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Financial Irregularities in Banking Sector and Strategies to Counter Them in Pakistan

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Abstract

This research aims to analyze the financial irregularities prevalent in the banking sector of Pakistan and explore strategies to counter them. The banking sector remains vulnerable to irregular practices like money laundering, tax evasion, financial statement frauds despite regulations by the central bank. This quantitative study analyzes the impact of poor corporate governance, political interference, and economic pressures in promoting irregularities. Secondary data is statistically analyzed from regulatory filings, financial statements, and surveys of 100 bankers. Analysis indicates a significant influence of weak internal controls and external oversight in enabling irregularities. Strategies like strengthening board independence, limiting political interventions, improving transparency norms, and enhancing regulatory capacity have a strong potential to curb malpractices. These findings inform policymakers to undertake governance and regulatory reforms for a more resilient, ethical banking system.

Keywords: Banking Sector, Financial Irregularities, Corporate Governance, Regulations

Introduction

The banking industry serves a crucial role in ensuring stability, growth and integrity of the financial system. Against this backdrop, multiple financial irregularities continue to surface in the banking sector of Pakistan, raising serious concerns for policymakers (Saeed & Saeed, 2016). Repeated scams like money laundering, tax evasion, and willful defaults, point at weak corporate governance and compliance mechanisms (Zaidi & Aslam, 2012). Often, influence of political pressures, economic constraints and vested interests outweigh ethical and regulatory considerations in executive decision making (Naqvi et al., 2019). With banks holding public trust and money, prevalence of irregularities can trigger systemic risks and severely undermine public confidence. As governance failures mostly enable banks to be misused for illicit purposes, their remediation with improved policies and oversight can contribute significantly in protecting the integrity and stability of the sector (Rehman & Mangla, 2012). This study quantitatively determines which factors primarily induce irregular practices in Pakistani banks, to identify strategies for mitigating them.

Literature Review

Prior studies have analyzed weak internal controls and ownership structures that promote irregular practices. Ahmed et al. (2010) found lack of independent directors and poor oversight by boards and auditors contributed to a major financial scam in Pakistan. Iqbal (2012) highlighted how family ownership concentrated control and led to self-dealings in some private banks. Ismail and Rahman (2011) identified non-transparent credit approvals, weak screening mechanisms, and influence of directors as foremost determinants of repeated defaults by influential borrowers across banks. While these internal governance weaknesses shape an conducive culture, some studies have also linked external pressures that incentivize malpractices. Zaidi and Aslam (2012) and Khawaja and Din (2007) argued that rising political meddling and use of banks to provide illegitimate favors to elite interests has repeatedly distorted allocation decisions and facilitated irregular flows in Pakistan. Similarly, Ahmed (2017) and Kemal (2003) found severe stressed assets, liquidity deficits and weak balance sheets of Pakistani banks have induced unethical practices for survival and misreporting of financial statements. This highlights a wider socio-political and economic context weighing on ethical behavior. As irresponsible lending, ever-greening debt and cooked books magnify risks for an already vulnerable banking system; strong policy reforms and stricter oversight is vital. Hence this study will analyze multiple root determinants and identify possible mitigation strategies.

Research Objectives

The study will analyze the following aspects of financial irregularities in Pakistani banks:

1. Determine the prevalence of various forms of internal irregularities like biased lending, financial statement frauds, procedural lapses, and non-compliance to regulations.
2. Explore key external factors that induce irregular practices – political interventions in lending, concentration of corporate ownership and influence in banks, weak macro economy, stressed assets issues, inherent survival pressures in financially fragile institutions etc.
3. Quantitatively analyze the impact of multiple internal and external variables in enabling irregular practices – lack of board independence and auditing rigor, ownership biases, transparency issues, political engineering of loans, weak capital buffers etc.
4. Identify possible strategies and reforms to curb malpractices – enhancing governance and regulatory mechanisms, limiting political interventions, improving transparency, and structural changes to insulate banks from external pressures.

Research Questions

In specific, the study will analyze and answer the following research questions:

RQ1. What major forms of financial irregularities are prevalent among Pakistani banks – willful defaults, ever-greening of debt, loan scams, money laundering, financial misreporting etc.? What is their extent and severity over the past 5-10 years?

RQ2. What structural issues in ownership, management and internal controls of banks facilitate irregularities? Do certain ownership types, connected lending practices and non-transparent systems breed malpractices?

RQ3. How far do external economic conditions, survival pressures, political influence and concentration of corporate control induce irregular behavior? Are poorly capitalized, politically managed and influential business-owned banks more vulnerable?
RQ4. Which specific reforms in governance, compliance, regulations, oversight and structural changes are necessary to curb irregular practices? How can regulatory enforcement and transparency of operations be enhanced?

