NUST BUSINESS SCHOOL

"IMPACT OF BANKING SECTOR REFORMS ON THE SOUNDNESS OF BANKS IN PAKISTAN"

A Research Paper

Course: Financial Institutions and Capital Markets

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ABSTRACT

This study assesses the impact of Banking Sector Reforms on the Soundness of Banks Operating in Pakistan during and after the first generation reforms. Thus, the paper ascertains the deep impact of reforms on the performance of banks. The scenario has been marked with consolidation and mergers, capital adequacy ratios appear stronger, asset quality has been improved with a check on Non Performing Loans and management has been exhibited soundness. The analysis suggests the need for continuity of banking sector reforms. Though salient measures have been undertaken by the governments to update and improve the legislative framework, there remains a need to constantly upgrade them in the light of changing global conditions.

LITERATURE REVIEW

Financial Structure in the Pre-Reform period

In the pre-reform period, activities of the financial sector were largely directed by the government as a means to implement its development strategy. The financial system consisted of commercial banks (including foreign banks) and non-bank financial institutions (including development finance institutions). There was overlapping of regulating functions between State Bank of Pakistan (SBP) and Pakistan Banking Council (PBC) in matters relating to Public sector banks and development finance institutions.

In 1974, the well functioning banking industry largely owned by the private sector was nationalized. The public sector dominance along with instruments of direct monetary control, had led to financial sector inefficiency, crowding out of credit to the private enterprises, deteriorating quality of assets ad rising vulnerability of financial institutions.

In 1990, total of 24 commercial banks (7 domestic and 17 foreign) were operational in Pakistan (Table 1.1). Domestic banks were catering to the large banking needs of the economy with 90% share in total assets and total deposits of the banking sector. "With the government as the main player in the arena, supported by passive supervisors and a few large sized nationalized banks and DFI's private sector participants were sidelined and financial savings from the households were diverted to the government and priority sectors. There were hardly any markets in the true sense of the world i.e. market where players' interaction resulted in pricing and cleaning. Financial markets, after nationalization of commercial banks were not equating the supply of funds according to their demand, rather than a set of distortion was being imposed through the system of financial repression characterized by credit rationing and other controls". (SBP, Financial Sector Assessment, 1990-2000: Karachi, 2002)

Banks were given detailed instructions on the allocation of credit to specific sectors and a plethora of administrative interest rates were set for various purposes. Prudential regulations, particularly capitalization and provisioning requirements were weak. In this environment, banks had little incentive and scant means to mobilize additional savings, reduce operating costs, or make lending decisions based on creditworthiness[1].

Objectives of financial Sector Reforms

In early 1997, the reforms were implemented with the help of the World Bank. The aim of the reforms was to resist the flow of bad loans, restrict loss making and safeguard the assets of the

[1] IMF Working Paper: 'Bank Reform and Bank Efficiency in Pakistan'.

nationalized commercial banks (NCB's) and Development Finance Institutions (DFI's) while they were being prepared for privatization[2].

The reforms aimed to increase the efficiency of financial intermediation by reducing market distortions, and strengthen the legal processes to enable a more effective enforcement of financial contracts. Reforms regarding, improved governance structure, professionalism of management, internal controls and systems, downsizing of workforce, curtailment of irresponsible trade union practices, and recapitalization of banks were undertaken.

Banking Law Reforms

A number of amendments were made during 1990s in the following banking laws:

- SBP Act, 1956
- Banking Companies Ordinance, 1962
- The Banks Nationalization Act, 1974
- The Banking Companies (Recovery of Loans) Ordinance, 1979
- The Banking Tribunals Ordinance, 1984

Changes in these laws were made with the following key objectives:

- To pave the way for privatization of NCBs
- To enhance competition by allowing private sector to establish new banks
- To increase the autonomy of SBP in formulating and implementing monetary policy
- To consolidate its role as regulator of banks and non-bank financial institutions
- To strengthen the internal governance of these institutions

[2] Reforms of Public Sector Banks – Case Study of Pakistan; State Bank of Pakistan (SBP)

- To improve the framework fro recovery of loans

METHODOLOGY

To study the impact of financial sector reforms on the soundness of banks operating in Pakistan, following periods is analyzed using the CAMELS framework:

I. 1990 to 1996 (during-reform period)

II. 1997 to 2002 (post-reform period)

CAMELS FRAME WORK

1. Capital Adequacy: This parameter concentrates on capital of banks which is critical for their solvency. It shows the strength of the banks to absorb shocks to their balance sheets. The two indicators used for capital adequacy are capital to risk-weighted assets (CRWA) ratio and capital to liabilities (CL) ratio. The former calculates assets on the basis of risk weights determined under Basel Accord for each balance sheet item. CL ratio shows the extent to which capital and reserves of a bank provide coverage to liabilities.

