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Review Paper

The Impact of Financial Liberalization on the Credit System of Pakistan: Historical Perspective

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Abstract

This paper provides an assessment and evaluation of impact of financial reforms on the structure of credit system of Pakistan. The analysis covers reform period of decade of 1990s, and post reform period of 2000-2007. Financial reforms have involved a paradigm shift in policy regime affecting changes in the structure of credit system, and governing its operations. The key factor has been a shift from nationalized financial system governed by administrative fiat to a privatized system whose operations are governed by deregulated and largely market based system. As a result the liberalized credit system intensified borrower concentration to the neglect of priority sectors.

Keywords: Credit system, financial reforms, deregulation.

Introduction

Bank lending is the centerpiece of financial intermediation. Since loans are main part of assets, and assets of the bank are basis of their profitability. Therefore, soundness of the banking system hinges on the reliability of asset structure in terms of secure loan portfolio and therein lies the threat to a bank's profitability in terms of emergence and growth of nonperforming loans[1]. In Pakistan, banking system lending and its operations provide a tragic story in the context of directed credit and nationalized banking which prevailed for a long time because of levers it provided to ruling elite to garner resources through mechanisms of nationalized banking almost free of cost and accountability. Not only did this lead to a drain on the banks' profitability but also had serious repercussions on the sectoral credit allocation in the country.

In Pakistan, banks lend money primarily for short term business liquidity purposes through instruments such as overdraft and trade financing. That is, the credit system does not provide for medium and long term investing purposes. Lately, banks have been very active in providing medium term credit for balancing, modernization and rehabilitation mainly of the textile sector[2]. For these reasons, Pakistan's economy has not been able to realize its full development potential. The financial system during the past thirty years or so has not been able to play the role to its full in promoting growth. Only recently it has begun to emerge from these shadows of the past.

There has been a reversal in structure of sources of credit between public sector and private sector in the wake of privatization of nationalized banks. At the onset of reforms in CY90, proportion of credit extended by public sector banks was an overwhelming 83 percent, while the share of credit extended by private banks, both domestic and foreign, was only 17 percent. In the wake of privatization of the share of private banks jumped to about 80 percent as can be seen from table 1.

As regards the uses of credit, the share of private sector borrowing was 55 percent in CY90 which increased to 83 percent in CY06[3]. This represents a significant change in uses of credit patterns compared to the pre reform period. This to some extent reflects the growth of the private sector but it also owes a great deal to privatization of a number of public sector enterprises who were the major clients of state-owned bank who held dominance during 1970s all the way through late 1990s.

Over the years, concessional credit schemes have led to excessive monetary expansion, which in turn contributed to rising level of financial repression. Mandatory credit targets at concessional rates distorted the interest rate structure, thus widening the market segmentation[4]. The system of credit ceiling was also repercussive as the magnitude of credit flows to the private sector was determined only after accommodating public sector requirements. In addition the ceiling also tended to accommodate established borrowers even if they were simply meant to rollover their loans, as banks were generally not willing to incur the cost of screening and evaluating new projects. The interest rates were administered in the form of floors on deposit rates and ceilings on lending rates of commercial banks. These controls were motivated by a desire to provide low cost funds to encourage investment in priority areas and to safeguard against the increase in the interest rates as it was considered politically or socially undesirable. As a result, the real interest rate on deposits remained virtually negative for most of the time, thereby discouraging savings and leading to financial disintermediation. Moreover, the directed system was also responsible for limited competition due to entry restrictions on new institutions and restrained activities of foreign banks and hence it created a hurdle in the development of financial system in Pakistan.

Table-1
Financial System Credit (as % of Total Credit)

	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07
Financial System Credit								
All Credit to Govt	31.09	34.75	24.14	16.30	13.37	14.45	19.37	16.57
All Credit to Private Sector	69	65	76	84	87	86	81	83
Banking Credit	52	52	60.49	64.11	67	68	66	67
to Private Sector	80.21	81.03	80.99	87.36	89.33	90.15	90.24	90.93
to Governemnt + PSEs	19.79	18.97	19.01	12.64	10.67	9.85	9.76	9.07
NBFIs Credit		11.02	14.63	17.25	17.10	15.91	14.67	14.74

