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Impact of Financial Liberalisation and Deregulation on Banking Sector in Pakistan

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The paper analyses the market perception about the performance of Pakistani commercial banks in the wake of financial liberalisation and deregulation measures taken by the central bank over the last two decades. For this purpose, it uses the Survey approach. Out of 35 commercial banks, 15 banks have been chosen for analysis purposes.

The paper mainly finds that key banking reforms have helped in removing the flaws in the banking sector of Pakistan. In particular, privatisation of banks, the deregulation and institutional strengthening measures, switching towards market-based monetary and credit management systems were instrumental in streamling banking operations. Similarly, the removal of restrictions on entry of private banks and operational restrictions on foreign banks also significantly contributed to the provision of quality banking services. The resultant competitive environment is the key factor behind improved efficiency of banks in Pakistan. The banks devised a number of strategies to respond to the competitive market conditions in the country. However, they faced various constraints in this regard, especially lack of managerial skills, and in hiring IT professionals, etc. As a part of future strategy, banks are likely to form more strategic alliances with foreign banks and undertake the expansion of business through widening of branch network. Despite a number of successful stories on different fronts, the central bank could not succeed in narrowing down the banking spread which is one of the key measures of banking performance. High domestic inflation, large non-performing loans (NPLs) of banks, high administrative expenses, larger intermediation costs, and poor debt recovery are identified as important factors behind widening of banking spread.

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1. INTRODUCTION

The banking sector of an economy generally performs three primary functions: the facilitation of payment system, mobilisation of savings, and allocation of funds to stakeholders like government, investors, consumers, and business community who can utilise them for generation of economic activities.[1] By virtue of its pivotal role, the

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[1]Patrick (1967), Porter (1967) and Jaffe and Levonian (2001).

banking sector can exert its positive influence on various segments of an economy.[2] This gives it a privileged position among other sectors. In view of its significant role, economic managers always endeavour to devise such policies which could help provide the sector a level-playing field, thereby enabling it to operate on sound, efficient, and competitive footings.

As in other emerging market economies, banks have been playing an important role in Pakistan also. However, the financial landscape of the country changed significantly in the 1970s with the nationalisation of Pakistani commercial banks. The Government also took various regressive steps, which included, among others, the initiation of subsidised bank credit schemes, the introduction of a complex system of credit ceilings, and imposition of controls on interest rates.[3] These policy measures severely affected the efficiency of the banks. By the end of the 1980s, it was felt that Pakistan's banking sector was not able to meet adequately the financial needs of the country.[4]

To minimise the adverse effects of state controls in financial matters, the recipe of liberalisation was proposed as it was considered to be helpful in improving financial deepening besides promoting economic growth of the country.[5] Accordingly, Pakistan initiated a comprehensive process of reforms for its banking sector in the early 1990s. Especially, more emphasis was given to financial liberalisation and deregulation measures. Although the first round of banking reforms has been completed, the second stage of the reforms agenda[6] is yet to be implemented fully. With regard to the successes of the reforms agenda, claims have been made by the IMF/World Bank,[7] the government and the central bank itself.[8,9] However, despite these claims, the efficiency of banks is generally criticised due to prevalence of large banking spread, high cost of access to banking services,[10] skewed credit distribution (which is tilted more towards government and textile sectors), large non-performing loans, poor recovery of loans, and high exposure of banks to risky and speculative transactions which increase the vulnerability of banks to exogenous shocks. In this backdrop, the policy-makers need to rethink their earlier assessment about the impact of reforms on banking sector, as poor performance of banks could have negative implications for the overall economy. In particular, we need to know whether the banking sector reforms, predominantly the liberalisation and deregulation of controls on banking practices, really help improve efficiency and performance of the banks.

The existing literature provides mixed evidence with regard to success of banking reforms. For example, the studies by Lewis (1950) and Gerschenkron (1962) favour

[2]See for details Jaffe and Levonian (2001) and Wachtel (2001).

[3]Haque and Kardar (1995).

[4]Hardy (2003).

[5]McKinnon (1973) and Shaw (1973).

[6]For details please see Akhtar (2006)

[7]Hussain (2005).

[8]Akhtar (2007).

[9]Akhtar (2008).

[10]In Pakistan, out "of 156 million people the number of deposit holder as per Statistical Bulletin is 26,321,688 which also include multiple accounts by same persons/entities. For a country with a population of approximately 156 million these numbers are abysmally low since it only accounts for less than 17 percent of total population" [Akhtar (2006)].

government participation in financial markets and ownership of banks on the basis of the commanding heights approach.[11] The empirical evidence also provides support to the argument of government involvement in banking sector, as it can have a growth-enhancing effect [Gerschenkron (1962); La Porta, *et al.* (2002)]. The studies by Claessens and Djankov (1999) find that state-owned firms perform relatively better than privatised enterprises or private firms, because they account for social objectives as well as externalities in natural monopoly markets. Moreover, the studies by Carlin, *et al.* (1997) and Frydman, *et al.* (1998) claim that the post-privatisation performance of firms remains poor. Similarly, Tulkens (1993), Altunbus, *et al.* (2000), and Denizer, *et al.* (2000) find that changes in ownership structure of firms have a limited impact on their efficiency level. Kumbhakar and Sarkar (2003) hold that deregulation does not yield efficiency gains in general, though private banks may increase their profitability by expanding output. A few studies carried out for US banks suggest that liberalisation of deposit rates has little or no effect [Bauer, Berger, and Humphrey (1993); Elyasiani and Mehdian (1995)].

However, the proponents of market-based banking operations provide substantial arguments in support of their views. According to them, functioning of banks under state control (or imposition of restrictions on their operations) can lead to financial repression. Particularly, economic policies favouring state-owned structure of banks, administratively controlled interest rates,[12] state-sponsored directed and subsidised credit schemes,[13] imposition of restrictions on entry and operations of banks,[14] high statutory requirements, have negative impact on banking operations,[15] which in turn impair both the volume and productivity of investments. Therefore, they are in favour of removal of policies causing financial repression and advocate greater role of market forces to achieve desired goal of sustainable economic growth [Demetriades and Luintel (997); Denizer, Desai, and Gueorguiev (1980); King and Levine (1993)]. Similarly, Claessens and Djankov (1999) claim that privatisation of state-owned firms is helpful: (a) in reducing information asymmetry between principals and agents, (b) creating market discipline, (c) improving corporate performances, and (d) transferring control rights from governments to private investors who are supposed to be closer to market demand. Further, privatisation makes firms efficient [Galal, *et al.* (1994) and La Porta, *et al.* (1997)]. Over the past two decades, a large number of industrialised, developing and transition countries have undertaken extensive reforms in their banking sector. Empirical evidence substantiates the viewpoint that financial liberalisation and deregulation measures help improve performance of enterprises [e.g. Fry (1997); King and Levine (1993) and Wachtel (2001)].

[11]The phrase "Commanding Heights" was first used by Vladimir Lenin in 1922 which meant that the state would control the most important elements of the economy. Later on, his successor, Joseph Stalin, extended that notion to all elements, with the total eradication of all private markets.

[12]The floor on lending rates tend to crowd out "low-risk, low-return" projects that become unprofitable with higher interest rates [Demetriades and Luintel (1997)].

[13]The loans to priority sectors can have a destabilising effect on banking system, since they are often less profitable and more likely to be nonperforming [Ganesan (2003); Shirai (2002)].

[14]To strict entry restrictions for new banks effectively shield the banks from competition [Deolalkar (1999)].

[15]High cash reserves and statutory requirements creates under-supply of credit by taking liquidity out of the market while on the other hand it inflates artificial demand for government securities [Demetriades and Luintel (1997); Denizer, *et al.* (1998)].

In case of Pakistan, there is hardly a comprehensive study that presents an analysis of the performance of Pakistani banks in the backdrop of financial liberalisation and deregulation. There are some studies by Burki and Ahmed (2011), Qayyum (2007), Ansari (2006), Iimi, (2004), Patti and Hardy (2005), Hardy (2003), Burki and Niazi (2003), Iimi (2002), Rizvi (2001), Shahid (2001), and Hardy and Patti (2001) which attempt to analyse the impact of financial sector reforms on the banking industry in Pakistan. However, they used either the parametric or nonparametric approaches to assess the efficiency of Pakistani banks. None of them used a "survey based approach". Unlike the aforesaid approaches, the survey based approach gives more flexibility to analysts. Especially, one can analyse the impact of reforms from different angles. In the present case, the approach helps in assessing the perception of bankers regarding the need of reforms in Pakistan, its impact on banking performance, and the responses of bankers to the reforms agenda, especially the measures pertaining to financial liberalisation and deregulation of banks. In fact the survey based approach provides a first-hand knowledge of stakeholders (i.e. bankers) who respond to central bank policies and can be affected directly or indirectly by the good or bad policies of the regulator.