2. Asset quality: The solvency risk of banks often originates from the quality of their asset portfolio. As lending makes up the largest portion of banks' assets and renders a significant source of earnings (and losses), the credit quality has the direct bearing on the banks' net worth. The ratio of non-performing loans to total loans is used. An increasing trend signals deterioration in the quality of asset portfolio and eventually cash flows, net income and solvency.

3. Management soundness: A major prerequisite for robust growth, a sound management can be judged by total expenses to total income (EI) and interest rate spread. A high EI ratio indicates the

operating inefficiency that could be due to flaws in management. Interest rate spread reflects the difference between effective returns on earning assets and interest expense on interest paying liabilities. A higher spread may be caused either by higher operating cost reflecting management inefficiencies or by banks' efforts to earn more profit.

4. Earnings: Although there are various measures of profitability, the profitability indicator used in our study is Return on Assets (ROA).

5. Liquidity and Sensitivity to market risk: The liquid asset ratio and loans to deposit ratio are being used.

ANALYSIS OF THE BANKING SECTOR

CAPITAL ADEQUACY

Capital to risk-weighted assets is applicable from 1997 when SBP introduced the risk-based system for capital adequacy consistent with the BASEL Committee requirements. According to Table 2.1, CRWA ratio was only 0.6 percent in 1997, apparently much lower than the 8 percent benchmark set by the BASEL Committee. This is indicative of acute solvency dilemma for that year. This ratio was tremendously low because of the losses suffered by major banks which resulted in capital support of Rs 30.7 billion from SBP in 1998, in addition to revaluation of fixed assets by Rs 13.9 billion, thereby raising the CRWA to 10.8 percent. The gradual fall in the ratio was attributed to the growing non-performing loans eroding capital base and increase in riskier assets in the portfolio of banks. Consequently, SBP had to again provide capital support of Rs 8 billion during 2000[3].

[3] Financial Sector Assessment 1990-2000, State Bank of Pakistan

Although the reforms were aimed at strengthening the competitiveness of the banks, the desired result was not achieved as most of the new banks were under-capitalized. The fragmentation was impeding the banking sector from attaining economies of scales and technological advancement, which can reduce intermediation cost- a key goal of the financial sector reforms. Thus, the SBP doubled the minimum paid-up capital (net of losses) requirement for scheduled banks to Rs 1.0 billion. Banks were required to meet this target in two phases, i.e., Rs 750 million to be achieved till end December 2001 and the final figure to be met by end-December 2002[4].

Increase in the capital base of the banking system improved the capital adequacy indicators at the end of 2002. CRWA was already above the required benchmark of 8 percent in 2000 and improved further. This improvement was rooted in changes in the asset mix of the banking sector. The banking sector witnessed a significant increase in the share of investment (primarily in government securities) and a fall in that of advances by the end of 2002 compared to 2000. Since investment in the government securities is assigned zero risk while advances are weighted as hundred percent risky assets, the change in the asset mix played an important role in improving CRWA ratio.

Since 1990 (Figure 2.1), CL ratio has been declining, showing an adverse capital base, while reaching its lowest in 1997. Capital injection and revaluation of fixed assets in the next year explain the sharp recovery in 1998. SBP again supported one of NCBs through capital injection in 2000 that posted a loss in 1999. This resulted in the improvement in CL ratio in that year.

[4] Financial Sector Assessment 2000-2002, State Bank of Pakistan

ASSET QUALITY

The ratio of NPLs to total loans has shown an overall increase in the 1990s. In Pakistan the Nationalized Commercial Banks have been facing the problem of NPLs, which increased from Rs. 25 billion in 1989 to Rs. 128 billion in June 1998, or 4% of the GDP. Moreover, the NPLs increased from Rs. 230.7 billion in December 1999 to Rs. 240.1 billion in December 2000[5] (Table 3.3).

