Policy Considerations before Bank Privatization
Country Experience

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Introduction

A well functioning financial system is a pre-requisite for the economic development of any country. A large body of recent theoretical and empirical research has also confirmed the view that the development of financial markets and institutions in a country is crucial for economic growth[1]. Realizing this importance of the financial sector in economic development, some governments in developing countries sought to increase their ownership of banks and other financial institutions, in order to direct credit towards priority sectors. However, the importance of state-owned banks in many developing countries contrasts worryingly with recent research findings, which show that the state ownership of banks has serious negative effects on economies in developing countries. A recent study[2] finds that state ownership is negatively associated with bank performance and the overall development of the financial sector.

Background

After a highly successful decade of rapid growth under a Capitalist model of growth, popular perception had developed in Pakistan that income and regional disparities has widened resulting in Concentration of Wealth in a few hands. It was wrongly deduced that the separation of East Pakistan which is now Bangladesh was directly attributable to the problem of economic disparities. In 1971, a popularly elected Government led by a charismatic leader Zulfiqar Ali Bhutto came to power on a platform of promotion of socialist economy in the country. The new Government decided that the best way for achieving equitable growth in Pakistan was to nationalize the industry, banks, insurance, educational institutions, etc.

[1] See Thorsten *et al.* (2000) & Khan and Senhadji (2000).
[2] See Barth *et al.* (2001).

To put things in context, it may be recalled that the exports of Pakistan in 1969 were higher than the combined exports of Indonesia, Thailand, Philippines and Malaysia[3]. But this momentum was reversed by the nationalization of the 1970s.

Consequently, the financial landscape was significantly altered in the early 1970s, with the nationalization of domestic banks and the expansion of public sector Development Finance Institutions (DFIs) under the framework of the Banks Nationalization Act 1974. The Pakistan Banking Council was set up to act as a holding company of nationalized commercial banks and to exercise supervisory control over them. By the end of the 1980s, it became quite clear that the national socio-economic objectives, sought under the nationalization process, were not being met. Instead, the pre-dominance of the public sector in banking and Non-Bank Financial Institutions (NBFIs), coupled with the instruments of direct monetary control, were becoming increasingly responsible for financial inefficiency, crowding out of the private sector, and the deterioration of the quality of assets, in addition to the rising vulnerability of financial institutions. Due to nationalization, not only was the financial system becoming more stressful, but the supervisory system was also losing its effectiveness. The role of the State Bank of Pakistan as a central bank, had also been considerably weakened due to the presence of the PBC, which also exercised supervisory control over banks. The duplication of the supervisory role was diluting the SBP's enforcement of its regulations over Nationalized Commercial Banks (NCBs).

The dominance of public sector banks at the beginning of the nineties was apparent with a share of 92.2 percent in total assets (Table 1) of the banking sector. The remainder belonged to foreign banks, as domestic private banks did not exist at that time. Similarly, high shares existed for deposits and equity of the public sector banks. With these characteristics, the banking sector at the end of FY90 did not provide a level playing field for competition and growth.

[3] World Bank (2002), Pakistan-Development Policy Review.

Table 1: Pre-privatization structure of the Banking Sector (1990)

Banks	No.	Assets		Deposits		Equity	
		Amount (Rs. Billions)	Share (%)	Amount (Rs. Billions)	Share (%)	Amount (Rs. Billions)	Share (%)
State-owned	7	392.3	92.2	329.7	93	14.9	85.6
Private	-		-	-	-	-	-
Foreign	17	33.4	7.8	24.9	7	2.5	14.4
Total	**24**	**425.6**	**100**	**354.6**	**100**	**17.4**	**100**

Source: Financial Sector Assessment 1990-2000, State Bank of Pakistan

A total of 24 commercial banks (7 domestic and 17 foreign) were doing business in Pakistan as on June 30, 1990. Domestic banks, with absolute public sector ownership and a broad branch network, were catering to most of the commercial banking needs of the economy. This explains their very large share (around 90 percent) in total assets and total deposits of the banking sector. The nationalized commercial banks, which dominated the banking sector at the start of the nineties, were characterized by:

- High Intermediation Costs
- Over-staffing and over-branching
- Huge portfolio of Non Performing Loans
- Poor Customer Services
- Under-capitalization
- Poor Management / Narrow Product Range
- Averse to Lending to SMEs/housing & other segments
- Undue Interference in Lending, Loan Recovery & Personnel issues

Rationale for Privatization in Pakistan

In Pakistan, the privatization process was initiated in the early 1990s, as part of the larger economic reforms program. The Privatization Commission was set up in 1991, in order to provide an institutional framework for the privatization process in the country. The Privatization Commission (PC) was entrusted with selling federal government property—such as its share in banks, industrial units, public utilities, oil and gas companies, transport companies, and infrastructure service providers—in an open and transparent manner. The following objectives were sought to be achieved by privatization:

1. Reduction in fiscal deficit

   Towards the end of the eighties, the mounting losses of public sector enterprises were becoming a burden on the national exchequer. The fiscal deficit reached a high of 8.5 percent of GDP in 1987-88, which severely constrained the fiscal space available to the government.

2. Increase in the efficiency levels

   Efficiency levels of public sector enterprises were low in Pakistan. Production costs of public enterprises were high as a result of political interference. While private producers could be forced to reduce their cost to a minimum for their survival, public firms were not under pressure to reduce costs as they were under no compulsion to ensure an acceptable return to their equity holders. Private firms' managers had more flexibility in taking decisions but this was not so in public sector firms as their accountability for results was almost non-existent. Moreover, public sector firm's investment decisions were largely influenced by political considerations, thus adversely affecting efficiencies in the allocation of resources.

3. To foster competition

   It was believed that when public sector units were sold to a large number of private parties, this would result in healthy competition in different sectors of the economy.

4. Broad basing of equity capital

   Broad-basing the ownership of equity capital was necessary for achieving distributive justice. Privatization could help achieve that. Moreover, privatization would result in strengthening and deepening of the capital market when a percentage of shares of public enterprises were sold to the public through the stock exchange.

5. Releasing resources for physical and social infrastructure

   Privatization of loss making public enterprises would make more funds available for public sector development projects aimed at upgrading physical infrastructure and improving social services.

Modalities of Privatization in Pakistan

The Privatization Policy of 1998, outlined the following four modes of privatization to be adopted for public sector enterprises

1. Total disinvestment through competitive bidding

   This involves the sale of 100 percent shares of a public sector enterprise to a strategic investor through a process of competitive bidding.
2. Partial disinvestment with management control

   In this method, a percentage of the shares of a public sector enterprise are sold to a private investor or group of investors and the management control is also transferred to that party
3. Partial disinvestment without management control

   This entails the sale of a percentage of the shares of a public sector enterprise to a private investor or group of investors, while the government retains management control.
4. Sales/ Lease of assets and property

   The assets/ properties are sold or leased out to any party.

Steps involved in the Privatization Process

The privatization process, which is aimed at selling government property in an open and transparent way with a view to obtaining the best possible price, varies somewhat depending on the nature of the asset and proportion of shares being offered for privatization and whether the transfer of management is involved. The following steps are taken in the privatization process.

1. Identification

The first step is the identification of the entity or list of entities to be privatized. In a typical transaction, the Privatization Commission, in consultation with the relevant ministry, identifies a public sector unit, which is then put before the Cabinet Committee on Privatization (CCOP), for approval as a Candidate for privatization.

2. Hiring of a Financial Advisor

The process of hiring a financial advisor is carried out by the transaction manager with the approval of the relevant board. In November 2001, the government approved regulations for hiring a financial advisor in order to make procedures that were largely being followed over the last decade, more transparent through the Hiring of Financial Advisor Regulations 2001.

