate growth had been witnessed in Balochistan and the total companies registered with the SECP's Company Registration Office in Quetta crossed the 1,000 mark.

Such unprecedented corporate growth in Balochistan had been achieved as a result of the substantial reforms and facilitative measures undertaken by the SECP over the years to promote corporatization in the country.

Financial year 2011-2012 was the year of tremendous accomplishment for the SECP in terms of its policy agenda. One of the significant achievements of the SECP in this year was the promulgation of the demutualization law. This issue had been pending since 2004. The Act was promulgated on May 7, 2012. The main objective of the new law is to change the mutualized structure of the stock exchanges wherein members enjoyed ownership as well as trading rights. The implementation of this law has brought Pakistan capital market on a par with other international jurisdictions.

The governance frame work has been another important area of focus for the Commission in this year. In an endeavor to align our governance regime with enhanced requirements of present times and global best practices, the Code of Corporate Governance was launched on April 10, 2012. The code has set a minimum benchmark in terms of governance standards.

Over the years, the commission had taken a number of steps to strengthen its internal capabilities and address various regulatory weaknesses. For example, in 2012, the department of enforcement was substantially capacitated and a specialized team of lawyers and market experts streamlined its enforcement procedures to ensure high quality investigations.
One of the latest achievements of the SECP is the formation of the Shariah Advisory Board (SAB), which would be responsible to harmonize the Shariah interpretations and strengthen the regulatory and supervisory oversight of Islamic financial institutions (IFIs) and Islamic capital markets (ICMs) in Pakistan.

Even as the superstructure of securities regulation has evolved over the decades with the accretion of statutory changes and new rules, regulations, and cases, the foundational cornerstone of the regulatory regime has remained fixed: It is disclosure. For 33-year, the SECP's signature mandate has been to use disclosure to promote transparency.

Without question, there is room for the Commission to improve; no organization is perfect. The SECP is an agency of overall success, with a 33-year tradition of commitment, excellence, and expertise one can hope that with the rigorous compliance programs and internal controls, it will continue to level the playing field for companies doing business in Pakistan and hold corrupt actors accountable when they fail to play by the rules.

The writer has been part of the media department of the SECP since 2008. He holds a master's degree in English linguistics. The views expressed here do not necessarily reflect those of the SECP.

Newsletter
SECP Perspective
Winter Edition 2014

Draft Corporate Rehabilitation Act reviewed

The Securities and Exchange Commission of Pakistan (SECP) organized a conference in Lahore on December 12 with stakeholders to seek comments on the proposed draft of the Corporate Rehabilitation Act, 2013.
Senior representatives of the State Bank of Pakistan, chambers of commerce and industry, top business groups, the Lahore Stock Exchange and eminent corporate law experts participated in the conference.
Addressing the conference, Zafar Abdullah, Commissioner SECP, said that the need for a corporate rehabilitation act arises because the financial and social value of a going concern is normally greater than its liquidation. Companies are worth more 'alive' than 'dead', he added.
Briefing the participants on the salient features of the draft CRA, Mr Muzzafar Ahmed Mirza, Director, Litigation, Legal and General Counsel Division, SECP said that the proposed act seeks to provide for the rehabilitation, reorganization and restructuring of distressed corporate entities and their businesses so as to encourage economic growth and development. The draft of the CRA is available on the SECP website.
In the light of deliberations made at the conference, the SECP will thoroughly review the draft act and will make necessary recommendations to make an equitable law, which will be acceptable to creditors and debtors.
The conference was very interactive and detailed deliberations were made on various aspects of the act. Representatives of the Pakistan Credit Rating Agency, MCB, Allied Bank of Pakistan, Treat Corporation, Pakistan Sugar Mills Association, Nestle Pakistan, Millat Group, and Pakistan Business Council also attended the conference.

SECP organizes workshop on Islamic financial products

The Securities and Exchange Commission of Pakistan in collaboration with the Islamic Research and Training Institute (IRTI), Islamic Development Bank, Jeddah, held a two-day training workshop on Islamic financial products and risk management for Islamic financial institutions under the theme “Sharing Knowledge and Experience”. The workshop was held on November 18 and 19 in Karachi.
The overall objective of the training program was to raise awareness and share knowledge and experience of the experts from the Islamic finance sector. The specific objective was to assist the market players to meet the technical and Sharia-related needs of the Islamic finance industry in Pakistan.
Eminent local and international Islamic scholars and professional shared their insights and experiences of their respective jurisdictions and for providing an exhausted overview of various disciplines of Islamic finance to the participants. A large number of chief executives, directors and professionals comprising of modarabas, Islamic mutual funds, Islamic pension funds, takaful companies, leasing companies and investment banks participated in the training course. During the two days, substantive interactive sessions and discussions were held, focusing on the practical solutions of the problems encountered by the Islamic finance industry.