During 1990s, state-owned banks had the largest share in total nonperforming loans of the banking sector, which was much greater than their share in assets or deposits (Table 3.2). Although this share declined in later part of 1990s, this was more due to increase in NPLs of private banks rather than any improvement in state-owned banks.

Banks were reluctant in writing off the 'historically' bad loans mainly because of poor quality of underlying collateral and to avoid any possible legal complication. This contributed in pilling up of bad loans in the asset portfolio of these banks. Strict disclosure requirement put in place by SBP in 1997 forced banks to disclose the true classification of their loans. This disclosure resulted in a substantial rise in NPLs. However, a larger increase in advances and almost stagnant value of NPLs at 1999 level, led to a fall in this ratio during 2000. Nevertheless, the volume of NPLs severely constrained the earning capacity of these banks.

MANAGEMENT SOUNDNESS

EI ratio for state-owned banks (Table 4.1), which was already very high, increased further from 95.7 percent in 1990 to 96.8 percent in 2000. However, during 1996-99 this exceeded 100 percent mark,

[5] Khan, M. A. and Khan, S. 2007. Financial Restructuring in Pakistan. Pakistan Institute of Development Economics, Paper No. 4141

primarily due to the provisioning against NPLs. It is important to note that 1997 was the only year when operating expenses were greater than interest expenditures, mainly because of, Rs 26.5 billion increase in provisioning against NPLs and, to some extent, Golden Hand Shake (GHS) schemes offered by three major nationalized banks.

The emergence of new banks in the private sector was expected to enhance competitiveness and eventually efficiency for state-owned banks. Contrarily, the rising trend in the interest rate spread with deteriorating profitability indicated the growing inefficiencies of state-owned banks coupled with higher operating expenses to total expenditure ratios. A significantly large proportion of non-performing loans and provisioning (part of reform process) affected earnings of banks negatively leading to higher banking spread during second half of 1990s. A large deduction of advance tax from the banking industry was another factor for higher interest rate spread, as these advance taxes were non-earning assets and treated as expense in income statements.

EARNINGS AND PROFITABILITY

The profitability of the banks deteriorated in the 1990s especially after mid 1996 (See Table 5.1). This was due to falling share of earning assets, rising NPLs and their increased provisioning requirements and rising expenses due to the increased share of borrowings in total liabilities[6]. Earnings of the foreign banks also declined after 1997 due to the freezing of the foreign accounts in 1998 which severely affected the earnings capacity of the foreign banks.

[6] Pakistan: Financial Sector Assessment, 1990-2000 (SBP)

One reason for the low profits of the banking sector is the transition cost of ongoing reform process since banks are required to disclose true nature of their financial accounts and to adequately provide for their non-performing assets. With the implementation of the International reporting standards, it was not possible for the banks to window dress their accounts. The profitability of the banks showed an increasing trend from year 2000 onwards (See Figure 5.1). This is when the impact of banking reforms was starting to be visible i.e. the banking industry was on its path towards sustain profitability. The rise in after tax profits of the banking sector was backed by considerable rise in net interest income (See Figure 5.2).

LIQUIDITY AND SENSITIVITY TO MARKET RISK

The liquid asset ratio and loans to deposit ratio shows some deteriorating trend after 1998 (Figure 6.1). However this was intentionally brought about by the monetary policy changes by the SBP. In FY99, both the cash reserve requirement (CRR) and the Statuary liquidity requirement (SLR) were reduced to tackle the increased withdrawals of deposits due to freezing of FCA's. These steps were reinforced by decline in SBP's discount and T-Bill yields during FY00[7].

The negative gap i.e. higher RSL than RSA shows that banks are risk sensitive to changes in interest risk (Table 6.1). The growing gap of state owned banks during 1990-1998 shows their exposure to rising interest rates risk (Figure 6.2). The gap reduced in the last two years of 1990's due to higher growth in rate sensitive assets, primarily in advances and relatively slower growth in deposits. For private banks, the gap is also widening over the period with contraction in 1997, due to increase in

[7] Pakistan: Financial Sector Assessment, 1990-2000 (SBP)

investment especially government securities. The performance of private banks in this regard is better than that of state owned banks due to low level of non performing loans which enabled them to keep interest rate spread low.