It may be noted that Pakistan initiated the process of privatisation of banks mainly to enhance their efficiency. Till now, major state-owned commercial banks have been privatised with the exception of the National Bank of Pakistan, Bank of Punjab, Bank of Khyber, and First Women Bank.[16] Therefore, it is essential to know the impact of deregulation of banks on their efficacy. Further, Pakistan's banking sector provides an interesting setting for examining the impact of key banking sector reforms due to the presence of banks of varied nature e.g., domestic commercial banks [which include new private banks, partially privatised banks, fully privatised banks, Islamic banks], and foreign banks operating in almost comparable environment. However, the prudential regulations meant for Islamic, SME and Microfinance banks are somewhat different from those of traditional commercial banks. Out of 35 commercial banks, 15 banks have been chosen for analysis purposes which include one Islamic bank. The specialised commercial banks were excluded from the analysis because of their limited role.

The study is organised as follows: Section 2 provides a brief description of the methodology used to capture the market perception of the banking reforms. Section 3 evaluates the need, timings, sequencing, significance, and overall impact of the reforms on banking sector. Section 4 is devoted to the impact analysis of deregulation and financial liberalisation measures. Section 5 captures the impact of key banking measures on the performance of state-owned and privatised banks. Section 6 focuses on the emergence of competitive effect and its benefits in the wake of financial liberalisation and deregulation measures, and Section 7 is about concluding remarks. At the end, some references are given.

[16]Banks (Nationalisation) Act, 1974 was amended in 1990, which enabled the Government to sell all or any part of the share capital of the nationalised banks. A bank falls outside the ambit of the Act, 1974 when 51 percent of its share capital is taken up by the private sector. Further, the amendment in the Act, 1974 allowed private sector to operate as banking companies. However, Section 27 of the Banking Companies Ordinance was amended in 1997 to take the government out of the process of licensing of banks and make State Bank of Pakistan as the final decision-making authority in the matter.

2. METHODOLOGY

Unlike the parametric and nonparametric approaches, the current Paper employs a perception Survey approach which aims at capturing the feedback/ responses of executives/senior bankers with regard to the impact of banking sector reforms. In fact, the interviewees were the officials of banks who were aware of the significance of the banking reforms and were practically involved in the process of designing of policies of their respective banks in the backdrop of banking reforms of 1990s-onward. In view of the historical nature of some questions, the interviewees were also supported by their colleagues who had been associated with the concerned bank for a long time.

The Survey questionnaire was tested before conducting interviews of the executive/senior officials of the banks. The sample questionnaire was revised in view of the feedback received from some of the banks.[17] In particular, the key banking sector measures of 1997 were incorporated in the sample questionnaire. The anonymity and confidentiality of the respondents (i.e. senior bankers) was also ensured mainly to get their unbiased feedback/views on different aspect of banking reforms.

As regards selection of banks, it is tilted more towards nationalised and privatised banks which are likely to be affected largely by the key banking reform agenda, particularly the liberalisation and deregulation measures by the central bank. Besides privatised and nationalised banks, foreign banks, private banks and an Islamic bank have also been included in the analysis. Among foreign banks those banks are included in the sample, which have a longer history of operation in Pakistan. Similarly, the rationale behind the inclusion of private banks is to assess their role in competitive environment. Although their asset share in total assets of commercial banks is negligible, they are considered more efficient in terms of provision of intermediary services. AlBaraka Islamic Bank, which contains both the characteristics of a foreign and an Islamic bank, has also been included in the sample.[18] However, specialised banks have been excluded from the analysis because of their limited role. Details of sample banks, by type of ownership structure, are given as under:

Public Sector Banks: National Bank of Pakistan, First Women Bank Limited, and Bank of Punjab.

Privatised Banks: Muslim Commercial Bank Limited, United Bank Limited, Allied Bank Limited, and Habib Bank Limited.

Private Banks: Bank Al-Falah Limited, Bank Al-Habib Limited, Metropolitan Bank Limited, and Askari Commercial Bank Limited.

Foreign Banks: Citi Bank, Standard Chartered, ABN Amro Bank.

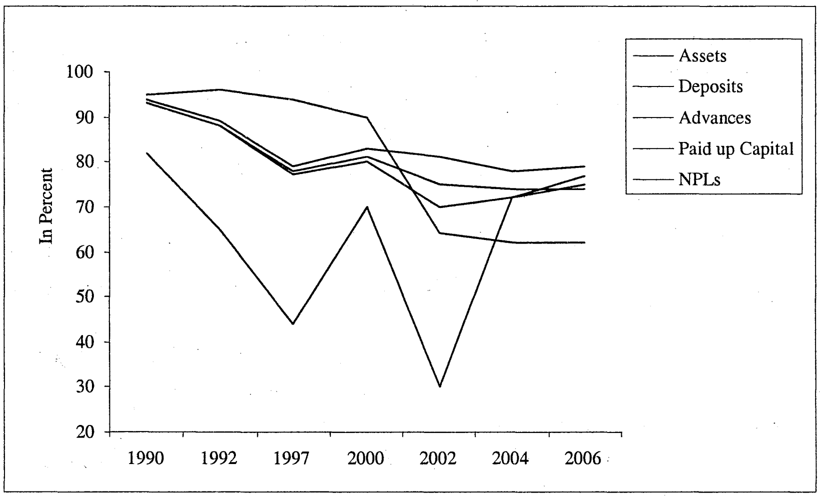
Islamic Banks: AlBaraka Islamic Bank.

[17]The survey was conducted in June 2008 by a Team supervised by the authors.

[18]The prudential regulations (PRs) meant for agriculture, Islamic mode of financing, SME and Microfinance are a bit different from those of traditional commercial banking (For details please see the PRs placed at the following SBP's web link: http://www.sbp.org.pk/publications/prudential/index.htm).

As regards the sample size, the selected banks dominate in the banking industry in terms of asset holdings, deposit mobilisation, extension of advances, paid-up capital, number of employees, etc. Their asset share in total assets of commercial banks stands at 74 percent in 2006, lowering from 93 percent in 1990 (Figure 1). They hold 79 percent deposits of the industry. Similarly, the paid-up capital to assets ratio is also around 77 percent. For analysis purposes, descriptive statistical tools have been used in the study.

Fig. 1. Key Indicators of Sample Banks



3. MARKET PERCEPTION ABOUT BANKING SECTOR REFORMS

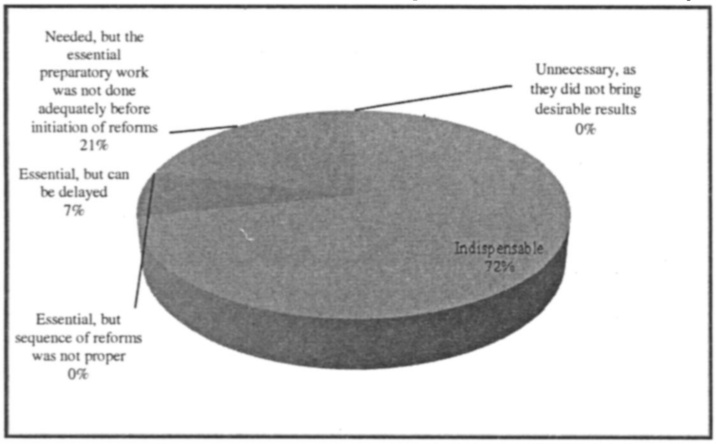
Since the banking sector reforms in Pakistan were considered a panacea for removal of banking problems, firstly it deems more appropriate to get an overall market perception of the reforms initiated in early 1990s.