Source: Authors' estimates based on SBP Annual Reports, FSA reports

Layered System of Credit Control, Pre-Reform Era

Banking system credit in the pre-reform banking policy and control regime was based upon quantitative targets at all levels in a layered fashion. Credit targets at macro-financial level were imposed under the duress of the Standby Arrangement with the International Monetary Fund for the purpose of monetary control at the macro level. Since the interest rate was administered and subsidized there was credit rationing to benefit priority sector financing which became an automatic eligibility for credit at below cost rates of interest. There were overlapping sets of rules and requirements intended to regulate banking system in the country at aggregate level as well as at sectoral level and at the enterprise level by ownership. There were several layers of control. First layer was at macro-financial level, aggregate level in which the annual monetary program specified growth targets for credit to the economy to be achieved both by the banking system and the State Bank. It further defined the distribution of credit among the private and public sectors In order to control rate of growth of domestic credit State Bank used to set a ceiling on the amount of credit for all banks which was expressed in terms of a percentage increase in bank credit over the preceding year's level. At sectoral level, second layer, State Bank detailed the bank by bank credit ceilings for priority sectors. This emphasizes that priority sector financing to sectors such as SME, exporting, agriculture, was mandatory for all banks and not just the DFIs. Third layer was at micro level where borrower categories were specified. Types of enterprises to be financed were also clearly pointed out. These credit guidelines were strictly enforced and there were financial penalties imposed for non compliance.

Market Based Credit, Post -Reform Era

The transition in credit system of Pakistan from a directed financial regime to market based system has largely been completed. Owner-ship of banking system is mostly in the hands of the private sector or under a semi privatized system. Therefore role of government in the banking system has reduced drastically and is expected to fall further in future. Since the capitalization and equity of banks is private, profits and losses of the banks are absorbed in their respective balance sheets. This makes the bank a business organization that has to be run efficiently and effectively to be able to earn profits. Unlike the nationalized system in which entry of financial institutions was based on the need arising from objectives of development, entry in market based system is based on the financial capability of the owner. The amount of paid in capital required to set up a bank in Pakistan is determined by the State Bank and has been continuously rising.

In Pakistan at the system level credit is extended by commercial banks and specialized banks. In FY04, total financial system credit was Rs1,351 billion. Among this, banking system credit was Rs1,242 billion of which commercial bank credit was Rs 1,147 billion, and specialized banks credit was Rs 95 billion, and a large portion of it was provided by ZTBL (Zarayee Traqiyaati Bank Limited). In addition, DFIs are estimated to have extended Rs109 billion in credit, or about 9 percent of total financial system credit. Institutional structure for allocating credit is divided into two parts; there is corporate lending to big businesses and blue chip companies and retail lending to relatively small enterprises.

Under the market based regime the major lending instruments of the bank is the Letter of Credit both Usance and Sight. Other than trade financing and working capital financing which is short term, the banks extend some term lending through overdraft facilities. Medium term loans are by and large extended for locally manufactured machinery credits and long term loans are extended mostly for the purpose of investment and housing. Most of the loans given in Pakistan are collateralized loans and banks extend cash credit. Since there is a conflict of interest in profit making and prudential rules of the bank and regulations issued by the SBP, management of the credit system is very difficult. All banks indulge in Asset Liability Management which requires that all the three portfolios, the loan, deposit and investment portfolios have matching maturities in such a way that the bank minimizes risk caused by interest rate fluctuations and maximizes its income and profitability[5].

The interest rate structure is more liberal and tends towards being market determined[2]. Some rigidities still remain in the credit system. There are advisory credit targets given by the SBP to the banks to finance the priority sectors such as agriculture and export. There are Prime Borrower rates, which gives credit to big corporations at very low interest rates across all sectors. Generally, the funding is cost based and market segment based. Banks like to lend to the biggest, richest borrower as it ensures low credit risk and low transaction costs. Downside is that this leads to market concentration and segmentation. The priority sectors also tend to suffer because banks prefer to lend to well established large businesses regardless of the social distribution of income[6].