Liquidity position of the banks improved in the year 01-02 (Table 6.2). Continuous fall in the loans to deposit ratio since CY00 was witnessed due to remarkable growth of deposits towards the end of CY01 to CY02. On the other hand, banks saw relative slowdown in growth of advances[8]. Both impressive deposit growth and subdued increase in advances led to higher liquid assets to total assets ratio.

CONCLUSION

The banking sector reforms have induced competition within the system and improved internal efficiency. The State Bank of Pakistan is adhering to its agenda for the second generation reforms in the financial sector covering the period 2005-2010. Thus, the process of launching reforms is a continuous process. The ongoing economic slow down along with the continued monetary tightening by the State Bank of Pakistan (SBP) has rendered the banking sector to undergo tough times in terms of rising infected loans, shrinking liquidity and thus deteriorating profitability. A key feature is the increased number of mergers and acquisitions among banks in order to meet SBP's revised minimum capital requirement of PKR23bn in phased manner up till CY13 (PKR6bn for CY09). The process has already initiated with the merger of Atlas Bank and KASB Bank under way.

[8] Pakistan: Financial Sector Assessment, 2001-2002 (SBP)

ANNEXURE

LIST OF TABLES

Table 1.1: Structure of Banks in 1990

	No. of Banks	Branches	Assets	Advances	Investment
State Owned	7	7,043	92.2	92.1	93.5
Private	0	0	-	-	-
Foreign	17	45	7.8	7.9	6.5
Total	**24**	**7088**	**100.0**	**100.0**	**100.0**

Source: Pakistan; Financial Sector Assessment 1990-2000(SBP)

Table 2.1: Capital Adequacy Indicator (Capital to risk-weighted assets)

percent

	1997	1998	1999	2000
Capital to risk-weighted assets	0.6	10.8	10.0	9.5
No. of banks below 8 percent CRWA	4	0	1	1

	CY00	CY01	CY02
Capital to risk weighted assets			
PSCBs	10.4	9.6	12.3
DPBs	9.2	9.5	9.7
FBs	18.0	18.6	23.2
Specialized banks	-3.3	-13.9	-31.7
All banks	9.7	8.8	8.8
All banks (Excl. Sp. banks)	11.4	11.3	12.6
Bank below 8 percent CRWA (numbers)			
PSCBs	0	0	0
DPBs	3	3	2
FBs	0	0	0
Specialized banks	2	2	2
All banks	5	5	4
All banks (Excl. Sp. banks)	3	3	2

Table 3.1: Asset Quality Indicators

percent

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Earning assets to total assets	80.2	75.8	77.0	77.8	77.2	77.0	75.0	73.4	71.3	70.6	71.6
NPLs to gross advances	18.0	19.9	18.6	22.1	25.6	23.3	23.5	26.5	25.4	27.7	24.4
Loan defaults to gross advances	10.7	10.8	11.4	11.2	12.8	12.2	13.2	21.9	18.9	16.0	14.8
Provisioning to gross advances	6.6	7.4	9.3	8.1	8.0	7.6	9.0	14.1	13.7	12.7	13.2
Cash recoveries to total default	12.0	6.8	6.5	5.3	8.2	8.6	9.1	9.5	6.3	8.0	8.4

Table 3.2: Share of State-owned Banks in Banking Sector

Percent

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2000adj
Assets	92.2	89.1	83.7	80.1	78.4	76.7	72.3	68.7	70.5	71.8	70.6	54.0
Advances	92.1	90.0	84.1	83.4	79.3	76.1	73.0	67.0	67.6	69.2	68.1	50.2
Investment	93.5	87.9	82.6	77.2	78.8	80.9	73.0	67.4	71.7	78.9	72.3	54.8
Deposits	93.0	89.8	85.4	82.1	80.2	78.8	74.1	69.9	71.7	74.6	73.7	56.2
Capital	85.4	80.4	65.5	60.6	57.8	52.6	41.7	20.8*	56.6	50.6	55.6	47.1
NPLs	95.0	95.8	92.6	94.4	95.8	94.1	92.5	91.7	90.9	88.9	88.1	72.1

*: This low ratio is due to the intensity of capital erosion in 1997 due to Rs 35 billion loss shown by two large banks.
adj: Excluding two privatized banks (MCB and ABL).