3.1. Banking Sector Reforms—Need, Timings, and Sequencing

The overall reform agenda set for banking sector appears to have achieved a significant support of the bankers in Pakistan. This is reflected from their feedback which indicates that about 71 percent of them considered the reform agenda indispensable for removal of banking sector problems and were against any decision leading to its delayed implementation (Figure 2). Similarly, around 21 percent of the respondents believed that though needed the preparatory work for the reforms was not done adequately. However, a negligible percentage of respondents think that the banking reforms can be delayed despite their significance. As against expectations, a few respondents showed their satisfaction over the sequencing of the said reforms programme, despite the fact that sequencing and timings of financial sectors reforms, mostly sponsored by the IMF, had been criticised by researchers and considered its sequencing and timings an important factor for successful outcomes.[19]

[19]Alawode and Ikhide (1997) recommend that the timings, sequence and speed of reform agenda are very important for its successful outcomes.

Fig. 2. Overall Perception about Banking Sector Reforms of Early 1990



3.2. Banking Sector Reforms: A Panacea for Inefficient Banking Operations

The bankers supported the key steps taken in early 1990s and onwards mainly to improve performance of banking sector in Pakistan. Especially, a significant percentage of respondents (i.e. 85 percent) believe that privatisation of state-owned banks helped in correcting the flaws in Pakistani banks[20] (Table 1). The aforesaid viewpoint also appears to be consistent with the research work carried out on the subject issue. For example, the studies by Galal, *et al.* (1994) and La Porta, *et al.* (1997) find that privatisation of firms make them efficient and their performance improves in relative terms. Similarly, Claessens and Djankov (1999) also claim that privatisation of state-owned firms helps in reducing information asymmetry between principals and agents, thereby strengthening market discipline and improving corporate performances, as private investors are close to market demand. Similarly, the study by Burki and Ahmad (2011) finds that state-owned banks that were selected for restructuring (in Pakistan) experience efficiency losses in the years after restructuring, but this trend is significantly reversed once these banks adjust to

Table 1

Market Perception About Usage of Key Banking Sector Measures

(in Percent)

	Don't Know	Not Significant	Slightly Significant	Significant	Highly Significant
1. Privatisation of state-owned banks	0	8	7	14	71
2. Entry of private banks	7	0	0	50	43
3. Adoption of new and separate prudential regulations for Commercial Banks/DFIs, SMEs, Microfinance, etc.	0	0	14	36	50
4. Switching over to indirect/market-based tools of monetary and credit management	8	0	21	50	21
5. Strengthening the supervisory role of SBP	0	7	0	50	43
6. Measures to improve financial health and soundness of banks	7	0	7	50	36

[20]For details please see the paper by Husain (2003).

market conditions. However, there is a negligible percentage of respondents who did not consider "privatisation of state-owned banks" an important measure in correcting flaws of banks.[21] The viewpoint is also supported by studies of Carlin, *et al.* (1997) and Frydman, *et al.* (1998) who claim that the post privatisation performance of firms remained poor.

Financial liberalisation is another key reform measure which has a substantial support of bankers. As per their feedback, about 93 percent of them considered it a revolutionary step which played a significant role in removal of flaws in banking operations. There are studies by Demetriades and Luintel (1997), Denizer, *et al.* (1998) which also recommend the adoption of policies which are helpful in removing financial repression from an economy. Nevertheless, about 7 of the respondents were not aware of its significance.

The bankers also supported the banking reforms of 1997 and onwards,[22] as they were supposed to be helpful in improving the financial health of the banking sector. The feedback from bankers indicates that around 90 percent considered these steps important for banks. Particularly, the measures pertaining to strengthening of supervisory role of SBP and implementation of CAMELS framework are among the key steps enforced after 1997 which helped in improving efficiency and soundness of the banks.. However, a negligible number of respondents believed that the measures pertaining to institutional strengthening remained slightly helpful in removal of flaws prevailing in the banking industry.

Not only the bankers supported the reforms in core banking areas, they also favoured the steps taken for strengthening of monetary policy in Pakistan. Especially, a significant percentage of respondents (70 percent) believed that market-based monetary and credit management programme of the central bank helped banks in improving their intermediary operations. Nevertheless, a negligible percentage of respondents (7 percent) appear to be not aware of the significance of "market-based monetary policy" measures. This requires the central bank to review its communication strategy, as bankers should be aware of the transmission mechanism of its monetary policy.

4. IMPACT ANALYSIS OF FINANCIAL LIBERALISATION AND DEREGULATION MEASURES

After having some knowledge about the overall perception of bankers regarding the reforms agenda, the subsequent analysis primarily focuses on some more specific type of reforms. Especially, these include the financial liberalisation and deregulation measures and their impact on the performance of the banking sector in the country.

4.1. Improvements in Key Performance Indicators of Banks

There is a great feeling among the bankers that financial liberalisation and deregulation of state-owned banks helped improve efficiency of banks in Pakistan. The

[21]Although, the process of privatisation of NCBs started in early 1990s, it has not completed by the end of June 2008 as some of the commercial banks are still operating under state control (e.g., National Bank of Pakistan, First Women Bank Limited, etc.).

[22]These measures include institutional strengthening and issuance of separate Prudential Regulations for commercial banks, development finance institutions (DFIs), SME banks, and Microfinance banks.

Survey results indicate that a significant percentage of bankers believed that financial liberalisation, privatisation of banks, and institutional strengthening measures helped banks in adopting best practices, induced them to become more disciplined in credit disbursement, persuaded them to follow SBP's prudential regulations, and assisted them in making independent lending decisions (Table 2).

Table 2

Impact of Liberalisation, Deregulation, and Institutional Strengthening Measures on Banks' Performance

(in Percent)

		Don't Know	Not Significant	Slightly Significant	Significant	Highly Significant
1	Lowered administrative expenses	7.1	21.4	28.6	42.9	0.0
2	Reduced banking spread	7.1	28.6	28.6	28.6	7.1
3	Improved bad debt portfolio	0.0	7.1	14.3	50.0	28.6
4	Increased profitability	7.1	0.0	0.0	42.9	50.0
5	Improved intermediation inefficiencies	0.0	7.1	7.1	64.3	21.4
6	Increased recovery of loans	0.0	7.1	14.3	64.3	14.3
7	Adopted international practices	7.1	0.0	7.1	71.4	14.3
8	Improved credit discipline	7.1	0.0	7.1	71.4	14.3
9	Became more regulation compliant	14.3	0.0	7.1	71.4	7.1
10	Adopted sound banking practices	14.3	0.0	7.1	50.0	28.6
11	Became more accountable & transparent	7.1	0.0	14.3	64.3	14.3
12	Updated technology in banking operations	7.1	0.0	7.1	64.3	21.4
13	Improved professional skills	0.0	7.1	14.3	57.1	21.4
14	Adopted good governance practices	14.3	0.0	14.3	42.9	28.6
15	No political influence	21.4	0.0	28.6	42.9	7.1
16	No denial of access to bank credit	14.3	0.0	28.6	50.0	7.1
17	Credit decisions based on market conditions	14.3	0.0	7.1	71.4	7.1
18	Operate under competitive environment	7.1	0.0	7.1	50.0	35.7

Also, the bankers believe that the aforesaid measures caused a significant improvement in key areas of banking operations. Especially, an improvement was witnessed in the intermediation process of banks, recovery of loans, accountability and transparency in policies/practices, and banking practices due to IT up-gradation. The bankers think that the measures taken in the year 1997 and onwards improved the soundness and health of the Pakistani banks in a significant manner. The survey results are also consistent with the findings of Burki and Ahmad (2011) which indicate that an "increase in total factor productivity (TFP) [of privatised Pakistani banks] appears to have taken place after 1999, which could be the result of different steps taken by the government to strengthen these banks, e.g., the liquidation of state-owned banks by injecting more liquidity".

Similarly, the banks liberty in HR related policies helped them in strengthening the skills of their staff through hiring of professionals and capacity building programmes. The respondents believe that the banks are operating in a relatively more competitive environment in Pakistan. The cases of denial of credit by banks have also declined significantly in recent time. However, it would be worthwhile to note here that the distribution of bank credit is still skewed more towards the manufacturing sector, despite having its 16 percent share in real GDP.[23] As regards reduction in bad portfolios of banks, about 79 percent of the respondents believed that the portfolios of banks had improved significantly, particularly after the adoption of BASEL II framework by banks.[24] Moreover, the governance of banks has also improved significantly due to compliance of rules/guidelines for banks issued by the regulator.

