SBP Staff Notes
03/17

Bank Credit to Private Sector: A Critical Review in the Context of Financial Sector Reforms

Asma Khalid[1]

Talha Nadeem

July, 2017

Disclaimer
Views expressed in this document belong to the authors only, and are by no means a reflection of the views of State Bank of Pakistan as an institution. Opinions expressed may be revised at any time. All errors and omissions are the sole responsibility of the author(s).

[1] The authors are Senior Joint Director and Deputy Director respectively in the Economic Policy Review Department at SBP. The authors gratefully acknowledge valuable input from Amjad Iqbal and Amer Hassan, and are also thankful to Farooq Pasha and Asif Ali for their comments on an earlier draft.

CONTENTS **Page**

I. Introduction 2

II. The Finance-Growth Nexus 3

III. The Role of Bank Finance in Pakistan's Economic Growth 4

IV. Financial Sector Reforms: What went wrong? 6

a) Reforms Overlooked the Inclusion Dimension – the liability side 8

b) Stringent Rules and Scrutiny Dented Inclusivity – the asset side 10

c) State Interventions are Still Common in Other EMs 13

d) Delayed Enactment of Non-judicial Foreclosures Proved Costly 15

e) Reforms' Sequencing Backfired 17

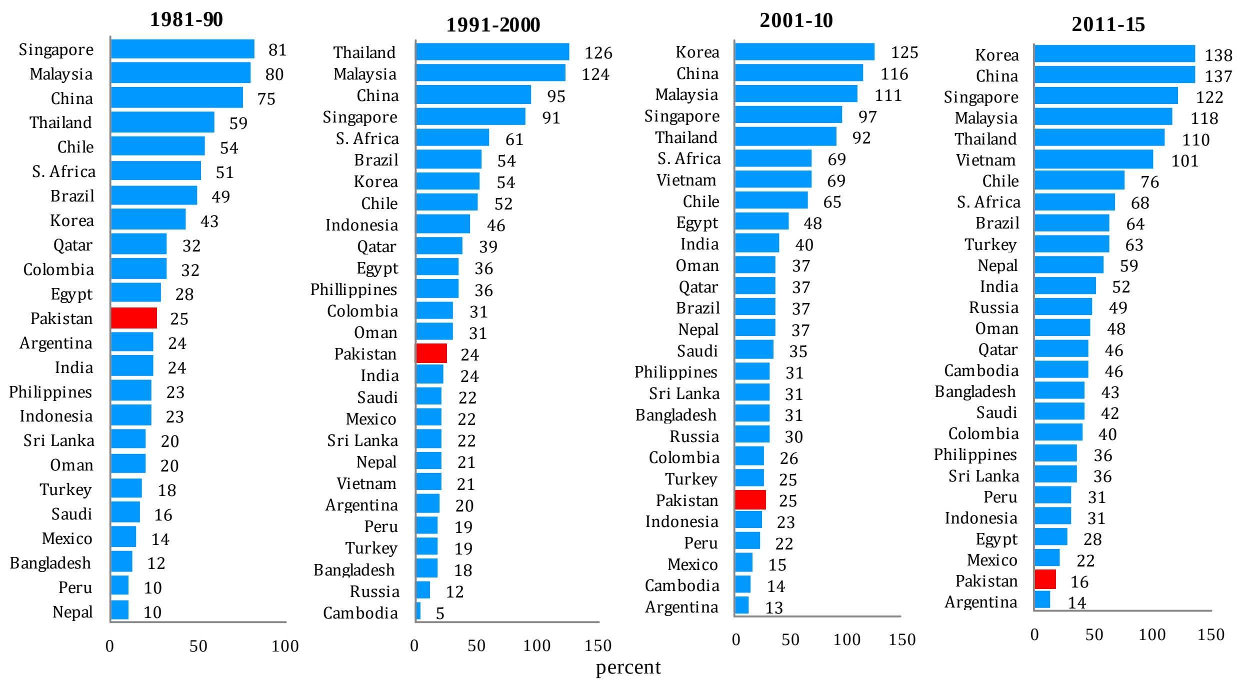
f) Credit Bubbles in EMs, Post Global Financial Crisis 19

V. Concluding Thoughts 20

I. Introduction

The penetration of bank credit in Pakistan's economy is quite low compared to regional and emerging economies; importantly, the gap is widening over time (**Figure 1**). Back in 1980s and 1990s, its standing was very much reasonable, with domestic banks making relatively deeper contribution to the economic growth process. Over the past 25 years, however, the ratio of private credit to GDP in Pakistan has shrunk even in absolute terms.