The State Bank issues broad guidelines for the credit growth at the economy level, but unlike the directed system there is no credit rationing. The amount of credit to be given to the private or the public sector is left to the market and is not determined by the government or the State Bank. Liberalized system is market based but some distortions still remain. There is a clash between distributive social goals and market led concentration and segmentation of the credit system. There is tendency for the market to crowd out SMEs and new enterprises[7]. There is distress because of concentration or over expansion of credit and likelihood of emergence of a financial crisis which would be at a large cost to the regulatory authorities.

Under the directed regime, Pakistan's banking system performed badly as evident by the large amount of nonperforming loans, the overhang of which still adversely affects profitability of banks. Moreover, all the social objectives for which the system was nationalized have failed. Now that banks have been privatized it is seen that interest rate structure is more liberalized and even though the interest rates have fallen over the past decade, total deposits with the banking system have risen as has lending. This phenomenon has defied all economic theory that in spite of negative real interest rates, deposits have shown an upward trend.

Priority Sectors

Credit extended for priority sector financing is primarily for the purpose of satisfying social objectives. The major sectors of the economy which play a vital role in the development process are Housing, Export, Small and Medium Enterprises, Micro finance, Infrastructure, Agriculture and Manufacturing sectors. These sectors of the economy largely cater to those borrowers who can not be classified as prime borrowers for the banks and therefore are not a source of profitability for the banks. So if left to the workings of the market, the banking system will not cater to the credit needs of the priority sectors in the economy. The same was the situation in pre-reform period, with mandatory allocations coming from the system of directed credit.

Under a liberalized financial regime, the need for priority sector financing remains unmet and there is a powerful rationale for the government and the State Bank of Pakistan to promote financing by the main stream of banking system to the priority sectors and not through specialized financial institutions. The past experience clearly demonstrates specialized institutions neither have the resources nor the out reach to cover majority of priority sector borrowers who lack the ability to meet the criteria for loans and advances set forth by the commercial banks.

In the former regime of credit controls the formation of the Development Finance Institutions was for the purpose of availability of formal credit to private and public sector industrial units and to agriculture, exports and SME borrowers. Banks were reluctant to lend to these borrowers because of their higher risk of default and high costs of lending[8]. These issues have not disappeared with the recently restructured banking system. Table 2 shows the percentage shares of these sectors in total financial system credit. Instead, it has further reduced the ability and access of borrowers in these sectors which are likely to have most impact on increasing employment levels, diversification of economic benefits and thereby alleviating poverty. Under the new market based system banks are unwilling to voluntarily expose themselves to higher risks and higher costs by lending to mainstream borrowers and thus enhance their profits instead of lending to SMEs or more risky borrowers in other sectors.

Table-2
Percentage share of Advances to Private Sector

	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07
Agriculture	14.8	15.2	13.8	14.2	13.1	10.2	8.3	7.0	6.7
Manufacturing	50.4	47.6	50.7	50.2	49.1	51.6	48.2	46.3	44.2
Textiles	22.9	22.4	24.2	23.5	25.1	21.0	16.7	14.2	12.8
Commerce	11.5	12.2	11.0	8.3	7.8	8.8	8.2	9.6	9.7
Personal	9.0	10.8	10.5	10.6	12.6	14.2	16.9	18.4	18.6
Consumer credit	6.0	6.6	7.7	9.5	10.1	11.0	14.0	15.8	16.0
Credit Cards	0.3	0.4	0.5	0.8	1.1	1.1	1.4	5.0	6.2
Housing Finance	0.3	0.4	0.5	0.6	0.5	0.9	1.9	2.2	2.5

Source: Authors' estimates based on SBP Annual Reports, FSA reports

This conclusion is supported by SBP data on banking credit by size of loans and their borrowers as reported during the past few years. Apart from small variations from year to year, the trend is very clear. Nearly 80 percent of banking credit is given in the amount of Rupees one million or more, and these are their main stream primary borrowers, the large corporate and business borrowers. In contrast, those borrowing smaller amount of loans, while they are 85 percent of the total number of borrowers, in terms of amount of banking credit obtained, their share is just about 10 percent of the total banking credit. Small borrowers across all sectors of the economy are on the fringes of credit system. This observation raises a disturbing issue of whether the privatized financial system is somehow not compatible with a system that would enhance employment and regional dispersion of growth and incomes without compromising its profitability and financial strength. Comparative experience shows that this is not necessarily true. It is more a matter of restructuring the enabling environment that will be conducive to these objectives.