Table 3.3: Non-performing loans in the Banking Sector

Year	NPL's (in Billions)	Gross NPLs to Advances (in %)	Provisions to NPLs (in %)	Net NPL to Net Advances (in %)
1997	173.0	23.5	46.6	-
1998	183.0	23.1	58.6	11.1
1999	230.7	25.9	48.6	15.3
2000	240.1	23.5	55.0	12.2
2001	244.1	23.4	54.7	12.1
2002	231.5	21.8	60.6	9.9
2003	222.7	17.0	63.9	6.9
2004	211.2	11.6	70.4	3.8
2005	177.3	8.3	76.7	2.1

Source: SBP Annual report (various issues)

Table 4.1: Management Soundness Indicators

Percent

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Total expenses to total income	95.7	94.2	91.2	90.9	92.8	94.0	105.7	122.0	101.7	101.8	96.8
Operating expenses to total expenses	39.1	38.5	39.5	40.0	39.4	39.6	36.6	51.3	38.5	41.7	42.9
Earnings per employee (million Rs)	0.4	0.4	0.5	0.6	0.7	0.8	0.8	1.2	1.4	1.4	1.5
Interest rate spread	3.9	4.2	4.2	4.6	4.4	5.0	3.4	5.0	5.3	5.6	5.5
Operating expense per employee (million Rs)	0.15	0.15	0.18	0.22	0.24	0.29	0.30	0.67	0.54	0.61	0.63

Table 5.1: Earning and Profitability Indicators

State Owned Banks

Percent

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Net profit to asset ratio	0.4	0.5	0.5	0.7	0.2	0.2	-0.3	-2.3	0.5	-0.7	0.1
Net profit to equity ratio	10.5	13.4	15.3	19.2	7.5	5.9	-14.8	-243.9	11.5	-19.8	2.8
Net interest margin	3.2	3.2	3.3	3.7	3.4	3.9	1.9	3.2	3.5	3.8	4.1
Total income to total assets	9.6	9.1	8.9	10.0	9.6	10.2	9.6	10.7	10.6	10.0	9.5

Private Banks

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Net profit to assets ratio	0.7	1.9	1.5	1.4	1.5	1.0	0.6	0.6	0.3
Net profit to equity ratio	6.3	20.0	17.2	14.4	16.6	13.3	8.0	8.4	4.6
Net interest margin	2.3	5.2	4.7	4.0	3.4	3.9	3.5	2.6	2.8
Total income to total assets	4.3	10.3	10.5	11.7	12.3	12.7	13.1	11.5	10.2

Foreign Banks

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Net profit to assets ratio	0.8	1.9	2.6	1.2	0.8	0.4	1.0	1.3	0.4	0.7	0.6
Net profit to equity ratio	10.9	27.1	30.8	13.5	8.7	4.9	12.8	15.9	4.8	7.0	6.5
Net interest margin	3.5	4.8	6.2	5.1	4.2	2.5	3.2	4.4	3.5	4.0	3.4
Total income to total assets	11.9	11.1	12.1	12.1	12.6	12.5	12.5	14.6	15.2	13.9	11.5

Table 6.1: Liquidity and Sensitivity Indicators

State Owned Banks

Percent

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Liquid assets to total assets	32.2	40.5	44.8	41.8	46.1	43.9	42.6	39.8	40.1	38.3	34.3
Loans to deposits	61.0	54.1	49.0	54.3	50.5	52.2	51.4	49.6	48.2	51.8	55.8
Gap (billion Rs)	-37.6	-62.1	-68.9	-70.6	-88.3	-106.6	-137.9	-158.2	-176.9	-210.3	-199.9
RSA/RSL	89.3	84.6	85.7	86.9	85.8	85.1	82.3	81.0	80.6	78.8	80.6

Private Banks

percent									
	1992	1993	1994	1995	1996	1997	1998	1999	2000
Liquid assets to total assets	55.4	53.1	49.0	41.6	40.4	40.0	41.7	38.8	33.3
Loans to deposits	54.7	53.6	59.3	68.5	62.8	61.6	61.7	67.6	74.8
Gap (billion Rs)	1.2	-1.1	-3.8	-7.0	-10.9	-5.1	-14.6	-21.2	-24.4
RSA/RSL	106.0	96.4	91.6	89.8	88.2	96.2	90.3	87.0	87.9

