

## **The Debt Problem in Light of Applying the Provisions of Law No. 41 of 1993**

It gives me great pleasure to participate in this conference, which discusses the difficult debt problem and its solution through the implementation of the provisions of Law No. 41 of 1993, concerning the purchase by the State of certain debts and their means of collection. First, I would like to extend my thanks to the Kuwait Chamber of Commerce and Industry for organizing this conference, whose participants include certain members of the National Assembly and a selected number of officials and individuals concerned with the banking and financial system and the economic activities of Kuwait. I hope this conference succeeds in achieving its objectives by providing the opportunity for dialogue and discussion in order to formulate a clear picture of the approach to solve the difficult debt problem, which should be objective, realistic and comprehensive.

We all know that enormous efforts have been exerted by specialists and concerned individuals to solve and eliminate the difficult debt problem. Numerous studies and reports on this subject have also been prepared. Therefore, I would rather not go into details concerning the evolution of this problem, its causes and the various solutions proposed since the liberation of the State of Kuwait from the brutal Iraqi occupation. Instead, I shall brief you on the background of the difficult debt problem, and then I will discuss the provisions of Law No. 41 of 1993 concerning purchased debts, and the likely economic implication of its application.

Briefly, the beginnings of the difficult debt problem can be traced back to the stock market crash in the early eighties;

however, the adverse effects of the problem began to surface after 1985 due to the insufficiency of measures taken to deal with the problem of post-dated checks and the negative impact of the Iraq-Iran war on domestic economic conditions. Financial and real estate asset prices took a steep downward decline, and the businesses of many debtor clients plummeted, leading to their inability to repay or service their debts. Thus, the problem was aggravated by the growth of these debts as interest accumulated, to form a significant part of these debts. The brutal Iraqi occupation further exacerbated the difficult debt problem, as most debtors were incapacitated from the repayment of their debts, and banking and financial institutions started to face a solvency predicament because of insufficient provisions against risks related to difficult debts and financial investment portfolios, as well as their inability to build up the necessary provisions to cover these risks.

In view of the gravity of this problem, it became imperative to find another solution to it than the Difficult Credit Facilities Settlement Program of 1986, which proved incapable of handling the problem after the liberation of Kuwait. Leaving the problem unresolved would have had destroyed confidence in the banking system, and caused a run on banks by depositors seeking to withdraw their deposits. Banks could not have sustained this run, and the State would have been forced to intervene to pay large amounts of money and incur huge losses that would harm public funds.

Therefore, several solutions were suggested to remedy this problem. The Central Bank of Kuwait initiated these suggestions through its views, that were declared in September 1991. This was followed by a number of suggestions from various parties. The Kuwait Chamber of Commerce and Industry presented its suggestion in November 1991. The main committee, formed by His Highness the Crown Prince and

Prime Minister and named then the Committee of Forty, submitted its suggestion in December 1991. After thorough discussion and debate about these suggestions, a consensus of opinions emerged on the inevitability of purchasing the debts from banking and financial institutions to rid them of the problem completely; however, no consensus was reached on how to collect these debts. Some called for carrying out collection on a uniform basis, regardless of debtors' financial positions. Others thought it was necessary to make collection according to debtors' financial positions on a case-by-case basis. Decree Law No. 32 of 1992 issued in May 1992, adopted the latter opinion.

At the time when the National Assembly was debating this Decree Law, a number of other suggestions came to the fore, focusing on the means for collecting the debts purchased by the State, with the cash repayment method as an alternative option. These suggestions included the views forwarded by the Financial and Economic Committee of the National Assembly, and new suggestions from the Kuwait Chamber of Commerce and Industry in March 1993. After all that, Law No. 41 of 1993, concerning the purchase by the State of certain debts and the means of their collection, was issued.