3. Due Diligence

The next step is to carry out the legal, technical, and financial due diligence by the selected Financial Advisor. This is aimed at identifying any legal encumbrances, evaluating the condition of the assets, and examining the accounts of the company in order to place a value on the company. After due diligence, the FA finalizes the privatization plan. This may include recommendations on any needed restructuring, in addition to specifying the amount of shares or assets to be privatized.

4. Enacting Any Needed Regulatory and Sectoral Reforms

For many major transactions, the ability to privatize and the amount of proceeds realizable depend critically on the level of regulated prices for the public enterprise's inputs or output and other sectoral or regulatory policies.

5. Valuation of Property

In order to obtain an independent assessment of the value of the property being privatized, the Commission relies primarily on external firms. The FA, where there is one, carries out the valuation to obtain a "reference price" for the property .The following methods are used for valuation of property: discounted cash flow method, asset valuation at book or market value and stock market valuation.

6. Pre-Bid and Bid Process

Expressions of Interest (EoI) are invited by advertising in the relevant media. The PC Ordinance 2000, spells out some of these advertising procedures. Depending on the kind of transaction, the EoI describes the broad qualifications that potential bidders must posses. Those submitting an EoI and meeting the broad qualifications are provided with the Request For Proposals (RFP) package containing the detailed pre-qualification criteria, instructions to bidders, draft sale agreement, and other relevant documents.

7. Post-Bid Matters

Following bidding and the identification of the highest bidder, the board of the PC makes a recommendation to the CCOP as to whether or not to accept the bid. The reference price is a major determinant in the recommendation, although the board may recommend the sale even if the offer price is below the reference price. Once the bid price and bidder are approved, the PC issues a letter of acceptance or a letter of intent to the successful bidder, indicating the terms and conditions of the sale. After receiving CCOP approval for privatization, it typically takes about 18 months to close a major transaction

Pre-privatization Activities

To prepare the public sector banks for privatization, the following steps were taken in the Pakistani banking sector:

1. Amendment in Banks (Nationalization) Act 1974.

   This Act, under which the banking sector in the country was nationalized during the seventies, was amended in 1990, to pave the way for privatization of the nationalized commercial banks.

2. Abolition of the Pakistan Banking Council

   The Pakistan Banking Council, established subsequent to nationalization of the banking sector in the seventies, was abolished in 1997.

3. Downsizing in NCBs

   In order to reduce the surplus staff in the nationalized commercial banks, voluntary separation packages were offered to employees. This resulted in downsizing of the work force of the three big NCBs (HBL, NBP and UBL) by 11,101 staffers out of a total of 39,277.

4. Closing of unprofitable branches

   As part of the downsizing exercise, 1,646 branches of NCBs were closed down.

5. Recapitalization of NCBs

   The balance sheets of public sector banks were cleaned up and their accumulated losses wiped off by the injection of new equity in Habib Bank and United Bank. A total of Rs46.6 billion was injected as equity in these two banks prior to their privatization.

6. Establishment of CIRC

   The Corporate and Industrial Restructuring Corporation (CIRC) was established in 2000 for acquiring Non-Performing Loans of NCBs. NPLs worth Rs47.4 billion have been transferred to CIRC at a discount so far for disposal.

7. Resolution of non-performing loan problem

   An incentive scheme for settling long outstanding non-performing loans was designed under the guidelines of SBP to clean up the balance sheets of NCBs.

8. Issuance of tax refund bonds to NCBs

   Tax refund bonds amounting to Rs6.5 billion have been issued to NCBs.

9. Installation of professional management in NCBs

   In order to streamline the working of NCBs, the State Bank put in place professional management in HBL, NBP and UBL. The Boards of Directors were reconstituted with private sector individuals of integrity and eminence.

