

Failure of Corporate Governance @ Mehran Bank Limited

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Abstract

Purpose – The purpose of this study is to provide an understanding of different ways in which financial institutions are vulnerable to the behest of influential people in developing country like Pakistan and how whimsical and unethical behavior can lead to business failure and ultimately bankruptcy of financial institution.

Design/methodology/approach – The study is descriptive in nature and uses case study design to present the artifact of one of the biggest financial scam of Pakistan of its time. All the data has been collected from published sources on print media and internet only.

Findings – It illustrates how the senior army officials withdrew a substantial amount of public money from Mehran Bank and directed it towards an ‘intelligence fund’. The scandal subsequently broke after the new senior army management decided to transfer the intelligence fund back to state owned banks as per official rules. Mehran Bank was unable to return to the [depositors](#) the money due to its poor financial state and collapsed. It was later discovered that large sums had been siphoned off to 39 fictitious parties/people

Research limitations – The study has been conducted on the basis of published sources on print media and internet only. Consequently, the interpretations presented in the study are not necessarily those of government officials or company employees.

Practical implications- This research suggests how mixing political motivations with business operations and misuse of public funds at a financial institutions disposal can lead to dire consequences and how ethics can be a strong source of competitive advantage.

Originality/value – The author discusses the consequences of weak corporate governance and in particular the poor control of state institutions on the workings of financial sector organizations. It also offers scope for a compelling discussion on the usual causes, the events, and the possible solutions of such failures of corporate governance in the context of the misuse of public money by influential people with political motivations at Mehran Bank.

INTRODUCTION

The major objective of this paper is to present the most horrific failure of corporate governance in the history of Pakistan. This paper also offers understanding about the corporate governance framework of the country and whether or not it has been successful in its objectives. The scandal commonly known as Mehran gate is one of the worst financial scams of 90's, that has rocked the financial pillars of the country [1].

RESEARCH METHODOLOGY

The study is descriptive in nature and uses case study design to present the artifact of one of the biggest financial scam of Pakistan of its time. All the data has been collected from published sources on print media and internet only. Selected copies of published material are also appended for a quick reference.

MEHRAN BANK - THE CASE STUDY

The year 1990 was starting point of secret movement in Pakistani political, military and intelligence world to destabilize the [sitting](#) government in era of 1990s. Later this turned out to one of biggest corporate and political scandal of the country. To support the movement, Mehran Bank, was used to supply funding for operation, to buy [loyalties of](#) politicians. The list also includes big names from business world as well as military camp and President House.

The State Bank of Pakistan ([regulatory body for banks](#)) had little autonomy to scrutinize or question new banking applications (and applicants) because of political affiliations of these private banks. State [bank](#) purports that Mehran bank was formed under dubious circumstances as it received massive, unauthorized support from one of the provincial governments [2].

Mehran Bank – An Introduction

Mehran bank was incorporated in lieu of the privatization fanfare in Pakistan on 31st October, 1991 as a public limited company and its shares were quoted in Karachi and Lahore stock exchanges. The bank began its formal operations from 22nd January, 1992 in the business of banking and operated as "Scheduled Bank" as defined by the Banking Companies Ordinance, 1962.

Mehran banks paid up capital was Rs 300 million (US \$ 10 million), assets of Rs 2.9 billion and stock market capitalization of Rs 500 million. It had six branches all over Pakistan located in Karachi, Lahore, Mirpurkhas, Peshawar, Quetta and Rawalpindi (Annual Report 2004). Mr. Yunus Habib was the founder and Chief Operating officer of the Bank. Since its inception Mehran bank had raised doubts and it was known as "a good idea but poor execution" [3].

The Allegations

The accused had misappropriated around five billion rupees, part of which was spent during election campaign in 1990[4] and giving loans and donations to politicians as well as Prime Minister, intelligence agencies[5]. There had been transfer of Rs 499 million to 39 account holders through investment bank without the consent of the depositors [6]. Mehran Bank's COO was also convicted in 148.5 million dollars Bearers certificates (DBC's) fraud case and for advancing Rs 300 crore loans against hundreds of fake accounts (BENAMI) as SEVP of HBL [7].