Before going into the main provisions of Law No. 41 of 1993 regarding the collection of purchased and managed debts, I would like to point out that this collection is subject to certain established general principles, the most significant of which are the following:

**First:** The basis of handling non-performing debts is represented in rescheduling on clear and definite principles over a relatively extended period of time, in order to enable a debtor to carry on his business and use its income for the repayment of his debt. Since 1991 the

Central Bank of Kuwait has based its views for solving the debt problem on this principle.

**Second:** Any suggested solutions for debt collection should take into consideration, as much as possible, minimizing its financial cost to the State. At the same time it should not ignore the economic cost, so that a solution has no adverse effect on domestic economic activities.

**Third:** The measurement of the actual financial cost incurred by the State, depends on debtors' ability to actually settle their debt according to conditions specified by the solution. Thus, the actual financial cost could be much higher than the calculated financial cost if the solution were unrealistic, which would also entail adverse economic and social effects.

The general principles, upon which Law No. 41 of 1993 concerning the collection of purchased debts was based, were, to a large extent, in agreement with what was established during the discussions about this subject. These principles are as follows:

- To disregard financial positions of debtors as a basis for collecting the purchased debts. Collection from all debtors depends on mechanical rules and not on subjective judgment.
- To allow debtors to choose from more than one method of repayment, such as immediate cash repayment, scheduling repayment or both.
- To give debtors a grace period for immediate cash repayment, and incentives in the form of decreased

repayment ratio when a debtor precipitates repayment ahead of the date specified by the Law.

- To allow debtors who choose scheduling repayment to pay installments before falling due.

Although Law No. 41 of 1993 gives debtors more than one repayment option, it is clearly prejudiced toward the cash repayment option against the scheduling option. It allows the collection of purchased debts by one or more of the following repayment methods:

1- Immediate cash repayment within two years from the enactment of the Law, according to concession ratios and categories in its attached table, which specifies progressive repayment ratios for debts outstanding on August 1990 reaching a maximum of 45.64%

2- Scheduled repayment within twelve years, starting the day after the end of the grace period on March 31, 1994.

The prejudice becomes clear from the ratio specified for the highest category of immediate cash repayment, 45.64%, based on an original assumption that the scheduling period would be interest-free for twenty years, including a two-year grace period, and a discount rate of 9% per annum. However, the scheduling period was cut to twelve years only, making the repayment options available to debtors inconsistent.

Consequently, a client who wishes to repay his debt immediately and in cash on September 7, 1993 will pay only 42.14% of his indebtedness, according to the provisions of Law No. 41 of 1993. This ratio represents the immediate cash repayment ratio, after the exclusion of incentives given by the Law to precipitate repayment. In contrast, the present value of

a similar debt of a client who chooses scheduled repayment will amount to 62.5%.

The Central Bank of Kuwait was hoping that Law No. 41 of 1993 would eradicate the difficult debt problem once and for all, after more than ten years without a solution. Unfortunately, data on debt repayment choices of clients that became available to the Central Bank of Kuwait from debt authentication show that the Law may become ineffective.

The bias of the Law in favor of the immediate cash repayment option against the scheduled repayment option has led most debtors to choose the immediate cash repayment option. Actual data indicate that the total number of debtors, whose debts are purchased and managed, is 10423. Their debts total KD 6262 million. Those who authenticated their debts totaled 3405 debtors with debts amounting to KD 5488 million. Those who chose immediate cash repayment numbered 3354 debtors, with debts amounting to KD 5333 million or 97.2% of total debts. Meanwhile, only 51 debtors chose scheduled repayment, with debts totaling KD 155 million or 2.8% of total authenticated debts. Moreover, 1363 debtors, whose debts total KD 200 million, failed to authenticate the required declarations.