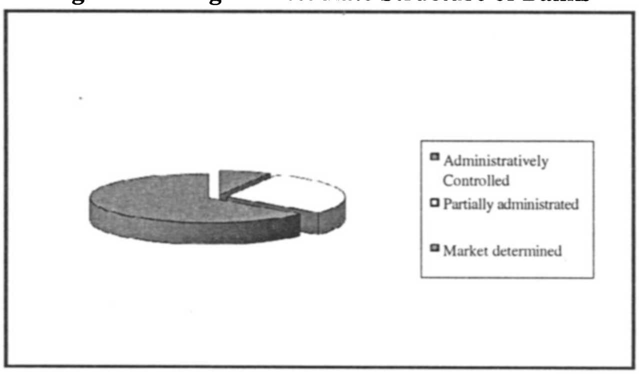
The bankers recognised that the enhanced competitive environment helped banks in improving their profitability indicators. Especially, the profitability indicators of privatised banks had improved significantly due to efficient practices following the privatisation of banks. Further, the privatisation of banks helped lower political interference in banking operations. However, government continues to interfere in banking affairs of NCBs. In the case of foreign and private banks, the interference of government in banking affairs is almost non-observable.

Reduction in administrative cost of banks and banking spread are the two areas where the bankers have showed their concern by indicating that the banking sector reforms have had no effect on these important areas in any significant way. This is a real concern for policy makers in Pakistan as banks could not bring down high administrative cost which is an important factor behind large banking spread in the country. Further, the banking spread is also considered an important indicator of financial repression in an economy. Therefore, the prevalence of a large banking spread may indicate failure of banking reforms in Pakistan.

4.2. Improvements in Interest Rate Structure

The bankers believed that Pakistan has a market-based interest rate structure. This issue is important as prior to financial liberalisation, the interest rates were controlled administratively which were said to be one of the major factors behind financial repression in the country. Later on the interest rates were liberalised gradually. The respondents (64 percent) supported the viewpoint that the existing interest rate structure is being determined by market forces (Figure 3). However, 29 percent of the respondents

Fig. 3. Existing Interest Rate Structure of Banks



[23]Economic Survey of Pakistan (2008).

[24]Although BASEL I served well Pakistan's banking industry since 1988, it lagged behind financial market developments and innovations. Removing shortcomings of BASEL I, the BASEL II Accord was implemented in Pakistan in a phased manner. The Pakistani banks were required to adopt Standardised Approach for credit risk and Basic Indicator/Standardised Approach for operational risk from 1st January 2008 and switch over to advanced approaches from 1st January 2010.

were of the view that the existing interest rate structure was being administered partially, while 7 percent of them considered it a fully administratively controlled interest rate structure. This is an area of concern for policy makers as the market-based interest rate structure ensures availability of bank credit to borrowers without any exploitation.

4.3. Reduction in Banking Spread

The banking spread[25] is considered one of the indicators of an efficient working of banks in an economy. An increase in the spread implies that either the depositor or the borrower or both of them are losing money. Similarly, the widening spread has also implications for the efficacy of lending channel of monetary policy. In fact, the changes in policy rate of the central bank influences interest rates of banks (i.e., cost of capital) which in turn affects the consumption and investment levels of an economy. If an increase in the spread is owing to low return on deposits then this discourages savings. Similarly, if the increase in the spread is due to high lending rates, then it may affect investment decisions.

In reality, the banking spread has been edging up in Pakistan during the last many years. Among others, the focus of banking sector reforms was to minimise the banking spread in the country. In this regard, the views of respondents (i.e., senior bankers) as well as the historical data indicate that the reforms agenda could not help narrow down the banking spread substantially. According to the bankers, a variety of factors were behind the widening of banking spread in Pakistan.[26] The Survey results exhibit that high domestic inflation and non-performing loans (NPLs) were among the major factors behind the large banking spread in Pakistan (Figure 4). Especially, if the impact of inflation shocks is not passed to deposit and lending rates in equal magnitude, then it may cause a widening of the spread. Similarly, about 29 percent of the respondents believed that larger intermediation cost has also contributed to widening of the banking spread, as banks are likely to offset high intermediation/administrative costs by over charging their customers. Further, the banks' reliance on interest income compared to non-interest income is also contributive to high spread in the country. Similarly, poor debt recovery was also said to be one of the causes of an increase in the spread. Further, the major banks in Pakistan still hold substantial assets of banking industry. This kind of market concentration leads to collusion which in turn enables banks to pay less on their liabilities and charge more on assets, thereby causing an increase in the spread.[27] If we go into minor details, we find that the imposition of high CRR[28] by State Bank of Pakistan and

[25]The interest rate spread is defined in different ways. Generally, it is defined as the difference between what a bank earns on its assets and what it pays out on its liabilities.

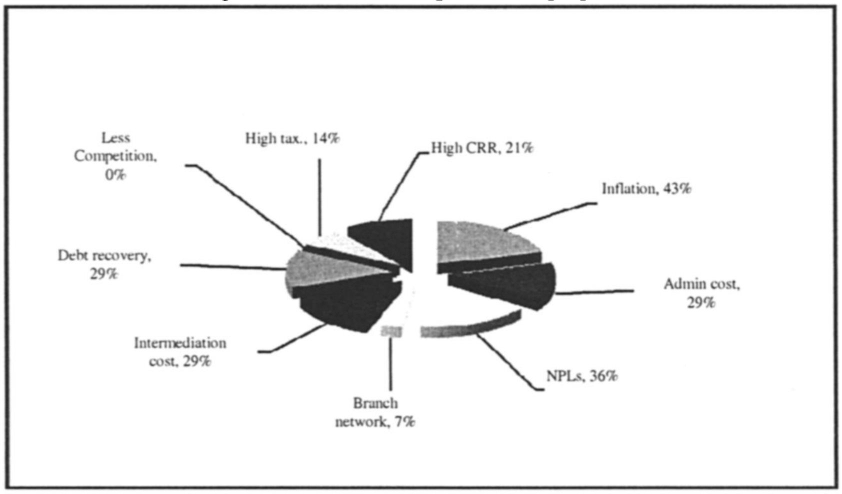
[26]The recent SBP financial stability report indicates that banking spread has declined in Pakistan due to lowering of interest rates of banks in the backdrop of cut in the policy rate of State Bank of Pakistan. The spread has come down from 557bps in January 2011 to 521 basis points in September 2011.

[27]An oliogopolistic market structure may result in higher spreads [Samuel and Valderrama (2006)].

[28]Banks in Pakistan are required to maintain a certain percentage of deposits as Cash Reserve Requirements (CRR) with State Bank of Pakistan. As CRR funds virtually earn no interest, maintaining a high CRR may prove punitive for banks and may lead to high banking spread thereby imposing an implicit tax on financial intermediation. Similarly, a reduction in CRR helps improve profitability of banks as more lendable funds are available to them. This in turn helps reducing the spread and benefit financial savers. Similarly, banks are also required to invest a certain specified percentage of Demand and Time Liabilities in government securities.

high tax on profit of banks contributed to widening of banking spread in the country.[29] The Survey results also indicate that large branch net work and the disintermediation of banks arising due to high rate on National Saving Schemes (NSS) were not the key factors behind large banking spread.

Fig. 4. Causes of Large Banking Spread



It seems that unlike the past, the adverse impact of large branch network relative to assets size of banks and high return on National Saving Schemes (NSS) on banking spread had either reduced or the respondents were not aware of the significance of such factors. This is again an important area of research work and requires detailed analysis of the subject issue. Since the reduction in banking spread is extremely important, it requires the central bank to take concrete steps to resolve the issue, as it has impaired the significance of the reforms agenda in Pakistan.