Mehran Bank's money was used to finance elections of President and to top down the provincial government amidst the NWFP crisis during the 90's [8]. Over Rs 130 crore belonging to various federal, provincial and Azad Kashmir bodies were stuck up in the bank when it collapsed [9]. These funds had been deposited in Mehran Bank through the good offices of holders of public

office to whom the bank advances loans and paid a fixed commission in cash for arranging the deposits [10]. The Chief of Army Staff during that time admitted receiving Rs 24 crore as a donation from (COO) [11]. One of the most coveted and sensitive institution of the country had also secretly used the bank to first deposit and then hastily withdraws the money [12].

During 1990, Mehran bank's founder made a disbursement of Rs 140 million loans to [chief of Army staff \(CAS\)](#) which was ultimately transferred to 39 prominent politicians. Once the CAS retired from the services and the new Chief of a premier intelligence agency decided to transfer the intelligence funds back to state owned bank ([National Bank of Pakistan](#)) as per official rules, Mehran Bank was unable to return the money due to its poor financial state and collapsed. It was later discovered that large sums had been siphoned off to 39 fictitious parties/people [13].

Apart from the above mentioned allegations the [Mehran banks COO](#) was also charged for being involved in the sale of land to the then President of Pakistan for Rs 15 million. This price was far below the market price and payment was made through an unknown (Benami) account [14].

Fraud with SBP

The accused had admitted that out of \$36.7 million generated through the sale of DBCs, a federal government paper that the SBP sold through commercial banks, he used \$20 million to pay back a portion of the amount owed to the [premier intelligence agency of the country](#) and used the rest to meet some other pressing obligations. According to the SBP rules, proceeds from the DBCs (Mehran Bank was given \$40 million worth) had to be deposited within 72 hours of the sale. However, he did not meet this deadline [15]. In fact, he never deposited the money at all. He was arrested on a complaint by the SBP for committing misappropriation in the sale proceeds of Dollar Bearer Certificates (DBC's) to the tune of \$36.7 million. On 14th December

1995, the **Banks COO** was awarded years of rigorous imprisonment and was fined hefty amount in a fraud case by the Special Court for offences in banks.

Consequences

Mehran bank scandal exposed some of the high dignitaries of Pakistan. It has also casted shadow over the functioning of important financial institution of state such as the SBP and some sensitive agencies [16]. Consequences of this massive financial scandal are fatal for corporate sector at all levels including individual, organizational and national levels.

Amalgamation of Mehran Bank: In 1995, SBP allowed the Mehran Bank's merger with National Bank of Pakistan (NBP). Consequently Mehran Bank was amalgamated with the National Bank of Pakistan [17]. In 1996 the NBP had to make full provision for Mehran's liabilities which resulted in a net loss that year to the bank of Rs 1.26 billion [18]. The SBP was also required to provide markup free finance to support the NBP.

A petition was also filed in the wake of amalgamation of Mehran Bank by some of the share holders. The petitioners submitted that the decision of the merger of the bank was in violation of the principles of natural justice as no opportunity was afforded to the shareholders to the object of amalgamation. Sindh High Court admitted the petition against MBL amalgamation [19]. The employees of Mehran Bank were demoted and some very experienced staff was offered clerical jobs [20].

Fate of the Banks Chief Operating Officer: The founder and Chief Operating officer of the **Bank started his career** in banking as a clerk and assistant in Habib bank in late sixties and early seventies. Within three years of his joining he got his first promotion. However, he was soon suspended and then retired from the services by the employers of Habib bank for indulging in

unethical banking practices [21]. After that with the help of his political allies and benefactors he founded a private bank under the name of “Mehran bank”.

The founder had allegedly siphoned off a staggering Rs5 billion and doled out millions of rupees to politicians in order to cover up his crime [22]. He was awarded unprecedented sentence of 17 years rigorous imprisonment with a fine of Rs 2.2. billion and two years extra jail in Dollar bearer certificate fraud case by a special court on February 28th 1995 [23].

ANALYSIS

This case provides unlimited opportunities for analyzing and presenting poor corporate governance practices and their consequences. A few points are discussed in detail:

Role of Management

The banks founder had enjoyed senior management position in the Bank. There have been countless allegations of cesspool of corruption and mismanagement of resources by the hands of the Bank’s COO . He played a double fraud, both on depositors of the Mehran Bank as well as the SBP [24].