Favoring immediate cash repayment would be justifiable, desirable and effective, since it would encourage debtors to choose it in order to eliminate the debt problem in the shortest possible time span, only if it were accompanied by actual repayment of obligations by debtors who chose this option. Unfortunately, after more than a year and seven months, actual debt settlements constitute only a small part of authenticated debts. 5655 debtors made cash repayment of their total debts of KD 574 million or 9.2% of total purchased and managed debts. This is despite the incentives given by the Law to debtors who make advanced cash repayment. Now less than five months

remain from the specified repayment period. It seems that the choice of the immediate cash repayment by most debtors does not reflect their actual repayment ability, but rather a sort of time-gaining method to avoid non-compliance with Law No. 41 of 1993.

Here, a number of queries arise about how a huge amount of money, estimated at KD 2200 million, can be arranged for immediate cash repayment within a period of less than five months from now, and what the possible implications of such arrangement on various domestic economic, monetary and banking indicators and variables would be.

In this context, potential sources of funds required for immediate cash repayment may be **external sources**, whereby debtors liquidate their external assets and use the revenues for the repayment, or domestic sources, or bank credit. No doubt, reliance on **external sources** for immediate cash repayment will not have any adverse effect on domestic economic and monetary conditions, but rather it will have a positive impact. In reality, following up changes in net capital outflows during the past period, and from our previous experience and analysis of clients' behavior in the past, we can assume that debtors' recourse to external sources for repayment is doubtful and cannot be relied upon. Thus, domestic sources and bank credit are really the fund sources available for debtors to settle their obligations through immediate cash repayment.

In light of this assumption, the **domestic sources** that debtors can resort to are not more than shares of listed companies, real estate, or deposits with banks.

The total collateral assets held by seller parties against purchased debts are valued at KD 2760 million. This value drops to KD 2364 million, excluding KD 396 million, which

represents the collateral whose value, exceeds the value of the debts they are pledged against. The total collateral assets comprise KD 520 million in shares, KD 1763 million in real estate and KD 477 in other assets. These values are based on the last available assessment, prepared in 1989. The current value of these collateral is significantly lower, considering the marked decline in asset prices, especially real estate, due to the consequences of the brutal Iraqi invasion.

In light of available data on the activity in the domestic asset markets, we briefly evaluate the potential of each domestic asset to finance immediate cash repayment transactions as follows:

#### **1. The Stock Market:**

Data on the Kuwait Securities Market indicate that the total value of traded shares amounted to KD 586 million during 1994 and KD 240 million between early 1995 and mid-April. Therefore, if collateral shares (amounting to KD 520 million) were to be offered for sale in the market during the remaining specified period for immediate cash repayment, less than five months, the market would not be able to absorb these shares, and share prices would be expectedly subject to downward pressures.

Obviously, market capacity is limited and lacks the needed flexibility to deal with share-selling offers that are expected to be concentrated - based upon logical reasoning and the past behavior of clients - close to the end of the specified period for immediate cash repayment. Thus, capital funds available in the market may not be sufficient to cope with a large supply of shares during a limited period of time. In addition, this will definitely create immense pressure on share prices, particularly as other non-debtor investors

might start selling their shares to cut losses due to their expectation of a downward trend of prices. Even with the assumption that the market can absorb the supplied quantities of shares with fresh funds or entry of marginal investors into the market, the final outcome will be an added negative impact on prices, which in the final analysis will reduce market capital value of shares as a result of falling market prices.

## **2. The Real Estate Market:**

It can be stated that buying and selling in the real estate market is often much less flexible than trading in the stock market, due to the relatively hefty value of its deals compared to the value of deals involving shares, and the difficulty of fractionating real estate, which makes demand in the real estate market relatively inelastic. Moreover, concluding a sales deal involves lengthy procedures even in ordinary conditions, and buyers should be experienced in dealing in the real estate market and should have the desire and the financial capability to purchase. All of these conditions cannot easily be made available in the local market within a relatively short period. Therefore, it is going to be hard to find buyers for the offered real estate. Activity in the local real estate market will be adversely affected by the availability of a large supply of real estate during a short period of time, which will by far exceed the capacity of the market, and in turn lead to substantial declines in real estate prices.