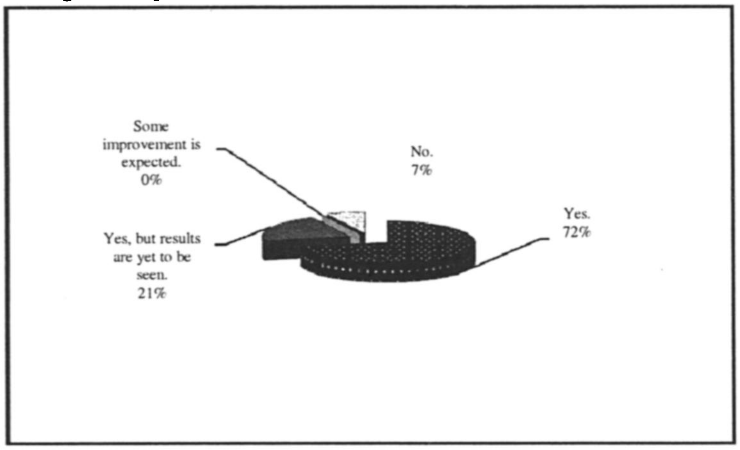
4.4. Progress on Corporate Governance Front

One of the key aims of banking sector reforms was to improve governance of banks. In particular, the State Bank of Pakistan paid significant attention on improving governance of banks after the year 1997 and issued guidelines for the formation of board of director of banks, etc. These measures are expected to have a significant positive impact on performance of banks.

According to the current perception Survey, a significant percentage of respondents believed that corporate governance guidelines of SBP helped in improving the quality of management of banks which in turn exerted a positive impact on the banks' performance (Figure 5). However, about 21 percent of the respondents shared that the impact of good governance had not yet appeared. Similarly, a negligible percentage of respondents were not aware of any impact of good governance measures on the efficiency of banks.

[29]Banking industry in Pakistan faced a high tax rate of 58 percent while the rest of the corporate sector paid only 35 percent [Husain (2005)].

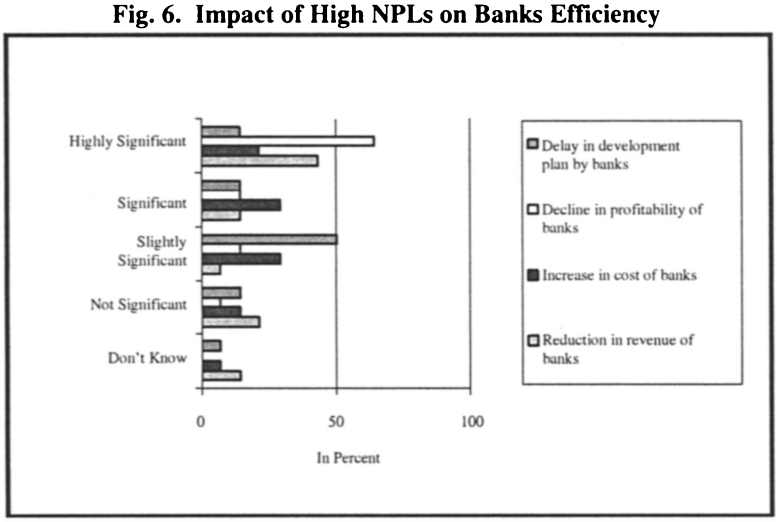
Fig. 5. Impact of Good Governance on Banks Performance



4.5. Reduction in Non-performing Loans

Besides others, the deregulation and financial liberalisation efforts were also aimed at bringing down the large magnitude of defaulted loans of banks, as it was considered a root cause of inefficient performance of Pakistani banks. The Survey results also indicate that an increase in the magnitude of defaulted loans or non-performing loans (NPLs) had a negative impact on the efficiency of banks. Especially, an increase in NPLs led to a decline in the profitability of banks (Figure 6). A significant percentage of respondents also believe that NPLs have reduced revenue of banks besides enhancing significantly the cost element. In fact, the net profitability of banks declined due to an increase in NPLs of banks. However, the reduction in profitability did not cause a delay in the development plans of banks. This indicates that banks continued their development plans, particularly the IT upgradation, despite provisioning against NPLs. This aspect of banks' commitment needs appreciation.

Fig. 6. Impact of High NPLs on Banks Efficiency



5. IMPACT OF KEY BANKING SECTOR REFORMS ON STATE-OWNED/PRIVATISED BANKS

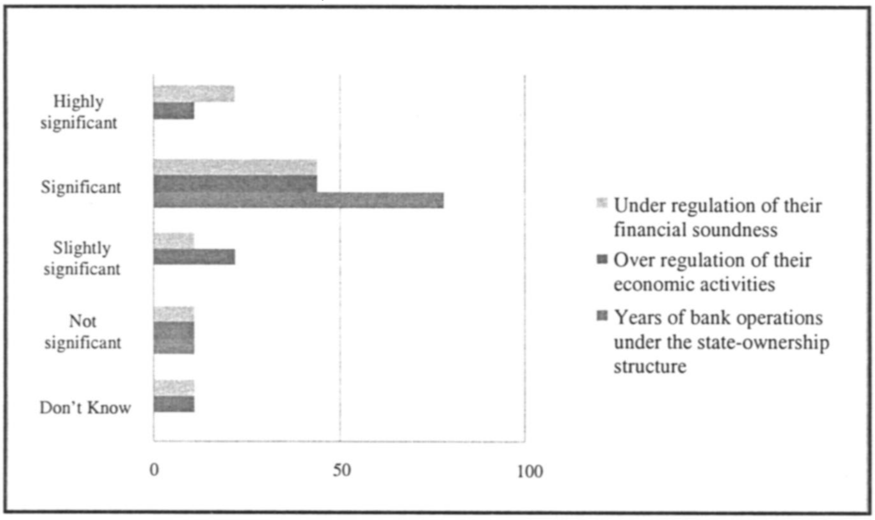
Since the nationalised banks were considered the most inefficient banks prior to initiation of banking sector reforms in Pakistan, it would be appropriate to provide some insights into the causes of their inefficiency and the state of their performance after implementation of financial liberalisation and de-regulation measures.

5.1. Causes of Inefficient Functioning of NCBs

It is a general impression about Nationalised Commercial Banks (NCBs) that their functioning was inefficient prior to banking sector reforms.

Factors like years of functioning under state-owned structure, over regulation of economic activities, and under regulation of financial soundness contributed to their inefficiency. The bankers have ranked "years of bank operations under the state-owned structure" as the prime factor behind inefficient functioning of NCBs (Figure 7). The viewpoint is also supported by Haque (1997) who finds that public sector dominance, among others, was the cause of this sector's inefficiency. Similarly, they also considered "under regulation of banks", an important factor behind their inefficiency and vulnerability. Dual supervision and poor regulatory controls mainly attributed to under regulation of banks affected the financial health of banks in the mid 1990s. The banking data also supported the viewpoint as NPLs of NCBs increased substantially during the 1990s.[30] Further, the study by Caprio and Klingebiel (1997) suggests that a strong regulatory and supervisory system is necessary to cope with financial crises besides to promote efficiency in financial markets. The respondents believed that "over regulation" also had a negative effect on the competitiveness, efficiency, and financial health of the banks.

Fig. 7. Key Factors which Caused Uncompetitiveness, Inefficiency, and Vulnerability of Banks



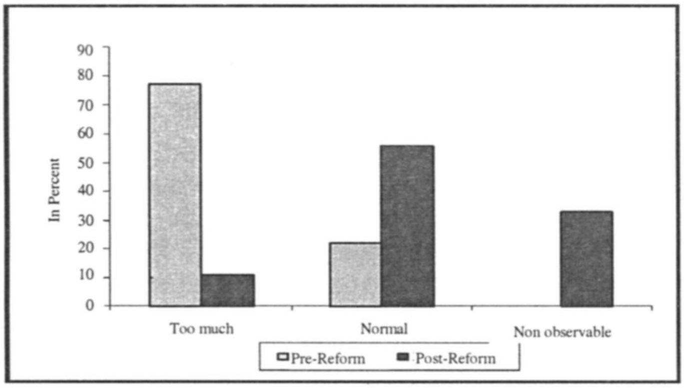
[30]Financial Sector Assessment Report (2000).

Privatisation is considered a major step in improving performance of the NCBs. Although the privatisation process of banks is still continuing, the feedback on this aspect is given as under.

5.2. Government Interference in Banking Affairs

To give the reader a better idea about the intensity of such an intervention, a comparison has been made of government interference in operational matters of the banks during the pre and post-reform period (Figure 8). Too much political and bureaucratic intervention in banking affairs is considered a major cause of poor performance of banks.