10. Promulgation of Privatization Ordinance

    To further strengthen the privatization process, the government promulgated the Privatization Ordinance in 2000. The Ordinance strives to ensure that privatization is carried out in a fair and transparent manner.

11. Committee for Revival of Sick Units

    The Committee for the Revival of Sick Industrial Units (CRSIU) was formed by the Government of Pakistan. The purpose of this committee was to restructure loans of sick industrial units, in order to make them viable.

It is illustrative to understand the political economy considerations also. All of the above tough measures were taken during the military regime headed by General Musharraf. It must be recognized that these were not easy decisions, that could be carried out under an elected representative government and a well functioning parliament. There would be all kinds of pressures on the elected leaders not to close the branches or shed off the redundant workers or to transfer the NPLs at a discount or issue the tax refund bonds. These were the tough measures that the President was convinced were necessary to prepare the banks for privatization and secure a decent buyer at a reasonable price. It is not therefore obvious that this experience would be amenable to replication under a different set of political regime.

The other important point is that fortunately, Pakistan had a very able cadre of bankers working in international banks. Citibank, ABN-Amro, Bank of America, to name a few, have many Pakistani bankers at senior and middle management positions. These persons were brought in and inducted to take over the management of the three big banks. Whether, in absence of such a readily available pool of banking professionals it would have been possible to restructure these state-owned banks can only be conjectured.

Role of the State Bank in Privatization

Banking is a sensitive industry. Unlike other corporate entities, the business of banking requires supervision and vigilance to ensure the safety and soundness of the system and also to protect the interest of its depositors. For this purpose, it is imperative that strict vigil should be exercised in screening the parties interested in acquiring share/management in a bank, so that the control of the bank should not go to unscrupulous elements. With this in view, the State Bank is actively associated with the privatization of banks and the rendering of professional advice to the Privatization Commission on different matters which, interalia, include the following:

1. Analysis of issues and the design of the restructuring plan for nationalized commercial banks (NCBs), as well as its monitoring, implementation and follow up.
2. Voluntary Separation Schemes for excess staff designed and implemented with financial assistance from the World Bank.
3. Approval of the Chief Executives and Boards of Directors of newly privatized banks in accordance with the 'Fit and Proper' test
4. Meaningful input on documentation viz-a-viz Advertisement, Statement of Qualification (SoQ) and agreement for sale of shares and transfer of management.

5. Screening and evaluation of the Strategic Investors for clearance of purchase of five per cent or more shares of NCBs in order to ensure quality and competence of the buyer.
6. Resolution of the issues raised by the strategic investors during the process of privatization.
7. Evaluation of bids

Post Privatization scenario

Banks privatized so far

So far, 6 banks have been privatized while shares of the National Bank of Pakistan have been floated through an Initial Public Offering (Table 2). Details of the privatized units are given below:

1. Muslim Commercial Bank Ltd – Fully divested and now owned and controlled by a domestic private group.
2. Allied Bank of Pakistan Ltd – 51 percent shares sold to the Allied Management Group (AMG) representing employees of the ABL.
3. Bankers Equity Ltd – 51 percent shares were sold to a domestic private Consortium but eventually the entity was forced into liquidation. An unsuccessful privatization episode.
4. Bank Al Falah Ltd – Fully divested, controlled and owned by a foreign group
5. United Bank Ltd – 51 percent shares sold and management transferred to a group of private foreign investor and expatriate Pakistani.
6. Habib Bank Ltd – 51 percent shares sold and management transferred to a private foreign group.
7. National Bank of Pakistan – 23.2 percent shares divested through Stock Exchange.

By March 2004, the share of the assets of state owned banks in the banking system of Pakistan had declined to only 18.6 percent (Table 3). On the other hand, private sector banks, whose share was nil back in 1990, now own 76 percent of assets of the entire banking sector. This includes the share of foreign banks, which increased, from 7.8 percent in 1990, to 10 percent in 2004. Similarly, the share of public sector banks in total deposits and equity, also declined while that of private and foreign banks rose over this period of 14 years.