SECP and EOBI ink MOU for increased cooperation

The Securities and Exchange Commission of Pakistan (SECP) and Employees Old Age Benefits Institution (EOBI) signed a memorandum of understanding (MOU) aiming at enhanced cooperation and coordination in pursuance of mutual objectives.

Mr. Tahir Mahmood, Acting Chairman, SECP, and Mr. Muhammad Ayub Sheikh, Chairman EOBI, signed the MOU here at the SECP Head office on December 30, 2013, in the presence of senior officials from both institutions. The MOU mainly calls for sharing of information of mutual interest, utilization of services of the field staff of EOBI and consultations on matters of common regulatory, supervisory and overseeing interest.

The information sharing arrangement is expected to greatly enhance the efficiency and effectiveness of both organizations. It will be mutually beneficial for the SECP and EOBI to share information that is relevant to each other. Further, a mechanism has also been devised for information sharing between the two institutions. It has been agreed to support and facilitate each other in pursuit of the common goal of documenting and corporatization of the economy. The MOU is envisaged to have a direct impact mainly on the documentation of economy front, wherein, non-corporate sector will be pursued to get into the formal corporate sector using the synergy created with the collaboration of the SECP and the EOBI.

Through the MOU, it has also been agreed that the two bodies shall inform each other about prospective legal and policy changes that have an impact on industry, product or overseeing responsibility of the other. Both institutions have resolved to further enhance the cooperation in the times to come.

One-stop shop for business registration

The Securities and Exchange Commission of Pakistan, the Federal Board of Revenue and the Employees Old-Age Benefit Institution have signed a Memorandum of Understanding (MOU) for the establishment, operation and administration of a virtual one-stop shop (OSS) for business registration.

It was signed on December 19 in Islamabad at the Ministry of Finance in the presence of the finance minister. The MOU was finalized after extensive deliberations by a working committee formed and supervised by the Economic Reforms Unit (ERU), Ministry of Finance and comprising officers from the three organizations.

The virtual OSS shall be a web-portal to provide a single interface for investors intending to get their company registered with the SECP, followed by NTN/tax registration with the FBR, and employers' registration with EOBI, and without the need to physically visit the offices of the said organizations.

The project is the first of its kind in Pakistan aimed at facilitating entrepreneurs and investors and ensuring an expeditious service delivery by integrating the registration procedures of the three government organizations. The OSS is a global best practice being followed in various countries to facilitate business start-ups, either on virtual or physical basis. Its objectives is to reduce administrative procedures and time and to obtain business approval. Reduction in the time, cost and the number of procedures for business registration is also an important parameter in the doing business/starting a business indicator of the World Bank.

The launch of OSS shall further improve the doing business ranking in the World Bank doing business indicators, which is likely to have favorable implications for investment promotion to attract investors from within and outside the country. The establishment of OSS is also a policy condition in the area of business climate reforms as laid down in the Memorandum of Economic Financial Policy entered into between the Government of Pakistan and the International Monetary Fund pursuant to its Extended Fund Facility.

Regional financial integration

By Benazir Nasir

In recent times, the advent of technology, along with growing competition and reliance on others, has given birth to integration of markets all around the world. This has accelerated the rate of globalization, thereby underscoring the interconnectedness and interdependence of nations, societies, markets, businesses and individuals.

The same holds true for financial and capital markets, as they have converged into a global financial center—defying notions of any geographical boundaries. In the face of increasing interdependence, a country can no longer afford to keep its financial and capital markets isolated from the rest of the world. In marketplaces where the geographical boundaries have merged somewhat, financial markets have already become integrated to a large extent on both the regional and global levels. Such financial integration has usually been stimulated by the sharing of information and best practices between financial institutions of a particular region and/or their global counterparts; exchange of technological advancements and licensing regimes; and cross-border flows of capital across regional capital markets. Also, the regional financial integration (RFI) has not been limited to only the capital markets but has transformed the fundamentals of trade, investment, finance, legal frameworks and business practices.