Note: Gap = RSA – RSL; RSA = Rate sensitive assets ; RSL = Rate sensitive liabilities

Table 6.2: Liquidity Indicators

percent			
	CY00	CY01	CY02
Liquid assets to total assets			
PSCBs	37.1	36.5	48.6
DPBs	34.0	39.8	45.2
FBs	45.2	50.3	48.3
Specialized banks	12.7	13.6	16.4
All banks	36.0	38.5	45.7
All banks (Excl. Sp. banks)	37.5	39.9	47.0
Loan to deposit			
PSCBs	54.0	53.8	44.3
DPBs	67.5	57.9	52.8
FBs	71.5	66.8	71.5
Specialized banks	553.0	450.5	453.3
All banks	66.2	61.7	55.1
All banks (Excl. Sp. banks)	60.5	56.9	51.2

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Figure 2.1: Capital to Liability Ratio

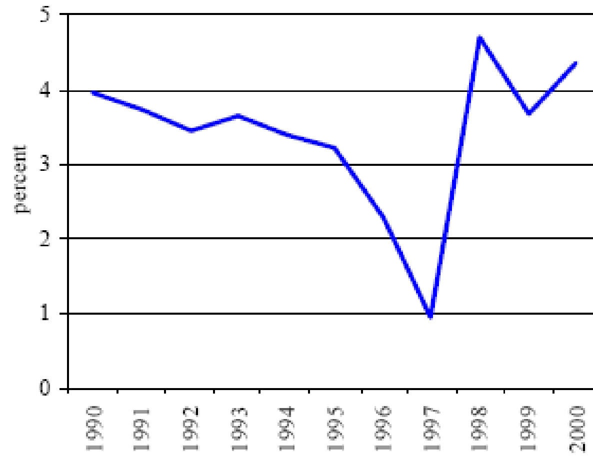


Figure 3.1: Non-performing Loans

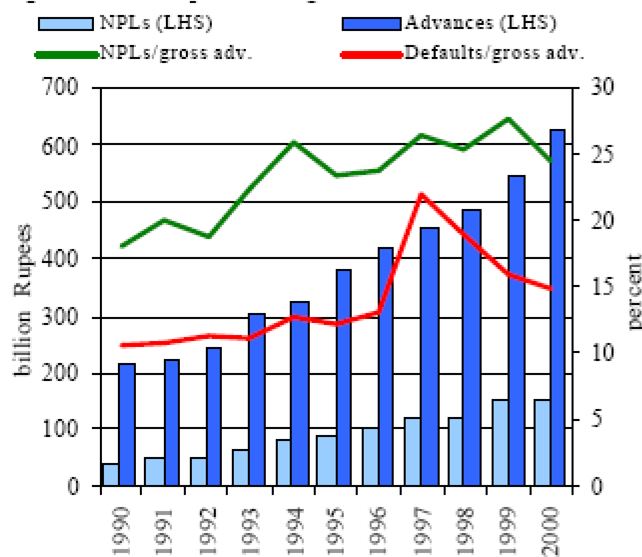
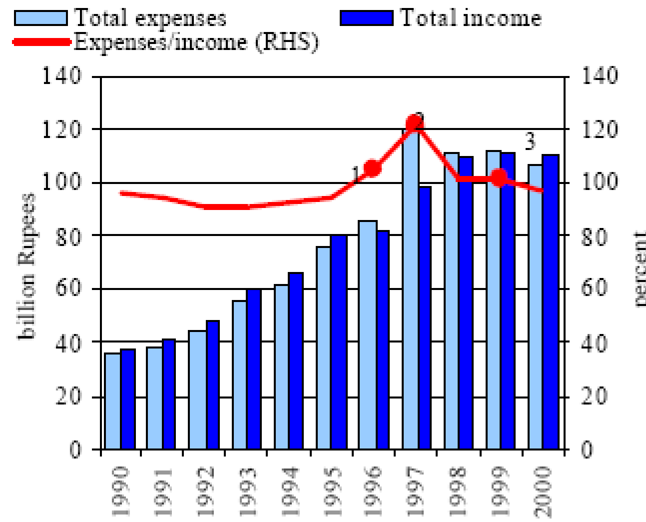


Figure 4.1: Expenditure to Income ratio



1. Interest income ? by Rs 2.2 bln due to ? in NPLs by Rs 9.8 bln and provisioning (expense)??by Rs 8.3 bln.
2. Operating expenses? due to ? in provisioning (Rs 26.5 bln) and GHS.
3. Provisioning?? by Rs 20.6 bln.