The Mehran Bank had been doing badly since its very inception in January 1992, and banking experts attributed this poor performance to the founder’s penchant for ‘extracurricular banking activities’. In fact, the only reason why the bank had managed to stay afloat was the protection and patronage enjoyed by his founder whereby hefty government accounts were brought to Mehran Bank.

Role of Regulators

After thorough analysis of this case, the role of the regulatory bodies of banks and business seems negligible. The SBP has the responsibility of supervising the affairs of banks in Pakistan however it was intentionally kept out of the matter [25]. Number of loopholes had been

identified in the Mehran bank scandal that puts SBP in a very vulnerable position. Most importantly, why the SBP ignored earlier warnings regarding the gross misconduct at Mehran Bank [26]. In fact there [had](#) been a strong evidence of delayed action by SBP even after the uncovering of the scam. In a system, where power, authority and money prevail rather than justice, accountability and democracy, the authority has lesser control over the matter conducted at high governmental levels. The whole game was played at upper levels to these regulators and the system is such that one cannot make their seniors accountable.

Role of Auditors

An important question from this case arises is that what was the role of the auditors of the SBP and the statutory auditors in Mehran bank. Were they simply negligent or were a "beneficiary" [27].

Rights of Minority Shareholders

Millions of rupees were invested by the small investors for the purchase of the share of the Mehran bank. However the government did not provide these small shareholders any protection and their investment was jeopardized. Instead of liquidating the shares they should have been dealt differently [28]. These investors did not get a single penny and the embezzlement of money was made by the highly influential people and the small shareholders were made escape goats

Violation of Corporate Governance principles

Banking and corporate crimes, misuse of public funds, bribery, chicanery and grand larceny are some of the terms synonymous with the bureaucracies and political elites of [the country](#). At the time of Mehran Bank Scandal, Securities Exchange Commission of Pakistan (SECP) had not devised any formal Code of Corporate Governance. (SECP manual for Corporate Governance

was developed in 2000). However, general corporate governance principles were adopted locally for corporate governance affairs and Banking laws were enacted.

The case is a classical Example of violation of the International corporate governance principles and local banking Laws. The practices of corporate governance are generally based on the principles of accountability, transparency; responsibility and disclosure; but they were willfully tarnished and disdained. No one except the chief operator officer of the bank (who served a very short sentence) was held accountable and responsible for the biggest financial scam of the Country. Although the main culprit had many allies who had enjoyed the bounties of the crime. If the bank had transparent and fair reporting system and impartial auditors than the small investors would not had this severe blow.

CONCLUSION

This case study discusses the consequences of weak corporate governance and in particular the poor control of state institutions, on the workings of financial sector organizations. It also offers scope for a compelling discussion on the usual causes, the events, and the possible solutions of such failures of corporate governance in the context of the misuse of public money by influential people with political motivations at Mehran Bank. Accountability based on close scrutiny of the conduct of office holders of public office is the essence of a democratic dispensation , However unfortunately any such mechanism is not practiced in letter and spirit in the Country that renders the actions of public figures transparent and overboard [29]. Although two high powered commissions of inquiry comprising of five independent judges of superior court were appointed to probe into the Mehrangate scandal but this commission was a mere cover-up by the government as all the key figures in the scam are still at large.

RESEARCH LIMITATIONS

The study has been conducted on the basis of published sources on print media and internet only. Consequently, the interpretations presented in the study are not necessarily those of government officials or company employees.

PRACTICAL IMPLICATIONS

This research suggests how mixing political motivations with business operations and misuse of public funds at a financial institutions disposal can lead to dire consequences. This case study might also be useful while training the young business /finance graduates.

ORIGINALITY/VALUE

The author discusses the consequences of weak corporate governance and in particular the poor control of state institutions on the workings of financial sector organizations. It also offers scope for a compelling discussion on the usual causes, the events, and the possible solutions of such failures of corporate governance in the context of the misuse of public money by influential people with political motivations at the [scandalous](#) bank.

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