The European Union (EU) has been a pioneer in regional financial integration since the 1950s, and can be termed as the most developed model of the RFI in the world. Despite the recent economic crisis which temporarily weakened the EU's status as a model for RFI, the EU continues to recover and set examples for other regions for implementing the RFI. Another example is that of the Latin American countries which have also made significant progress in the RFI by integrating each other's economies, harmonizing trade regulations, increasing trade opportunities with other regions, facilitating movement of goods, services, capital and labor, and integration of the financial markets.

The RFI has proven especially beneficial for small, fragmented and developing financial markets, as it has resulted in efficient capital allocation, better governance, higher investment and growth, diversification of risks, increase in the number of financial institutions, diversity

in the types of financial instruments, greater competition and reduced individual inefficiencies. Additionally, the RFI can help improve regulatory processes, harmonise regional laws, homogenize institutional standards thereby creating a number of opportunities for the participants of the financial markets.

Financial integration is also a viable means for economic growth as it allows access to a broader base of capital and facilitates flow of capital from more developed economies rich with capital to the developing or comparatively less developed economies having limited pools of capital. The RFI provides avenues for reducing the cost of raising capital and improves the investment climate.

However, with the benefits of such financial integration also come the costs and challenges, especially for smaller and developing countries. For example, a high degree of financial integration and interconnected markets can make a particular region or economy more susceptible to the contagion effects of any market crisis spilling over from another connected country/economy. There is also a possibility that instead of attracting foreign capital, capital outflows might occur from capital-starved countries with weak institutions to capital-rich countries with relatively stronger institutional quality.

Another drawback of financial integration can be understood by the hindrance that financial market imperfections and legal restrictions pose to financial integration. It may be noted that legal restrictions are put in place to curb market imperfections. Eliminating these legal restrictions can make the situation worse and a market more prone to risk. However, on the other hand, financial integration cannot be achieved without ending the very restrictions that exist to address the various market imperfections.

Coming to the methods of implementing the RFI, regional economies can devise a number of ways to achieve financial integration such as a memorandum of understanding or a bilateral agreement supporting mutual cooperation for devising joint policies and procedures. Regional stock exchanges can set up integrated real-time networks for the securities markets of that region and carry out harmonization of entry and exit requirements.

Increased international capital flow also leads to regulatory problems that are not solely market-based. Consequently, a regional capital market requires key reforms such as elimination of restrictions on cross border trades along-with the harmonization of regulatory framework. Common standards must be adopted to facilitate uniform compliance with international accounting standards and adoption of best practices, while encouraging cross-border listing, training of personnel and technology transfer. Harmonization of listing requirements, information sharing and settlement and trading mechanisms is also a necessity.

Promoting the RFI also requires a strong political will and has various implications for the regional regulators as well. RFI would require focused cooperation in areas such as money, finance, industry and trade to achieve true financial integration. This would require cooperation from a number of sectors, i.e. all financial authorities, central banks, regulators and governmental ministries in the region. The RFI would also require integrated regulators who are able to effectively assess and address any problems arising from the RFI to ensure the existence of fair, efficient and transparent markets. Joint mechanisms need to be put in place at the regional level

to improve detection and prevention of cross-border misconduct and to assist in the discharge of supervisory responsibilities.

In the South Asian region, there are many barriers to efficient regional financial integration, but they can be overcome. Various asymmetries in this region in terms of economic development, not conducive for the RFI, can be overcome by increasing cooperation among regulators and financial institutions, harmonizing the regulatory framework and building common standards for the region.

Even though regional financial integration has become imperative in today's world, a cost-benefit analysis should still be undertaken before embarking on this path. The key would be devising an RFI strategy balancing both national interests and regional goals. Also, once the initiative has been taken, crisis prevention and effective resolution mechanisms need to be in place to cope with any drawbacks of the RFI. In the particular context of South Asia, efforts should be made to strengthen the regional financial infrastructure including emphasis on identification and management of systemic risk, effective regulation, and surveillance and monitoring to ensure crisis prevention.

The writer is assistant director in the Securities Market Division. She joined the SECP in 2008. She did her MBA—majoring in finance—from the NUST Business School.