Table 2: Units privatized to date

(Rupees in Billion)

	1991 to Jun 2002		Jul 2002 to Jun ,2003		Jul 2003 to Jan15, 2004		To Date	
Sector	No.	Amount Realized	No.	Amount Realized	No.	Amount Realized	No.	Amount Realized
Banking	4	5.6	2	12.9	1	22.4	7	41.0 US $ 710 million

Source: Privatization Commission

Table 3: Post-privatization structure of the Banking Sector (March 2004)

Banks	No.	Assets		Deposits		Equity	
		Amount (Rs Billions)	Share (%)	Amount (Rs Billions)	Share (%)	Amount (Rs Billions)	Share (%)
State-owned[1]	4	518.8	18.6	379.3	20.1	22.5	17.2
Domestic private	20	1840.3	66.0	1292.3	68.5	92.8	70.9
Foreign	13	278.4	10.0	198.0	10.5	26.7	20.4
Specialized[2]	3	149.8	5.4	16.1	0.9	-11.1	-8.5
Total	**40**	**2787.2**	**100**	**1885.6**	**100**	**130.9**	**100**

Source: Banking Supervision Department, State Bank of Pakistan

[1] Three small new banks were set up in the public sector during the 1990s. These included the First Women Bank, set up to provide credit to women entrepreneurs; and two provincial banks; the Bank of Punjab and the Bank of Khyber.

[2] These include: Zari Tarqiati Bank Ltd, Industrial Development Bank of Pakistan and Punjab Provincial Co- operative Bank Limited.

Case Studies of Privatization of the Banking Sector in Pakistan

In order to analyze the impact of privatization at the micro level/ bank level, we would be presenting case studies of two public sector banks which have been privatized. By looking at various financial indicators of these banks, we can get a better idea of the impact of change of ownership on their performance. These banks are:

1. Muslim Commercial Bank
2. Allied Bank Limited

Muslim Commercial Bank

This was the first bank in the public sector to be privatized. On April 6, 1991, 26 percent shares of MCB were sold to the National Group at a price of Rs56 per share for an amount of Rs838.8 million on an "as is where is" basis. As a result of this transaction, the Federal Government suspended the application of the provisions of the Banks (Nationalization) Act, 1974 except for the section 5(6)(a) to the Bank for a period of six months.

As part of the Sale Agreement between the Government of Pakistan and the National Group, a further 25 percent of shares were offered for subscription to the public on February 19, 1992. Consequent upon completion of divestment of 51 percent shares of MCB, the application of Banks (Nationalization) Act, 1974, ceased on MCB. Later National Group purchased additional 24 percent shares of MCB on December 31, 1992, at a price of Rs56.15 per share thereby increasing their shareholding to 50 percent of the total shares of the bank. Further shares of the bank were sold in January 2001, November 2001 and October 2002, for proceeds of Rs1.3 billion.

Impact analysis of privatization

There has been a marked improvement in the performance of MCB following its privatization, as can be seen from its financial indicators. A healthy growth in the assets of the bank can be observed (Table 4), which by the end of 2003, represented over 28 percent of the assets of the nationalized commercial banks. Similar growth can also be seen in the deposits and advances of MCB, with deposits and advances standing at 26.5 and 26.7 per cent respectively in 2003.