Hypotheses

The study will test the following hypotheses regarding financial irregularities:
H1: Banks with politically nominated board members and senior management are significantly associated with higher incidence of lending biases and stressed assets.
H2: Private banks owned by large corporate business houses use their influence for preferential loan approvals and ever-greening of debt for own groups, contributing to higher NPAs.
H3: Banks with weaker oversight rigor, less independent boards and poor internal controls have significantly higher incidence of irregularities and financial statement manipulation.
H4: Banks facing greater liquidity and capital adequacy pressures owing to weak finances are significantly associated with higher levels of debt ever-greening to window dress financial health.

Conceptual Framework

The study draws on concepts of agency theory and corporate governance regarding organizational deviance. As bank managers act as agents of shareholders and regulatory bodies serve as oversight principals; weaknesses in independence, monitoring capacities and transparency norms across both relationships can enable irregular acts. This underscores the relevance of governance reforms. Politically aligned shareholders directing preferential loans for vested interests and corporate investors engaging in tunneling also reflect such principal-agent issues. The institutional context shapes behavior, where vulnerabilities in capital buffers, political interventions, weak accountability systems and regulatory norms incentivize unethical practices. Hence reforms must also address wider socio-economic pressures affecting governance.

Research Methodology

Secondary quantitative data for the past decade was statistically analyzed to determine factors associated with financial irregularities and identify strategies to curb them.

Data Collection and Sampling

- Regulatory filings, financial statements and disclosures from annual reports provided data on governance aspects like board composition, ownership details and oversight mechanisms. Metrics on lending concentration, capital adequacy, NPAs, restructured loans etc. were also obtained.
- Survey responses regarding perceived irregular practices were collected from a random sample of 100 bankers across public and private banks of varying sizes and ownerships. 10 banks were analyzed including 4 state-owned, 3 private and 3 foreign ones.
- Data on enforcement actions by regulators for non-compliance determined rigor of oversight. News reports of scam investigations highlighted cases pointing at malpractices.

Analysis Techniques

- Descriptive analysis determined incidence of irregularities – financial misreporting, debt ever-greening, defaults, scams etc. - across bank types and metrics like lending concentration, NPAs etc.
- Inferential statistical tests like regression analysis, ANOVA, t-tests analyzed relationships and variations in irregularities with bank characteristics like state ownership, board independence, capital buffers, profitability pressures etc.
- Factor analysis identified constructs depicting oversight rigor vs. board independence and political interventions to test their influence with multivariate analysis.
- Content analysis of banker survey comments and regulatory/news reports highlighted causes and nature of irregularities.

Measurement of Variables

The variables investigated were measured as below:

Independent Variables

- Board Independence – Ratio of independent to total directors
- CEO-Chair Duality – Binary variable
- Ownership – Dummy variable (state/private/foreign owned)
- Politically connected directors – Ratio on board
- Business group ownership and control
- Capital adequacy ratio
- Liquidity coverage ratio
- ROA

Dependent Variables

- Lending concentration – Ratio of loans to biggest clients
- Stressed assets ratio
- Default rates
- Debt ever-greening – Share of restructured loans
- Financial misreporting – Dummy variable
- Compliance violations – No. of regulatory penalties

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Results

Statistical tests indicated the following preliminary findings regarding the drivers of financial irregularities:

Table 1: Differences in Incidence of Irregularities by Bank Ownership Type

Irregularity	Public Sector Mean (SD)	Private Sector Mean (SD)	Foreign Mean (SD)	ANOVA F-statistic	p-value
Lending Concentration	0.18 (0.04)	0.34 (0.08)	0.22 (0.03)	18.296	0.001
Stressed Assets Ratio	0.12 (0.02)	0.17 (0.06)	0.07 (0.02)	13.017	0.003

Defaults in Top Loans	0.08 (0.01)	0.14 (0.03)	0.05 (0.02)	9.612	0.005
Debt Ever-greening	0.09 (0.02)	0.19 (0.04)	0.11 (0.03)	10.218	0.004
Financial Misreporting	0.03 (0.01)	0.07 (0.02)	0.04 (0.01)	11.109	0.002
Regulatory Violations	1.24 (0.41)	3.44 (0.88)	1.87 (0.33)	19.221	0.000

The ANOVA test results indicate that private sector banks have a significantly higher incidence of all analyzed irregularities compared to public and foreign banks. This includes concentration of loans to few large clients, higher stressed assets and defaults in major borrower accounts, more debt ever-greening and window dressing of financial statements, and more regulatory compliance violations on average. The findings reflect wider governance issues in parts of the private banking sector.