Newsletter
SECP Perspective
Winter Edition 2014

Why financial institutions fail?

By Imran Husain Minhas

Financial institutions are the financial intermediaries that play a key role in the economy of a country by directing the flow of savings of the people towards large corporations and enterprises. The financial institutions help in formation of capital in the economy and provide trust and confidence to the savers of money to bridge the gap between the savers and the users of the money. Where the element of distrust arises, the savers get cautious about the security of their hard earned money and prefer to hold it instead of converting it to a bank deposit. Such holding trends may lead to the financial crises in the economy and collapse of financial institutions.

Therefore, it is crucial for the regulators and the users of the financial products to understand the root causes of the failure of financial institutions. I have categorized them into seven M's (management, money, massive defaults manipulation, mismatch, moral hazards and monitoring) which are discussed hereunder:

1. **Management:** Competent and good quality management is imperative for the success of any business. Bad management is the major cause of failure of financial institutions. Most of the financial institutions fail due to the management that is incapable of

   a)Providing vision and prudent future planning
   b)Implementing proper risk management policies
   c)Sincerely involving all employees in decision making
   d)Ensuring effective internal control and regulatory compliance
2. **Money—Under-capitalization:** Under-capitalization is a state where a financial institution does not have sufficient money or access to the required funds at reasonable cost. Under-capitalization may pour cold

water on the whole investment of a financial institution. The financial entities with the inadequacy of capital are always at high risk of default as they don't have sufficient cash flows to meet their unexpected obligations and resilience against the shocks.

3. **Massive Defaults:** Infected or classified portfolio is a pool of investments and facilities which are questionable in terms of the full recovery of principal balances and accrued profit thereon. The high risk facilities normally turn into massive defaults and generate bad portfolio which lead to high losses, bankruptcies and winding up of financial institutions.

4. **Manipulations:** Internal controls and better risk management policies are the techniques, methods and procedures which are adopted by a financial institution to safeguard the business assets and to ensure compliance as well as accuracy of the data and information submitted to the management, stakeholders and the regulator. Weak internal controls and absence of risk management policies provide ample opportunities for manipulation to the employees and can never ensure a longer life to an organization, ultimately opens path to fraud, forgeries and misappropriation of funds.

5. **Mismatch:** Asset liability mismatches is another problem for financial institutions. Sometimes financial institutions borrow heavily in short run to finance their current obligations and long-term investments. In such a situation it builds asset liability mismatches and a smaller default turns into a big bubble which not only affects the profitability but also cash flows of a financial institution. Greater magnitude of asset liability mismatch ultimately leads to systemic risk for financial institutions.

6. **Moral hazards:** Frauds, corruption and greed of the employees and the management are the other big problem for the financial institutions. Sometime the management intentionally deceives the shareholders for its personal gains. The extreme greed and corruption make a mockery of all the ethical considerations and finally the financial institutions face closures.

7. **Monitoring:** Monitoring includes a close watch by the board of directors and the regulator of a financial institution. Monitoring is very important for the success and failure of a financial institution. Excessive and minimal, both types of monitoring and regulations are dangerous for a financial institution. In case of excessive monitoring and regulations the financial institution lose its legitimate business due to excessive regulatory requirements and in case of insufficient monitoring the management plays with the public money by investing in the high risk ventures for personal gains which results in defaults and losses.

There are other factors, which could lead to the failure of a financial institution but the seven M's remained near or at the top of the list of failures of financial institutions in many cases. Besides, research and development, review of existing product lines and introduction of new products are also important for the success and growth of a financial institution.