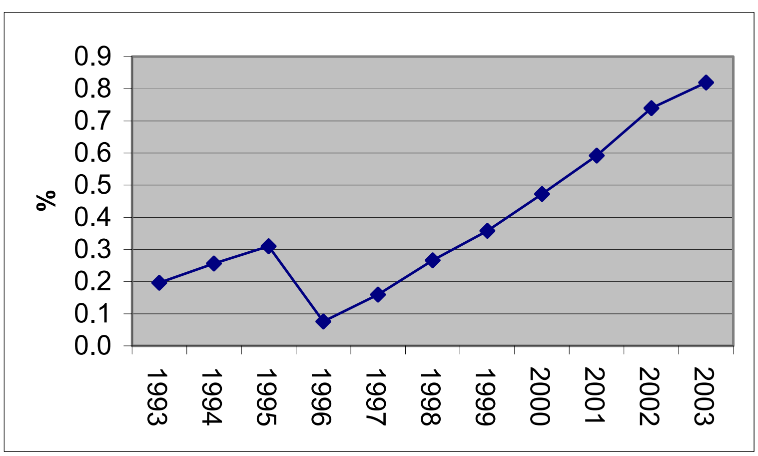
The non-performing loans as percentage of total advances have declined significantly during the period under consideration, reaching 11 percent of gross advances by 2003. If we take the net NPL ratio for the bank, this figure comes out close to 2 percent, which compares very favorably with net NPL ratio for the entire banking system at 5.5 percent. Profitability of the bank has also improved significantly, while return on assets increased from 0.2 percent in 1993 to over 0.8 percent in 2003 (figure 1).

Table 4: Financial indicators of MCB

	Assets (% of assets of NCBs)	Deposits (% of deposits of NCBs)	Advances (% of advances of NCBs)	NPLs (% of Total Loans)
1994	18.1	17.6	17.7	18.1
1997	21.5	20.8	21.9	11.6
2000	18.2	18.3	21.5	14.4
2003	28.3	26.5	26.7	11.3

Source: Financial Sector Assessment 2001-02, State Bank of Pakistan,
Banking Supervision Department, State Bank of Pakistan

Figure 1: Return on Assets (1993-2003)



Source: Financial Sector Assessment 2001-02, State Bank of Pakistan,
Banking Supervision Department, State Bank of Pakistan

Allied Bank Limited

The Allied Bank was the second bank in the public sector to be privatized. Unlike MCB, which was sold to a strategic buyer, ABL was privatized through an Employee Stock Ownership Plan (ESOP). On September 9, 1991, 26 percent shares were sold to the Allied Management Group, which represented the employees of ABL at a price of Rs70 per share. On August 23, 1993, another 25 percent shares were sold to AMG at a price of Rs70 per share This resulted in transfer of ownership from the Government of Pakistan to AMG and the application of Banks Nationalization Act 1974 ceased to be applicable.

In 1999, it transpired that one of ABL's major defaulters had purchased about 35-40 % of ABL shares from employees. Subsequently in July 1999, the State Bank imposed restrictions on the transfer of shares from employees to non-employees except with prior approval from the SBP. On August 3, 2001, the SBP removed the Chairman and three Directors from the Board of ABL, who were also employees of ABL, as they were found to be working against the interests of ABL and its depositors and appointed a new Board to look after the affairs of the bank.

In the backdrop of this situation, the State Bank proposed to the Privatization Commission to exclude the name of ABL from the list of privatization and transfer the strategic sale of ABL to the State Bank of Pakistan. Consequently, ABL was excluded from the list of privatization and the strategic sale of the remaining 49 percent government share was transferred to the SBP in April 2003. The State Bank initiated the process of reconstruction of the bank and transfer of its ownership to one of the existing financial institutions in the private sector that will acquire strategic shareholding. In February 2004, 6 parties were pre qualified by the State Bank for bidding for the 49 percent shares of ABL.

Impact analysis of privatization

Unlike the case of MCB, the performance of Allied Bank does not show any improvement after its privatization. In fact, some of its financial indicators show considerable deterioration in the post privatization period. Assets and deposits have shown only a marginal improvement. Advances, which had grown somewhat initially declined in the later years.