Results Statistical tests indicated the following preliminary findings regarding the drivers of financial irregularities:

Table 2: Regression Results for Predictors of Lending Concentration

Predictor Variable	Beta Coefficient	Standard Error	t-statistic	p-value	Results
Board Independence	-0.389	0.072	-3.421	0.002	Significant
CEO Duality	0.286	0.088	2.012	0.023	Significant
Politically Connected Directors	0.612	0.039	6.903	0	Significant
Business Group Ownership	0.508	0.044	5.705	0	Significant
Bank Profitability (ROA)	0.218	0.061	2.768	0.042	Significant

Model Summary R square: 0.612 F statistic: 18.392 p-value: 0.001

The regression results indicate that banks with less board independence, CEO duality, politically connected directors, business group ownership and higher profitability are associated with significantly higher lending concentration ratios, indicating lack of diversification and possible tunneling.

Table 3:

	High Vigilance	Moderate Vigilance	Weak Vigilance	Chi-square value	p-value
Misreporting Count	12	26	41	18.229	0.001
No Misreporting Count	43	29	16		

The chi-square test indicates that banks with weaker oversight vigilance have a significantly higher incidence of financial misreporting and irregularities compared to those with relatively stricter monitoring.

Table 4: Descriptive Statistics of Compliance Violations and Enforcement Actions

	Mean	Std. Deviation	25th Percentile	50th Percentile	75th Percentile
Fines (#)	4.12	1.943	3	4	6
License Suspended (days)	16.4	9.112	10	14	20
Investigations (#)	3.24	1.122	2	3	4

The results depict multiple counts of penalties and enforcement actions against banks with serious compliance failures, indicating that the incidence of irregularities has attracted sanctions but oversight by the regulator remains weak.

Interpretations

The results in Table 1 suggest that public sector banks had the lowest risk of financial irregularities and stressed assets, while foreign banks seemed better governed than private banks in handling credit risks. The large differences by bank ownership empirically highlight that lending biases and high defaults are serious issues in private banks, possibly due to connected lending and conflicts of interest.

Table 2 indicates that multiple factors in ownership, board structures, and profit motivations contribute to concentration of loans under conditions of influence and control. The impact of political linkages, industrial groups controlling banks, and greater pressure to generate higher returns on equity reflects the channeling of credit to group firms or politically-backed borrowers instead of diversifying risk across unrelated parties.

Table 3 statistically supports the hypothesis that weaker oversight encourages reporting malpractices. Strikingly, 70% of banks with high rates of misreporting also had poor vigilance and so were able to window-dress their books and conceal issues in asset quality or liquidity. The ch-square test confirms a significant association between the two.

Table 4 shows banks have regularly faced punitive actions over unethical practices but the persistence of a high magnitude of offenses and repeated sanctions points to lax enforcement. Though penalties provide an indication that regulators have taken note, they are yet to serve as an effective deterrent. The figures also seem to reflect the iceberg principle, where many infractions avoid scrutiny so visible sanctions likely capture only a small subset of actual irregularities.

Conclusion

The results empirically demonstrate that financial irregularities remain widely prevalent among Pakistani banks owing to weaknesses in governance, political interventions, regulatory capacities and inherent vulnerabilities in parts of the sector. Ownership structures facilitating tunneling of loans, boards failing in overseeing integrity of executive decisions, and external pressures subverting ethical banking have jointly bred an enabling environment for malpractices. Specifically, political influence over credit allocation, dominance of business groups without adequate buffers or continuity planning in private banks, discretionary lending models without strong screening and concentrated exposures on few names have magnified instability. Though

sanctions by SBP against irregular acts provide some reassuring steps, oversight mechanisms need considerable strengthening to restrain systemic risks of unethical practices.
Future Directives This study sets the groundwork for exploring specific mitigation strategies using empirical findings on high-risk areas. Detailed examination of processes in banks with relatively better governance and regulatory compliance can also inform framing of policy guidelines. Research on political economy factors shaping ownership-supervision dynamics can help design systems resilient to external interventions. Impact assessment of governance reforms like independent director requirements and risk management structures is another useful dimension for academics and policymakers. Surveying bank employees across hierarchies could also provide valuable ground-level insights that complement the quantitative approach of this study.

Limitations

As data limitations constrained a wider set of metrics from being tested, the models have omitted relevant variables like ownership identities of defaulters, tenure and qualifications of independent directors, board meeting minutes indicating oversight, sanction rates showing enforcement effectiveness etc. Surveying bankers could also not capture possible response bias and social desirability affecting honesty on disclosure of irregular practices. The fast changing structure of Pakistani banking with mergers, acquisitions and privatization of public banks means statistically tested relationships can evolve with industry shifts.

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