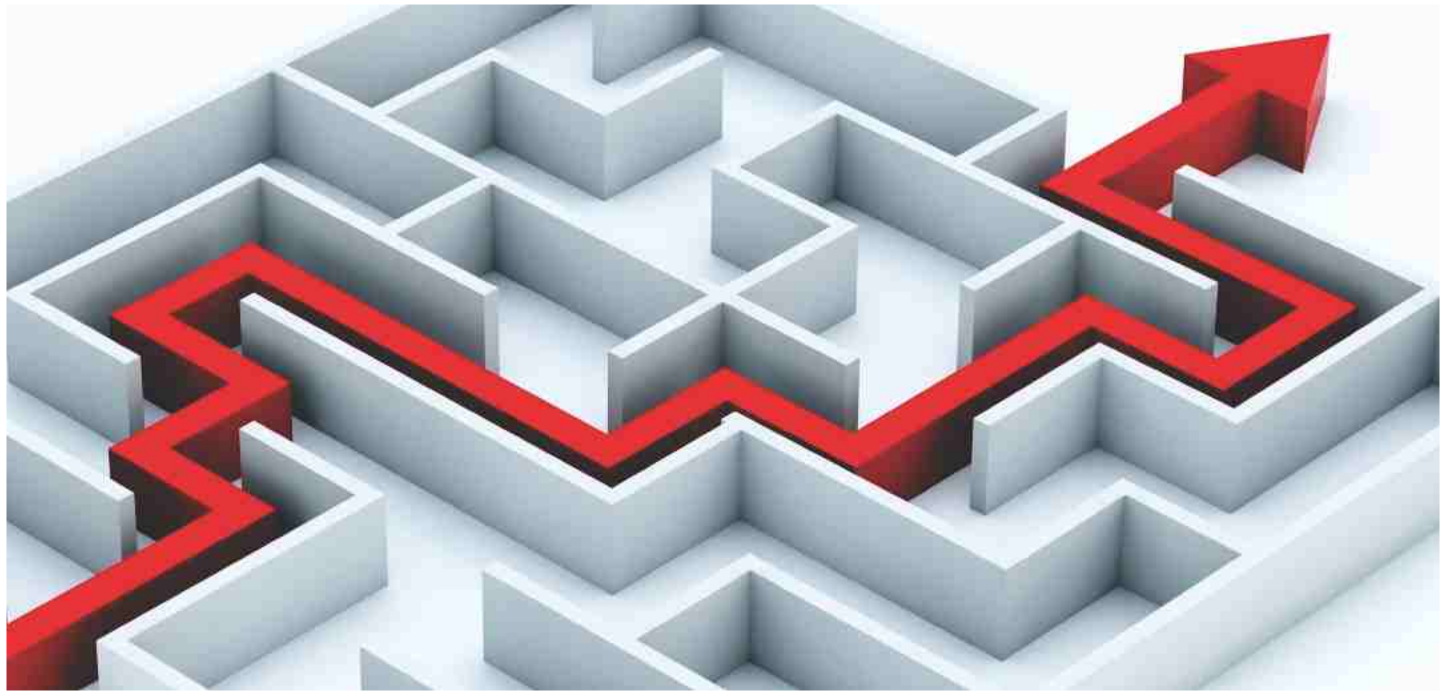
If a management succeeds to positively overcome the seven M's, which are interlinked and require a normal prudence, experience and training to control, most of the disasters can be averted.

The writer is Joint Registrar in the Modaraba (Islamic Financial Institutions) Wing at the SECP. The view expressed here are purely of the writer, and not of the SECP.

Newsletter
SECP Perspective
Winter Edition 2014

Regulatory risks and policy

By Mian Ahmad Ibrahim



Pakistan today stands at an important crossroads, surrounded by the fastest emerging and most rapidly expanding financial markets in the world today. In China, already a global manufacturing powerhouse, the process of liberalizing the financial sector is well underway as the country moves towards a free market economy and India appears poised to double its already enormous economy by 2020. The Middle East continues to reinvent itself as a major fiscal hub and Malaysia and Singapore too have recently undertaken extensive renovation of their corporate and financial regulatory framework to meet the unique challenges of the globalized age.

Finance is an integral part of any country's growth and development. The extent to which a given amount of investment translates into actual growth depends on the financial system. A common man can reap benefits of a good financial system and that brings about a real change. In my view a capable financial system is one that is flexible for the small entrepreneur and would give even small-time farmers and merchants the ability to manage the uncertainties of business by hedging and to raise capital with ease to grow big. When there is no consolidated action plan, a lack of direction and regulatory arbitrage in the financial system, serious difficulties arise in any attempt to develop infrastructure. The legal framework governing the financial sector today is a product of decades of reactionary legislation some in place since the colonial times, carried across independence despite the relentless pace of change that has marked the 20th century.

There are dozens of acts and ordinances, each with multiple accompanying rules and regulations with amendments made time and again which form the financial regulatory framework of Pakistan. Many of the laws that form this framework are drawn up in an almost unrecognisably different economic landscape. The corpus of this governing law shows its ad hoc heritage at every step, many of the acts and provisions overlap and intersect each other in a haphazard fashion that inevitably allows gaps in the law and leads to contradictory interpretations and inconsistent judicial applications.