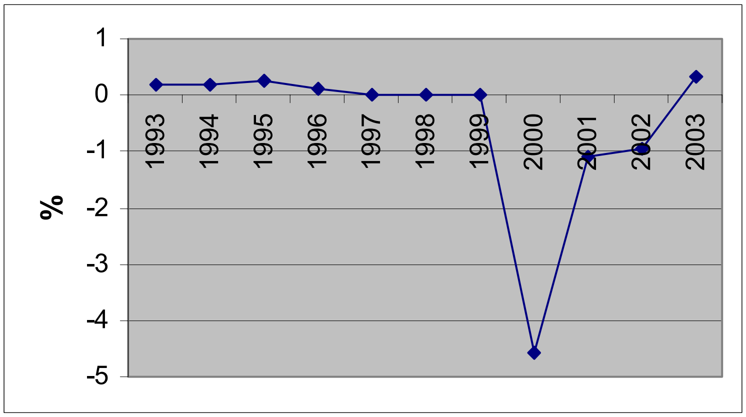
The most alarming development has been the jump in non-performing loans of ABL. NPLs as a proportion of total loans reached nearly 44 percent by 2003 from 16 percent in 1993. It is interesting to note that in 1994, the NPLs of MCB were slightly higher than those of ABL. While the new management of MCB was successful in bringing down the NPLs, the employee management group in ABL was responsible for a drastic increase in the NPLs. As a result of the increasing NPLs, the profitability of Allied Bank has also suffered, the bank made huge losses between 2000-02. The situation only started improving after the SBP removed the Board of Directors in 2001, replacing it with a new Board. The ROA has been negative since 1999, and the bank came out of the red only in 2003.

Table 5: Financial indicators of ABL

	Assets (% of assets of NCBs)	Deposits (% of deposits of NCBs)	Advances (% of advances of NCBs)	NPLs (% of Total Loans)
1994	9.6	9.8	10.9	16.6
1997	10.4	10.6	12.5	17.9
2000	11.7	13	14.2	29.4
2003	12.2	14.3	11.2	43.8

Source: Financial Sector Assessment 2001-02, State Bank of Pakistan,
Banking Supervision Department, State Bank of Pakistan

Figure 2: Return on Assets



Source: Financial Sector Assessment 2001-02, State Bank of Pakistan,
Banking Supervision Department, State Bank of Pakistan

Conclusion

As a result of the privatization of the banking sector in Pakistan, only 18.6 percent of banking sector assets now remain with the public sector. Prior to the initiation of the privatization process, public sector banks controlled more than 92 percent of banking sector assets, while the rest were in the hands of foreign banks, which were playing only a marginal role. At that time, there were no banks owned by the domestic private sector. Now, more than 80 percent of banking assets, deposits and equity are with the private sector banks.

Today, competition in the banking sector has intensified so much that the average lending rates have come down from 21 percent to 5 percent within a span of few years. The intermediation costs of the banks have come down significantly; prime borrowers can now get loans at three to four percent. Inflation has come down to three to four percent; as a result of which the real interest rate has been reduced to almost zero percent. This rapid transformation, as observed in the banking sector of Pakistan, is very rare among developing countries.

Now we come to the question – what lessons have been learnt from the privatization experience of Pakistan? The Allied Bank was not transferred to a strategic investor but instead management control was given to its employees. This approach proved even worse than the experience with public sector ownership. Efforts are now underway to transfer the majority share to a private sector financial institution through a competitive bidding process. In contrast, MCB was sold to a group of private strategic investors who have turned around the bank and improved all indicators, including improved service to customers, technology up gradation and cost efficiency. We can, therefore, conclude that for privatization to bring about tangible results, it must be done the right way.

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List of abbreviations

ABL:	Allied Bank Limited
CCOP:	Cabinet Committee on Privatization
FA:	Financial Advisor
MCB:	Muslim Commercial Bank
NCBs:	Nationalized Commercial Banks
NPLs:	Non-Performing Loans
PBC:	Pakistan Banking Council
PC:	Privatization Commission
ROA:	Return on Assets
SBP:	State Bank of Pakistan