If we take into consideration the fact that available estimates on the volume of trading in real estate investment during 1993 and 1994 show that this volume was KD 160 million per annum on average, then by comparing this with the value of total trading in collateral assets alone (KD

1763 million), it becomes obvious that the market can not sustain this supply of real estate, which, if it occurs, may lead to results similar to those in the stock market, but more intense, whether with regard to lack of capacity, or a decline in real estate prices and in turn in the capital value of real estate in general, whose negative effects will not be limited to debtors alone.

## **2. Private Sector Deposits with Local Banks:**

Available data on the balances of local bank deposits of resident clients who compose the private sector, excluding deposits of government and semi-government institutions, were as follows at the end of February 1995:

	<u>KD million</u>
Current Deposits	649.1
Savings Deposits	632.0
<u>Time Deposits</u>	<u>2797.5</u>
<u>Total Deposits</u>	<u>4078.6</u>

Both current and savings deposits are temporary in nature, because current deposits are normally used as a means of payment and settlement of direct transactions, while savings deposits are mainly used as a dispenser by small savers and for the transfer of salaries, and can be withdrawn at any time. Thus time deposits are expected to be the main source of immediate cash repayment of debts. As these deposits pertain to citizens and expatriates, deposits of expatriates and non-debtor citizens, for which data are not available, should be excluded in determining the amount of deposits available for repayment. Therefore, it is difficult to determine the amount of deposits pertaining to Kuwaiti clients whose debts have been purchased,

especially as time deposits include balances of a large number of non-debtor public shareholding companies.

Scrutinizing the collateral pledged against purchased debts reveals that most of it is in the form of real estate and shares, while the rest, which represents a small percentage of debts, is in the form of other assets. If we assume that most of the other assets are actually collateral deposits, even then these deposits will constitute only a small percentage of total debts. It is well known in banking that most clients generally do not resort to borrowing unless all their money deposits are exhausted, and if such deposits exist, they are often pledged as collateral.

Besides domestic and external sources, **bank credit** is treated as a major source for debtors who are seeking to arrange funds for the immediate cash repayment of their debts. Of course, utilizing this source requires meeting a number of necessary conditions; among these are: 1. the desire of the clients themselves to obtain credit facilities from banks, 2. the feasibility of this credit provided that the decision to extend this credit is sound and takes into consideration CBK regulations, and 3. the adherence to rules pertaining to maximum credit concentration levels set by the CBK. In addition, sufficient funds should be available at banks to enable them to meet the demand for credit by their clients.

Available data on the development of bank credit indicate that the increase in utilized cash credit facilities extended by local banks to residents during 1994 totaled KD 358.8 million. Hence, arranging large sums of money through credit facilities does not seem very likely.

We can conclude that the prejudice of Law No. 41 of 1993 toward immediate cash repayment has resulted in most debtors choosing this option, with their debts representing 97.2% of

total debts. As the end of the specified repayment period approaches, analysis of available fund sources reveals that arranging funds for immediate cash repayment from external sources is doubtful, and that resorting to domestic sources will have an adverse impact on local assets, besides limiting the capability of debtors themselves to settle their debts, as value of their assets will decline as well, which has implications for the whole of the national economy.

These negative implications will not only be limited to clients whose debts have been purchased, but also will affect other debtors who obtained new credit facilities after the liberation, because when the prices of their free and collateral assets will fall, they may default on their debts, which will probably create another difficult debt problem, leading to yet another intervention by the State at huge cost in view of its commitment to guarantee depositors' rights.

Given the intricacy of financial relations among domestic economic units, the circle of affected clients will expand to include other economic units, thus damaging the confidence in economic and financial transactions and in the local investment environment in general, as well as in the banking and financial system in particular. This will prolong and aggravate the phenomenon of capital outflow and thus increase pressure on monetary policy.