From a banker’s perspective lending to SME borrowers, not to say of small and micro-credit clients are higher indeed, and also are more risky. But these costs can be managed and their risks can be diversified and absorbed because their repayment performance is not so bad as post reform experience has shown, provided the lending instruments and mechanisms are redesigned, and a fresh approach is adopted.

Similarly, lending to new and small exporters is even more promising if they are brought into the formal credit network of banking system, supported by a reorganized export financing scheme without adversely affecting the flow of credit to already established large exporters. If an approach were to be adopted that reinforces the outreach mechanisms of banks with new lending instruments, the profitability of banks need not be adversely affected, while sectoral finance can be diversified and enhanced from its current levels in Pakistan. Under these circumstances, some segmentation of the priority sectors will occur, as is currently the case. The segmentation entails that only specialized financial institutions like the micro finance banks cater for the lowest category borrowers, micro credit clients, for they can do so in a relatively superior way then the main stream commercial banks. However, this in no way precludes the main stream banks to extend micro credit where and when feasible.

In contrast to the micro finance situation, for exports, housing, agriculture and SME borrowers, reliance has to be placed on the main stream banking system to provide credit which it is doing so quite actively today. Zarayee Taraqiatee Bank Ltd is focusing on extending credit to the agriculture sector while other commercial banks are providing credit for exports and housing at close to market interest rates prevailing in the economy. Credit for the purpose of exports has been given high priority and the export financing scheme introduced by the State Bank of Pakistan for this purpose provides subsidized credit for the development of this sector. For small and medium enterprises borrower, however, an implicit interest subsidy of the type given to exporters is not appropriate because the issue is not the interest cost of credit rather cost of lending to SME borrowers spread all over the country. Moreover the problem with housing, SME and micro credit is that of access to proper documentation as required by banks and not the interest cost.

Importantly, segmentation should be done by activities and performance, and not based on institutions or entitlements. This is the first pre-requisite of effective credit allocation for the development of the priority sectors. Credit to priority sectors need not be subsidized, but has to be regulated on the basis of activity, for instance, all exporters will get the same treatment regardless of area, institutions or entitlements.

Non-Performing Loans

Nonperforming loans pose a threat not only to the solvency of the banking system but are also a burden on its profitability and a source of financial distress[2]. In Pakistan, the higher share of directed credit programs caused investments with low rates of return and thus the banks felt the weight of accumulating NPLs. In the mid 1970’s, due to the nationalization of the banking system, very high levels NPLs began to emerge. These gained in frequency during the 1980s and by the early 1990s had reached alarming proportions. This resulted in system level insolvency and bankrupted many major institutions, both nationalized commercial banks and DFIs. This plunged the banking system into a severe crisis. State owned banks felt the major crush since they had the largest share in total non performing loans of the banking system, which was much greater than their share in assets or deposits. By the end of the year 1990, nationalized commercial banks showed the most accumulation of NPLs at 95 percent of the banking system.

The effectiveness of such credit programs was also questionable on the ground that it was difficult to ensure that the credit was being used by actual intended beneficiaries. Consequently, there was not only a growth of the Non Performing loans, which had their own lasting repercussions, but also the growth of a default culture. Since the banking system was owned by the Government, the tremendous loan losses and bankruptcies were financed by it, in turn leading to a heavy fiscal burden. Major financial institutions extended a large amount of money as loans to a group of borrowers who were influential in their social or political status, majority of whom defaulted on their loan obligations, deliberately or otherwise. These defaults caused immense losses to these financial institutions. Since all financial institutions were owned by the government and government guaranteed all bad debts, time and again it ended up replenishing equity base of these institutions or absorbed these losses in the budget, or eventually these institutions were sold off or closed down. In this distorted process of financial intermediation, the financial system was being used as an effective channel of transfer of resources from depositors, tax payers, or the general public to borrowers who ended up being willful defaulters.