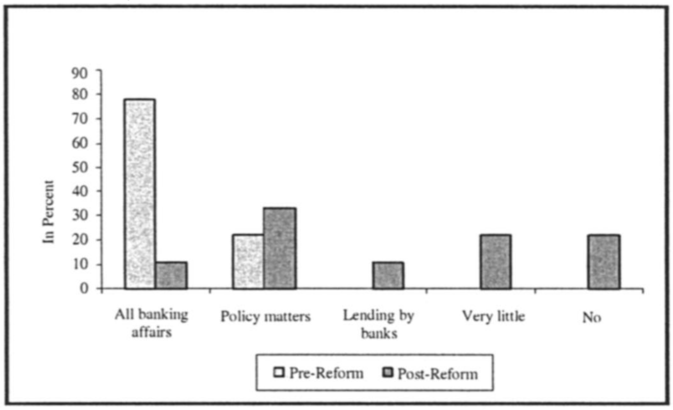
Fig. 8. Government Interference in Banking Affairs



In the pre-reform period, there was too much governmental interference in the operational affairs of nationalised banks. Apparently, the purpose of such an intervention was to divert financial resources of nationalised banks towards the achievement of government's economic targets. The government and its institutions were used to get priority in banks lending while the private sector, which is supposed to be central point of all sorts of economic activities in a market-based system, was almost ignored in bank lending. However, in the post-reform period, the degree of governmental interference has reduced significantly.

The Survey results indicate that government was used to intervene in almost all areas of banking operations in the pre-reform period. However, the feedback of respondents showed that the governmental interference was restricted to policy matters of banks only. After the introduction of financial liberalisation, deregulation, and institutional strengthening reforms, the degree of government interference has reduced significantly in all banking affairs (Figure 9). Regarding interference in lending decisions, a negligible percentage of respondents (i.e., 11 percent) shared that the government had started interfering again in lending decisions of banks. However, about 22 percent of the respondents reported that a very low level of government intervention still existed in banking affairs. The affirmative response appeared to be due to inclusion of nationalised and partially privatised banks in the sample where government intervention is possible owing to having more than 51 percent equity holdings. The degree of government intervention is likely to reduce in banking affairs after full privatisation of the remaining NCBs.

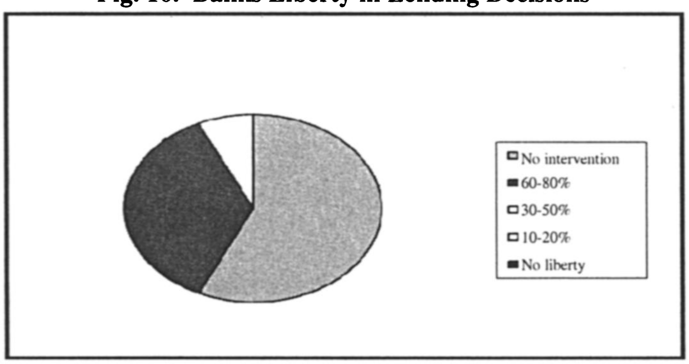
Fig. 9. Government Intervention in Banks



5.3. Bank's Liberty in the Credit Decisions

The Survey results indicate that banks were taking lending decisions independently and did not face any bureaucratic or political interference in recent times (Figure 10). As against this, the nationalised banks had little choice in lending decisions in the pre-reform period, as they were required to firstly finance fiscal deficit together with financing of plethora of government sponsored schemes. High reserve requirements and bank-to-bank credit ceilings by the central bank also left little room for banks to extend credit at their own will.

Fig. 10. Banks Liberty in Lending Decisions



With the change in the mechanism of monetary and credit management, the privatisation of NCBs, the abolishment of Pakistan Banking Council,[31] the grant of autonomy to SBP in its operational decisions, and the implementation of BASEL-II framework, the liberty in lending decisions of banks has increased substantially. However, 36 percent of the respondents think that banks face bureaucratic or political interference rarely in their credit decisions. Similarly, a very negligible percentage of respondents have informed the non-existence of bureaucratic or political interference in lending decisions of banks.

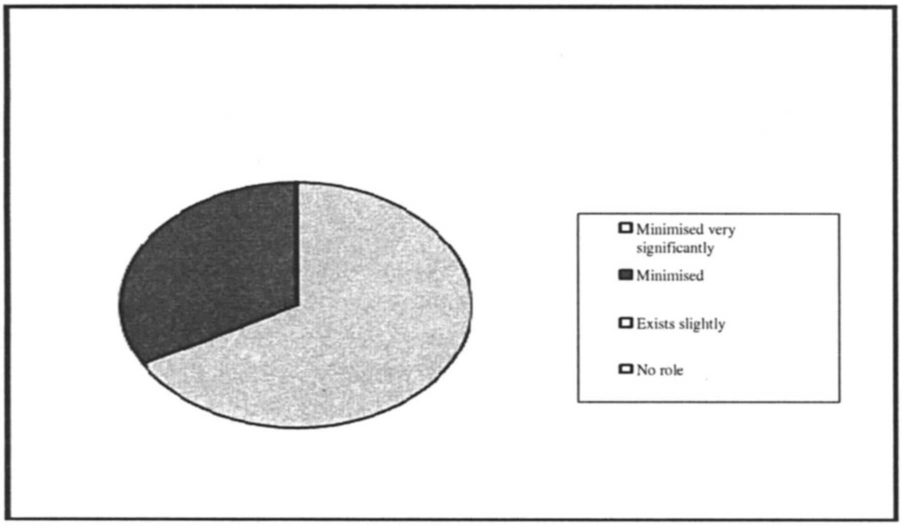
[31]Before 1997, nationalised banks were supervised by State Bank of Pakistan and Pakistan Banking Council. The dual supervision of banks impacted on SBP's enforcement of its regulations over the banks.

5.4. Role of Employees' Unions

In the pre-reform period, the role of staff unions had become very strong in banking affairs. Especially, they were used to interfere in managerial decisions pertaining to recruitment, promotion, transfers and postings of staff, which caused a negative impact on the efficiency of state-owned banks. The role of staff union was particularly dominant in day to day affairs of nationalised commercial banks. With the privatisation and restructuring of banks, the role of staff union was expected to weaken significantly.

According to the Survey results, about 67 percent of the respondents believe that the role of employees union has been significantly reduced after privatisation and restructuring of banks (Figure 11). Furthermore, no respondent indicated any role of staff union in banking affairs in recent times.

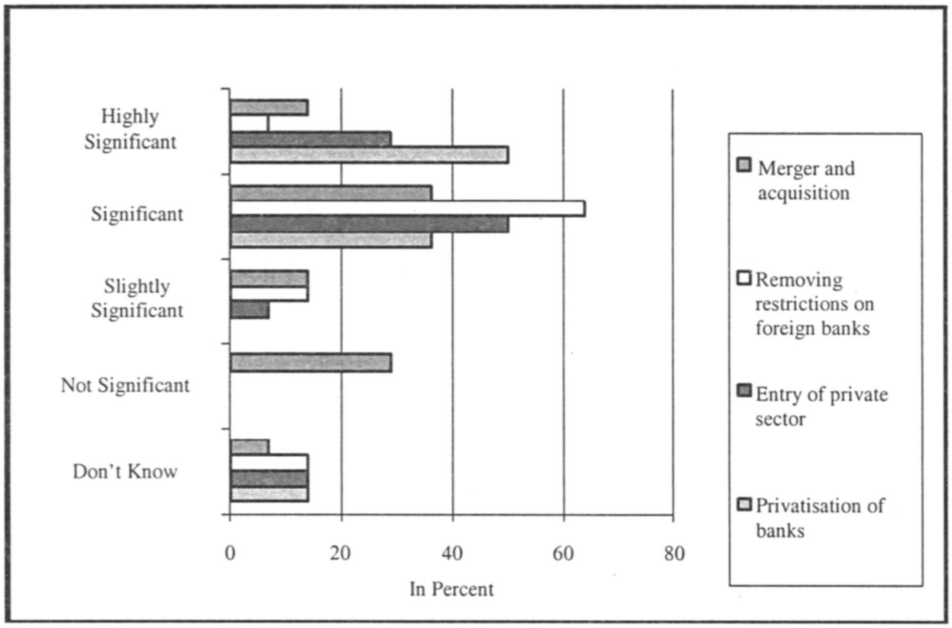
Fig. 11. Role of Employees Union after Privatisation and Restructuring of Banks



5.5. Quality of Banking Services

One of the key objectives of banking sector reforms was to improve the quality of services of banks. According to the Survey results, about 86 percent of the respondents reported that the privatisation of NCBs positively influenced the quality of banking services (Figure 12). However, 14 percent of them were not aware of its impact on the quality of banking services. The entry of private banks also contributed to improvement in services. The entry of private banks also led to creation of a competitive environment which in turn caused diversification as well as improvements in quality of banking services. Similarly, the respondents are of the view that the removal of operational restrictions on foreign banks contributed to competitive environment which induced local banks to bring the quality of services at par with those of foreign banks.