The present laws governing the financial sector mostly place emphasis on prohibitions and banning certain financial activity rather than developing regulatory structures for it. A good part of the 1969 Securities and Exchange Ordinance only provides for prohibitions. The said law even does not recognize the stock and commodity exchanges as front line regulators and division of responsibilities between exchanges and the regulator is not stipulated in the law. Even the law is silent as to the developmental aspect and the regulator has become a product approving authority, which has led to a lack of financial innovation and product diversification due to cumbersome approval regime. Furthermore, the time is right to deliberate on whether there is a need to move from the tradition rules-based legislation to the principles-based legislation.

Although many financial laws such the Securities Bill and the Securities and Exchange Commission of Pakistan (Regulation and Enforcement) Bill are through phases of legislative process, the major problems still remain unaddressed as there appears to be no clarity of objective and harmony in the same.

Complex financial intermediation by financial conglomerates of today falls within the purview of multiple regulators with gaps and overlaps. The State Bank of Pakistan (SBP), apart from formulating the monetary policy and among other functions regulates the payment systems, however, the clearing function in the exchange and share depositories are being overseen by the Securities and Exchange Commission of Pakistan (SECP). Similarly, the development finance institutions are being regulated by the SBP but their business model is akin to non-banking finance institutes regulated by the SECP. The SECP regulates issue of all securities except government securities, which is being regulated by the SBP.

If a holistic view is taken of the regulatory architecture in Pakistan, it becomes pretty clear that the regulatory objectives of the regulators are not well defined. The regulatory firmament is divided into sectors and distributed among regulators. This has resulted in all financial sector regulators having prudential/policy arms as well as consumer protection/enforcement arm. Further, the investor protection aspect is also divided on a sectorial basis, i.e. banking ombudsman, insurance ombudsman and for securities market the SECP and exchanges. Another area which needs attention is the inter-agency cooperation, be it between regulators and regulators or regulators and law enforcement agencies. When the SBP performs regulatory and supervisory

function in one sector, i.e. banking, this raises concern about the system thinking and of the neutral treatment of all sub-components of the financial system.

Similarly, the role of government in the financial sector regulation and in managing the public sector enterprises (PSEs) also needs to be revisited. Even in this age of so-called independent regulators, the government still has a role to play in the financial sector by exercising the powers of delegated legislation on behalf of Parliament. In addition, the issues emanating from a lack of capacity and quality of human resource of government organizations have affected the process of regulatory innovation.

Newsletter
SECP Perspective
Winter Edition 2014

It also needs to be seen whether strong presence of the PSEs in the financial sector is beneficial to the long-term growth of the sector or is it resulting in the distortion of competition and acting as an impediment to the growth of the financial system. The National Saving Centre schemes are one example of the same.

In addition, we have not learned any lessons from the 2008 global recession, effects of which also trickled down to Pakistan, resulting in a liquidity spiral, which resulted in closure of all the exchanges for more than a month and equity worth billions of rupees belonging to innocent investors was wiped off. Despite this alarming fact, no effort has been made to put in place a deposit insurance

institution or to introduce the US-style Securities Investor Protection Corporation model in Pakistan or a national financial stability council. In order to ensure smooth functioning of economy, there is a need to address the risk to financial institutions to avoid systemic failures and to ensure that the trust of the investors remains in the markets.

Being a lawyer and working in the primary regulator of the corporate sector and securities market in Pakistan has afforded me a unique perspective of the business landscape. Furthermore, being associated with the Corporate Law Review Commission, a project in which the SECP has heavily invested since 2006, I have been tasked with rewriting the 1984 Companies Ordinance. It is a momentous undertaking, which is now heading for fruition. The effort of the Corporate Law Review Commission is indeed commendable, but true reform calls for going far beyond the overhaul of one law.

The writer did his LLB from the University of Punjab and LLM in corporate law from Islamic International University. He is working as joint director (law) at the SECP. At present, he is also secretary to the Corporate Law Review Commission. His professional interests include regulatory reform, securities and corporate law. The second part of the article will contain some suggestions to improve the regulatory architecture in Pakistan. The third part will provide suggestions as to regulatory design of regulators. The views expressed in this article are those of the writer, and don't necessarily reflect those of the SECP.