The amount of NPLs of the banking system kept rising and reached a peak Rs245 bn in CY01. Since then the amount of NPLs outstanding has been declining and was Rs 187 bn in CY07. This happened because of improved management of NPLs, resolution of loan defaults, loan write-offs, loan recovery, and above all a substantial increase in the provisioning of NPLs by banks and DFIs. All these elements of improvement in NPLs occurred as a result of emphasis placed on their management in the reform process. Consequently, overall management of NPLs improved considerably during 1998-2006. As a result of this improvement the risk of insolvency has been considerably reduced and is no longer a threat as it was in the past. However, the amount of provisioning done has been a drag on the profitability of banks but not a source of financial stress as banking returns have been spectacular in the same time period.

As part of the management of NPLs, a public asset management company was established in CY00. The non performing loans were removed from the loan portfolio of newly privatized banks and hence the NPLs within this company no longer affect the financial statement of these banks. Lack of sound lending practices increased loan losses in state owned banks whereas now, the lending practices of private banks are conducted under a strict standard of lending to prevent incidence of loan defaults hence keeping their NPLs minimum.

There are several elements in the management of NPLs that have been disentangled as follows and led to the removal of the drag of NPLs. The first element has been reforms and restructuring of loss leaders. This has been accompanied by closing down of insolvent DFIs. Similarly, there has been a significant improvement in the banking regulation capacity of SBP together with enhanced diligence in its over site functions on not only the ailing banks but the entire banking system. The government and SBP together have shown firmness in dealing with the ailing banks of a type that did not exist before. As a result of these measures banking system is no longer facing threats of insolvency that was writ large during the reform period of 1990s.

This improvement has been documented by the following trends. The amount of net NPLs has decreased from Rs92 billion in CY97 to Rs45 billion in CY06. The incidence of NPLs for the whole banking system has come down to 2.9 percent in CY03 from 5.9 percent in CY01[9]. As the data shows, the systemic risk of the burden of NPLs has been eliminated, but their impact on earning potential of banks remains there because banks' funds are blocked in provisioning which does not produce any returns to the bank. Table 3 shows the amount of provisioning as well as net NPLs.

The privatization and deregulation of State owned financial institutions that occurred as the NPLs are no longer a pressing issue that it was during the 1990s when a large part of the banking system was in financial distress. In CY00, a public asset management company was set up to handle part of the bad loans jettisoned from the portfolio of newly privatized banks. Private bank are likely to impose a much tighter discipline on lending practices to prevent incidence of loan defaults. The persistent disregard to sound lending practices in the state owned banks that prevailed earlier has given way to overcautious lending in recent times. The management of NPLs, costly though it has been, restructuring of loss leaders, closing down of DFIs, a much improved regulatory capacity and diligent over sight functions, a firmness in dealing with the wayward banks by the authorities concerned rarely exhibited before—all these factors have contributed to this improvement. There are no imminent threats to solvency of the banking system that loomed large during much of the 1990s due to NPLs.

Table-3
NPLs of Banking System *(PKR in billion)*

	FY99	FY00	FY01	FY02	FY03	FY04	FY05
Public Sector CBs	129.00	125.00	130.00	96.00	86.00	40.00	38.00
Local Private Banks	35.00	43.00	46.00	67.00	67.00	103.00	96.00
Foreign Banks	7.00	7.00	6.00	5.00	4.00	3.00	2.00
Specialized Banks	61.00	65.00	63.00	64.00	54.00	54.00	42.00
Commercial Banks	170.00	175.00	181.00	168.00	157.00	146.00	136.00
All Banks	231.00	240.00	244.00	232.00	211.00	200.00	177.00
Net NPLs - All Banks, CY	119	108	111	91	76	61	45
Provisioning, CY	92.0	136.1	134.0	140.2	135.1	138.7	131.8

Source: SBP Annual Reports, FSA reports

Credit System: Volatility and Growth

The analysis of the credit system of Pakistan shows significant growth in terms of total assets of the banking system. But this analysis is not complete until we look at the profitability of banks in terms of gross income. Gross income grew at a large pace hence the operating expense to gross income ratio improved from 85.2 percent in CY97 to 39.8 percent in CY06. This drop in administrative costs as a proportion of income has been phenomenal. The privatization of banks led to downsizing and rightsizing in these institutions. Laying off excess staff through golden handshake scheme and closing down of unprofitable branches contributed to the reduction in the administrative expense. Banks cleaned up their balance sheets and the drag of nonperforming loans was removed through provisioning. Along with these the profitability of banks was greatly impacted by the interest rate changes. The differential between the deposit cost and the lending rate increased significantly thus reducing the interest cost and increasing the spread. This impact on profitability can be further seen from the ratio of administrative cost to total assets. Hence banks now have increased profitability in the privatized system which is now operating in a liberalized financial regime brought about by the financial system reforms.