Fig. 12. Impact of Reforms on Quality of Banking Services



5.6. Privatisation and Financial Liberalisation—Future Strategy

Although the process of privatisation of banks was initiated in early 1990s, it is still continuing as there are a few nationalised commercial banks which are operating under full state control. Further, there are some banks which are partially privatised and the process of their full privatisation has continued for the last 10-12 years. This lengthy privatisation process of NCBs might have impaired the potential benefits of changes in the ownership structure due to privatisation.

The Survey results indicate that about 36 percent of the respondents revealed their full satisfaction over the privatisation process. (Figure 13). About 43 percent of the respondents showed their satisfaction over the privatisation process while 21 percent respondents had suggested expediting the privatisation process of the remaining state-owned banks. Similarly, the financial liberalisation programme was also supported by the respondents. According to the Survey results, about 64 percent of the respondents showed their full satisfaction over the liberalisation process. There were a few bankers who even stressed upon the need for further enhancing the pace of financial liberalisation, but with a cautious approach (Figure 14). Since the strategy appeared to be highly beneficial, the respondents suggested for more liberalisation measures. As per their feedback, the continuity of financial liberalisation measures could help place the banking industry at the level of high performance industries of the country. The Survey results are also in line with the findings of the study by Burki and Ahmad (2011) which indicate that banks (in Pakistan) that underwent a governance change showed an improvement in TFP growth and its components vis-à-vis those banks that were not selected for governance change.

Fig. 13. Existing Pace of Privatisation of Banks

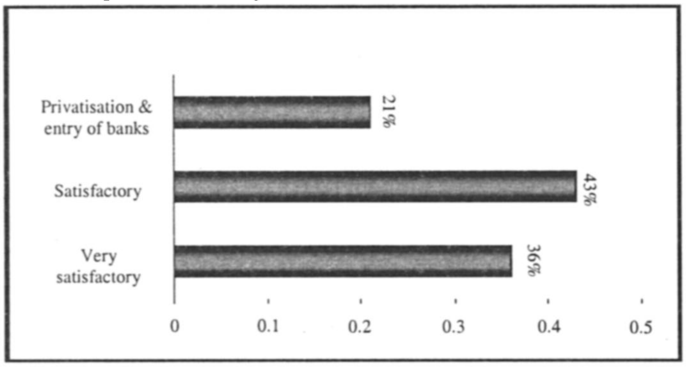
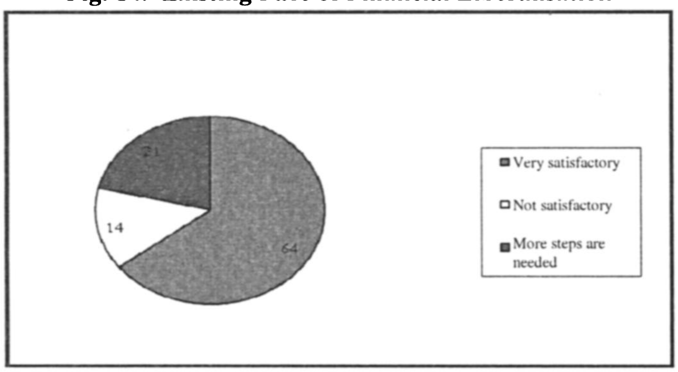


Fig. 14. Existing Pace of Financial Liberalisation



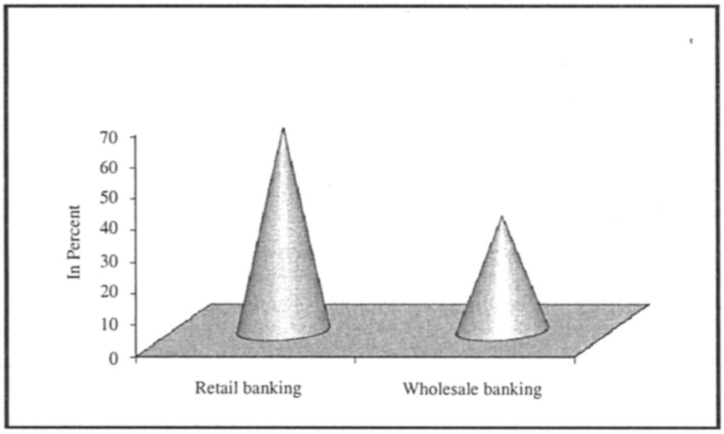
6. ROLE OF DEREGULATION AND FINANCIAL LIBRALISATION ON COMPETITIVE EFFECT

One of the prime objectives of financial sector reforms was to create a competitive environment in the banking industry of Pakistan. To what extent the competitive effect emerged in the wake of financial sector reforms is reflected in the findings of this survey indicated in the bankers' viewpoint.

6.1. Competitive Effect on General Banking

According to the Survey results, the deregulation and financial liberalisation measures impacted almost all major categories of banking products. Especially, it impacted retail banking significantly, as banks introduced innovative products in retail banking mainly to attract customers. As a consequence, these efforts helped banks enhance their earnings by lowering their cost of funds generation. Similarly, banks launched various wholesale banking products (Figure 15). This is an important development as most of the local banks are involved in retail banking in Pakistan while foreign and major commercial banks prefer wholesale banking. However, a foreign bank has commenced various schemes for retail customers recently. Such a change in the marketing strategy of the foreign bank could be attributed to increased competition in the area of retail banking.

Fig. 15. Competitive Effect on General Banking Products



6.2. Competitive Effect on Intermediary Services

The efficient provision of intermediary services by a bank play an important role in enhancing its profitability, as bulk of its earnings depend on provision of innovative and quality services. It was expected that the competitive effect in the backdrop of banking sector reforms and other strengthening measures would help improve the quality of intermediary services of banks, especially of NCBs.

According to respondents, the banking sector reforms and other strengthening measures affected the quality of intermediary services of banks. The Survey results indicate that the "Trust Services" are affected significantly due to competitive environment, followed by "Utility Services", "Project Financing", "Investment in Fixed Assets", and "Infrastructure Finance" (Table 3).

Table 3

Competitive Effect on Intermediary Services

(in Percent)

		Don't Know	Not Significant	Slightly Significant	Significant	Highly Significant
1	Advances	17	42	42	0	0
2	Deposits	33	8	50	9	0
3	Foreign exchange	0	42	25	25	8
4	Trust services	0	8	17	33	42
5	Investment	0	25	42	33	0
6	Money market placements	0	50	25	25	0
7	Investment in fixed Assets	0	25	25	25	25
8	Project financing	8	17	25	42	8
9	Export finance	9	33	25	33	0
10	Infrastructure finance	0	8	42	25	25
11	SME finance	9	50	33	8	0
12	Auto finance	17	33	17	25	8
13	E-banking	25	33	8	17	17
14	Utility services	0	33	17	33	17
15	Personal loans	9	33	33	25	0
16	Housing financing	16	42	17	25	0

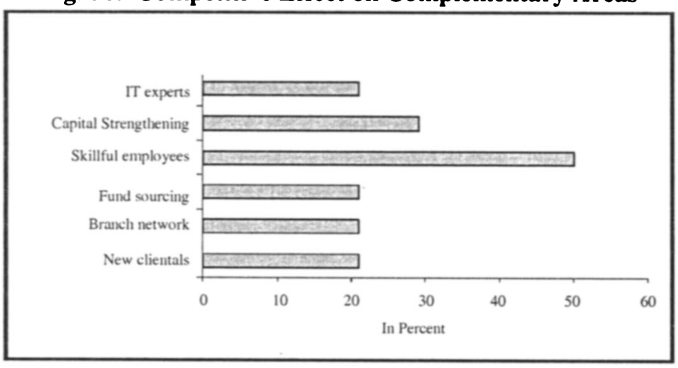
About 33 percent of the respondents said that "Export Finance" and "Investment" were affected most probably due to relatively due to greater customer awareness about prevailing business conditions. Similarly, around 25 percent of the respondents believed that consumer financing, which included "Auto Finance", "Personal Loans", and "Housing Finance", were affected significantly by the competitive environment. However, the "E-banking", "Deposit" and "SMEs Finance" are found to be the least affected areas of competitive effect. Especially, the deposits base of NCBs and privatised banks remained intact due mainly to loyalty factor and concentration of banking with a few PSEs as major clients. However, the banks faced minimum loss of business on e-banking, as majority of them are offering almost similar services.