As regards domestic economic activity, the decline in the value of local assets will directly affect the performance of various economic units. Domestic economic units that own local assets in the form of shares and real estate will have to make substantial provisions against the risks emanating from the declines in the value of their local assets. This will negatively impact their profitability and reduce the growth rates of these sectors. With the decline in share prices in the stock market, it

is expected that investors will refrain from investing in this market, contracting local investment opportunities and limiting the ability of economic units to make appropriate diversification in their investment portfolios.

Furthermore, these negative effects will create an atmosphere of uncertainty for private sector decision-makers. The adversely influenced investment decisions will affect aggregate demand and capital formation as well as economic growth in general.

**It is worth noting that the debate on Law No 41 of 1993 does not focus on repayment methods only, but addresses many technical and legal issues which are of concern here.**

I have tried not to protract the analysis of this problem, which has taken a lot of time and debate without reaching to any decisive solution to eradicate this problem in its early stages. As a result, it is not a problem of collecting the difficult debts purchased by the State, but a more complex problem with far-reaching effects on various aspects.

I hope this conference will help resolve the debate on Law No. 41 of 1993, and draw a clear picture of the appropriate solution to this problem. This can only be achieved through objective and realistic analysis that tackles all aspects of the problem and avoids insisting on theoretical solutions that are in fact impractical.

It may be appropriate to point out that these possible negative implications that I have just mentioned are based on the assumption that all debtors who have chosen immediate cash repayment will actually make repayment before the end of the period specified by the Law on September 6, 1995. Available data refute this assumption in the case of many debtors. It is

assumed that all clients who were not subject to the Difficult Credit Facilities Settlement Program of 1986 are able to repay, while available data on clients subject to this program show that their total collateral assets amount to KD 1230 million against their total purchased and managed debts of KD 3027 million, a 40.7% cover, according to pre-invasion prices of these assets. If this value is adjusted to reflect post-liberation market prices, the percentage of guarantees to total debts may drop to 31% with the assumption that these prices will not decline again by the end of August 1995. This clearly shows the inability of most clients of the program, whose debts constitute 48.6%, of total purchased and managed debts, to abide by the ratio of the immediate cash repayments as set by Law No. 41 of 1993 at 45.64%, for debts of over KD 500 thousand.

In light of this analysis, if clients will not make their immediate cash repayments after the end of the specified period, they will be referred to public prosecution for legal action against them in accordance with the provisions of Law No. 41 of 1993. This will create a general problem with such far-reaching social and economic consequences that it cannot be characterized as a simple problem of a client or a number of clients - individuals or judicial persons - who defaulted on repayment, as is the case in ordinary circumstances. This problem would engulf many individuals and economic units, due to their commercial and financial inter-relationships. It is known that default by debtors will not be limited to their purchased and managed debts, but will include the rest of their obligations to other creditors, which will in turn lead to default of those creditors on their obligations to others.

No doubt, taking legal and judicial actions against this large number of clients will lead to a significant problem. The time factor will not help in finding any solutions, but rather it may

revert the debt collection problem at the end of 1995 back to its starting point again. This will impose a huge financial, economic and social cost on the State whose negative consequences will be unbearable, uncontrollable, or difficult to deal with because the current debate about Law No. 41 of 1993 has not been resolved objectively and realistically to safeguard the higher interests of the country and pave the way for the State of Kuwait to assume a leading role in the region from the turn of the next century.

Finally, I would like to reiterate that in view of the seriousness of the economic and social consequences, it is imperative to dwell upon finding decisive solutions to help eradicate the debt collection problem and avert subjecting the State to problems emanating from failure to collect debts despite stringent laws. Any objective solution to the collection problem should seek an appropriate way to collect debts from debtor clients, and redress the various shortcomings of Law No. 41 of 1993 in a way that does not impose an unjustifiable financial burden on the State, taking into consideration the general principles upon which Law No. 41 of 1993 is based.

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