A detailed analysis of total system credit figures shows that growth in banking credit has been extreme volatility in the last seven years. Total system credit showed a 13.6 percent growth in FY00 from where it declined to show negative growth of -11.9 percent in FY02. After that the growth of credit reflected an upsurge and increasing to 33.2 percent in FY05 from where it has started to decline again and stands at 12.2 percent in FY07. Table 5 shows the volatility in credit over the CY00-07 time period. This imbalance in the system can largely be explained by the type of credit extended by banks.

Textile credit is largely taken for balancing, modernization and replacement purposes by existing businesses. Moreover the pent up demand for credit did not come forward until 2004. Banks at that time had significant liquidity and were eager to fulfill this demand. So as soon as the pent up demand for this credit was met by banks, there was a sudden decline in the total system credit. An upward trend is again witnessed owing to the increase in consumer credit which is the more profitable avenue for banks. Banks are faced with excess liquidity again and consumer credit as the only avenue for lending is not enough as it still makes up for only 14 percent of the total system credit. More credit can only be extended if new investment takes place and that can only occur if there is political stability in the country, unlike the political turmoil of today.

Conclusion

The primary objective of financial reforms as witnessed in many developing countries is the improvement in performance, financial strength and solvency of the financial system. Hence, the reform process can contribute to effective resource allocation in the economy and the ensuing impact on increased economic growth and macroeconomic stability. The reform process is long drawn and during its implementation the financial system has to undergo the impact of changes, absorb the shocks and consequently emerge financially and institutionally stronger than before. Reforms focus on the policy regime and structure of incentives governing operations of the financial system at macro-financial level, component level or even institutional level. Restructuring on the other hand focuses on ownership, spheres of operations, and on the legal infrastructure and regulatory systems.

In Pakistan since financial system reforms began in 1990s the system has undergone many changes and majority of the objectives of the reforms have been achieved. The financial system has been liberalized and the policy regime has been changed from a directed to one which is market oriented. The credit system has also been revamped and there has been a shift from directed credit to a market based system. With the privatization of all government owned banks, there has been a significant decrease in the role of DFIs. Large commercial banks have undergone restructuring and reorganization as a result of which there has been a marked improvement in their operational practices and business diversification. External sector has also been opened and exchange controls have been removed. There has been a substantial development in the regulatory and supervisory capabilities of SBP and SECP. The most important area of reforms has been the overhauling of the credit system. There has been a liberalization of credit allocation as concessional credit schemes and caps on lending rates have been removed and lending rates are now determined in relation to demand and supply conditions in the market. The market based credit system has also led to the demise of Development Finance Institutions. Credit extended to priority sectors has also witnessed a change and consumer credit has had its own very crucial impact on the banking industry in Pakistan.

Table-4
Operating Expenses to Gross Income (%)

	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04	CY05
Commercial Banks	85.80	78.50	76.90	71.60	62.70	56.70	48.60	51.70	41.20
All	85.20	72.70	75.80	71.60	62.40	59.10	50.50	52.00	41.50

Source: SBP Banking System Review 2005

Table-5
Financial System Credit Growth (%)

	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07
Total Financial System Credit	13.63	7.35	-11.88	3.41	22.90	33.17	27.18	12.23
All Credit to Govt	10.79	6.21	-13.48	-7.29	0.13	5.87	10.19	-0.78
All Credit to Private Sector	2.84	1.14	1.60	10.70	22.77	27.30	16.99	13.00
Banking Credit	10.62	8.36	2.41	9.59	28.10	36.37	22.25	14.73
to Private Sector	3.50	9.47	2.36	18.21	30.98	37.63	22.37	15.60
to Governemnt + PSEs	53.33	3.86	2.60	-27.11	8.16	25.79	21.16	6.68
NBFIs Credit	-7.26	-20.43	16.94	21.96	21.84	23.90	17.26	12.77

Source: Authors' estimates based on SBP Annual Reports, FSA reports

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