Overall, the emergence of competitive environment in the wake of financial liberalisation and de-regulation measures appeared to have affected the intermediary services of banks substantially.

6.3. Competitive Effect on Complementary Areas of Banking Operations

The banks also faced stiff competition in some of the complementary areas of banking. As per the Survey results, a significant competition was faced in recruitment of skilful employees/professionals (Figure 16). The banks also faced competition while raising "Capital" to meet the BASEL-II requirements imposed by State Bank of Pakistan. Some competition was also reported by the respondents in other segments like seeking of "New Clientele", "Funds Sourcing", "IT Experts", and expansion of "Branch Network". This indicates the start of healthy trends in banking business of the country.

Fig. 16. Competitive Effect on Complementary Areas



6.4. Strategies of Banks to Meet Market Competition

Banks took various measures to meet the challenges of enhanced competition in the industry. Some of their moves were aimed at meeting immediate stiff competition, while others were left as a part of their future plans. Realising the direction of modern banking, the banks invested in IT technology, as the future of banking activities was expected to move towards IT-based products and branchless banking (Table 4). The banks also introduced new products largely to meet their customers' demand besides keeping intact their relations with old clients. They also changed their mission and vision statements to make their businesses compatible with future needs. Further, they revamped their business processes, reviewed manpower policies, and hired consultants so that they could meet emerging challenges emanating from enhanced competitive environment.

Especially, the domestic banks needed to take relatively more steps. If compared with foreign banks, they were lacking in terms of resource availability, professional skills, and product diversification. Therefore, the domestic banks planned to introduce innovative products mainly to minimise the quality gap of banking services being offered by their competitor. The banks also reviewed their pricing policy to match competition, focused on other businesses, and started paying attention towards advertisement and promotion of their banking businesses. Some of the banks off-loaded their shares to raise funds through stock exchanges mainly to strengthen their capital base in the wake of BASEL II norms. Furthermore, the banks generated funds through issuance of Global Depository Receipts (GDRs). The result of the Survey indicates that the banks with an inadequate equity base decided to form alliances with strong banks, as they found it difficult for them to solely meet the equity requirements of the central bank.

Table 4

Actions Plans of Banks to Meet Challenges of High Competition

(in Percent)

		Action Already Taken	Immediate Action	Part of Future Strategy	No Action Required
1	Move to other markets	57	0	29	14
2	Change the mission/vision	69	8	8	15
3	Invested in new technology	79	14	7	0
4	Review pricing to match competition	57	43	0	0
5	Introduce new products	71	29	0	0
6	"Pirated" from other banks	18	0	9	73
7	Hire consultants	61	8	0	31
8	Increase bank network	50	14	36	0
9	Re-engineer all or some processes	62	23	15	0
10	Review manpower policies	64	21	15	0
11	Form strategic alliances				
(a)	With local banks	27	10	18	45
(b)	With foreign banks	27	0	45	28
12	Increase advertising and promotion activities	57	21	14	8

In this regard, their immediate preference was to form such an alliance with local banks as it was easy for their management to negotiate with that of the local banks. Similarly, the banks also found it easy to review their pricing policy to match the emerging competition in the industry. About 43 percent of the respondents said that banks needed to review immediately their pricing policy to match competition. Some of them (29 percent) also felt the need to introduce immediately innovative financial products mainly to keep intact their clientele base. The bankers also wanted immediate re-engineering of their banking businesses so that could meet the rising expectations of their clients. Around 23 percent of the respondents supported the need for immediate action for it. About 21 percent of the respondents wanted to support their banking business through aggressive advertisement strategy, as they thought it would help motive their clients to remain loyal with their banks. About 14 percent of the respondents were of the opinion that banks needed to invest more on IT projects on immediate basis and expand their banking network, as it would help expand their clientele base.

Banks also continued to stick with some policy action which could help them expand their banking business. The banks with a relatively better financial position were intended to form such alliances with foreign banks in future. About 18 percent of the respondents showed their preference for merger and acquisition with local banks while 45 percent of the respondents were in favour to form such alliances with foreign banks. Similarly, the expansion of business through branch network was an important part of future strategy of banks. They also intended to explore new areas of businesses where they would have some advantage over others. The banks also wanted to restructure their banking business in future mainly to meet the growing needs of their clients. About 15 percent of the respondents also wanted to review their HR needs, so that the skillful staff could be inducted in the banks mainly to handle complex banking processes.

7. CONCLUDING REMARKS

The study was primarily aimed at analysing the impact of financial liberalisation and deregulation reforms together with variety of complementary measures on commercial banks' performance. For analysis purposes, the current study employs perception Survey approach to capture responses of executives/senior bankers about the need, impact and possible reactions of their respective banks to key banking sector reforms. Out of 35 commercial banks, 15 banks were chosen for analysis purposes which included one Islamic bank, 3 state-owned banks, 4 privatised banks, 4 private banks, and 3 foreign banks. Specialised commercial banks were excluded from analysis because of their limited role.

The study mainly finds that:

(1) During the pre-reform era, years of bank operations under state-owned structure and under regulation of banks were identified as the key factors behind inefficiency and vulnerability of Nationalised Commercial Banks (NCBs). Similarly, the dual supervision of banks proved harmful for banks, as poor regulatory controls caused weak financial health of NCBs;

(2) During the pre-reform period, the imposition of high reserve requirements for banks, large credit allocations for government sponsored schemes, restrictions on opening of private banks, and putting restraints on branch network of banks, left little room for Pakistani commercial banks to extend credit at their own choice;

(3) The banking sector reforms remained successful in Pakistan. Especially, the key banking reforms [32] helped correcting flaws prevalent in the banking sector. Privatisation of banks, institutional strengthening, and adoption of market-based monetary and credit management system were particularly worth mentioning steps in this regard;

(4) Banks' performance improved due to enhanced competition in the backdrop of financial liberalisation, deregulation, and institutional strengthening measures.

[32]The key reforms mainly include financial liberalisation and deregulation measures.

As a consequence, banks adopted best practices, became more disciplined in credit disbursements, implemented Prudential Regulations issued by SBP, and faced less political interference in their lending decisions;

(5) Privatisation of banks also reduced political interference. Further, the privatisation and restructuring of banks minimised the role of staff union very significantly. Some of the bankers were not satisfied with the impact of restructuring plans for banks, most probably due to policy loopholes, implementation lags and continued government intervention due to the partial privatisation of some of the NCBs;

(6) High domestic inflation and non-performing loans (NPLs) of banks were among the prime factors that caused widening of banking spread in Pakistan. Further, high administrative expenses, larger intermediation cost, and poor debt recovery are also important factors behind the large banking spread. The profitability of banks also declined due to an increase in NPLs of banks. However, the reduction in profitability did not cause any delay in the development plans of banks. This indicates that banks continued their development plans, particularly the IT up-gradation, despite provisioning against NPLs;

(7) The entry of private banks also contributed significantly to quality of banking services. Similarly, the removal of operational restrictions on foreign banks also helped improve competitive environment which induced the local banks to bring the quality of their services at par with those of foreign banks;

(8) Banking spread, which is supposed to be an important indicator of financial liberalisation and deregulation measures, is still larger. Despite various successful stories, the monetary policy remained least helpful in reducing the banking spread;

(9) The competitive environment, which emerged due to implementation of a variety of banking sector reforms, affected various segments of banking operations. The banks devised various strategies to respond to competitive market conditions. However, they faced various constraints in this regard, especially the lack of managerial skills, hiring of IT professionals, etc.; and

(10) As a part of their future strategy, banks would form more strategic alliances with foreign banks. Similarly, the expansion of business through branch network is also likely to be an important part of their future strategy. Banks may also explore new areas of businesses where they would have some advantage over others.

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