Figure 5.1: Profits of Scheduled Banks

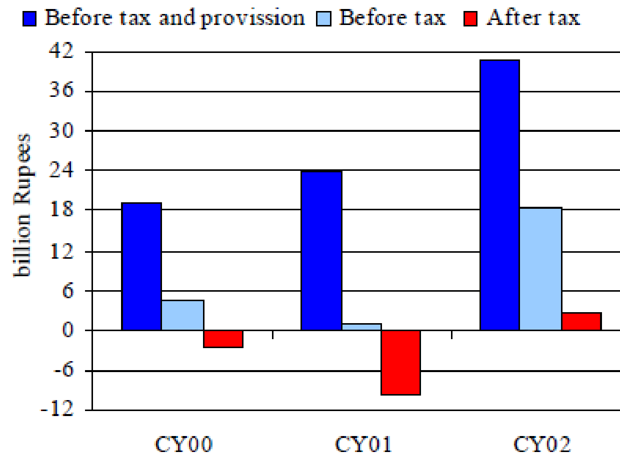


Figure 5.2: Net Interest Income

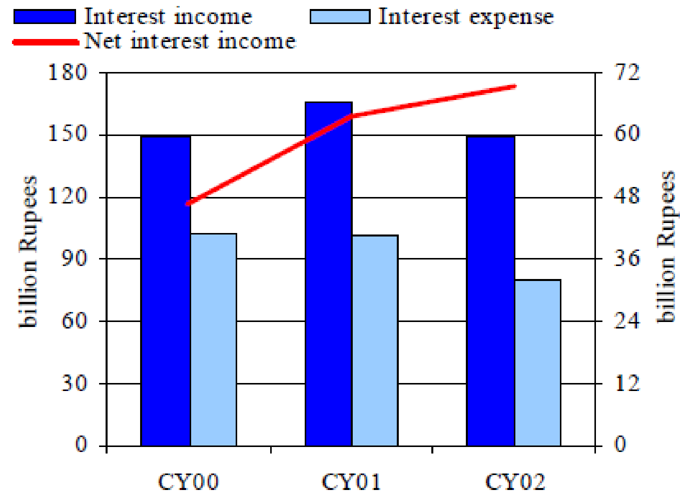


Figure 6.1: Liquidity Indicators

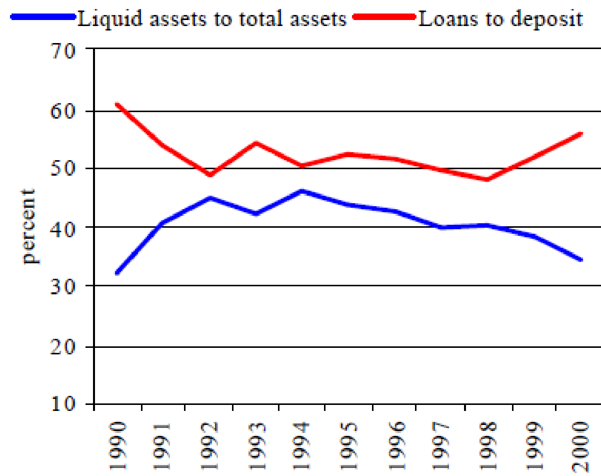
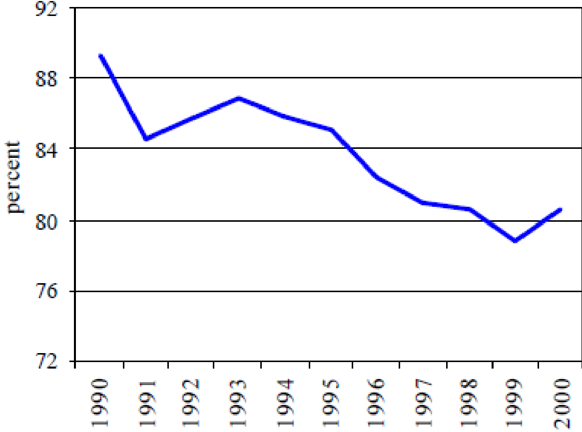


Figure 6.2: RSA / RSL



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