Figure 1: Pakistan's Relative Standing in Credit-to-GDP Ratio Across Decades



Source: World Development Indicators, The World Bank

The obvious inference from the trends presented above is that the overall environment for private credit growth in Pakistan appears to have deteriorated over time, and banks in the country are not effectively performing their core function, i.e. channeling depositors' savings into loans for creditworthy businesses and individuals. The repercussions have been quite overwhelming for the economy, namely, the dismal state of private investments, and financial and social exclusion of a large segment of the population. This situation begs the obvious question: did financial sector reforms – initiated in the early 1990s to reduce market segmentation, instill competition, and switch over to market-based monetary and credit mechanism – fall short of their objective? If yes, then was there a problem in their design or implementation, or was it just that their success was marred by an unhelpful macroeconomic environment? Or did the delays in structural reforms in other sectors of the economy (fiscal and debt, for instance) prove unhelpful?

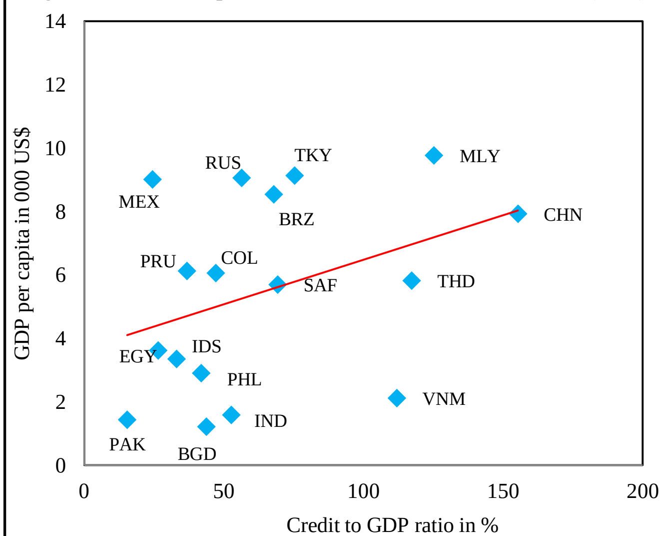
This note is an attempt to answer the aforementioned policy questions. We begin by explaining the theoretical nexus between finance and growth, and examining the role that bank credit played in the economic development of Pakistan. The discussion then moves on to teasing out factors that impeded credit growth in the country during the post-reform period; we especially pin down those which were either the direct outcome of reforms, or the ones that characterized the reform process itself. Where relevant, we share our observations on why and how other emerging markets (EMs) that implemented similar reforms were able to skirt around the kind of impediments that Pakistan faced. In presenting our concluding thoughts, we re-evaluate the coexistence of financial inclusion and stability in the country, and explain how these two complement each other. We also revisit the worth of directed lending in the country, especially given the existing ownership structure of the banking industry. Such considerations will serve as building blocks for the next generation of reforms.

II. The Finance-Growth Nexus

"...banks are the happiest engines that ever were invented for creating economic growth"
- Alexander Hamilton (1781)

Theoretically, efficient financial systems influence economic growth in the following ways: (i) channelization of savings of diverse households into investment, which reduces the transaction costs associated with external finance for both firms and households; (ii) allocation of resources to the projects with higher marginal product of capital, which increases productivity); (iii) provision of liquidity to individual investors with more profitable but illiquid projects, which reduces the premature liquidation of such high-potential investments; (iv) risk mitigation, by spreading investors' savings across many diversified investment opportunities; (v) promotion of technological innovation, by identifying entrepreneurs with new ideas of economic activity and better chances of successfully implementing them; and (vi) facilitation of trade, by extending credit and guaranteeing payments.

Figure 2: Relationship between Credit and Economic Growth (2015)



Source: World Development Indicators

This growth-enhancing role of the financial sector has widely been acknowledged on empirical grounds for well over two decades now. Levine and Zervos (1998) suggest that a developed banking sector – indicated by high proportion of bank credit to the private sector (as percent of GDP) – is a robust predictor of contemporaneous and future long-run economic growth; indeed, cross country data lends support to this idea, particularly with respect to contemporaneous growth (**Figure 2**). With regard to the channel linking finance and growth, Rajan and Zingales (1998) proposed that better developed financial markets allow firms that rely on external financing, to obtain funds at a relatively lower cost, thereby accelerating the growth of such firms. Interestingly, Demirguc-Kunt and Maksimovic (1996) contend that, in both developing and developed countries, firms tend to use internal financing to finance long term, fixed investment; the ready availability of external funds to finance short-term assets – a hallmark of well developed financial markets – simply frees up more internal resources for long term investments which can, in turn, accelerate growth.

Over time, the methodological advancements in cross-sectional, time series, and panel data methods, as well as the availability of more data points to facilitate cross-country comparison and capture within-country variations, helped unravel further dimensions of this finance-growth nexus. For instance, initial insight into the role of the legal system was provided by La Porta et al (1998), which suggests that investor protection influences financial development and ultimately growth. Levine et al (2000) built on this framework, utilizing both cross-section and dynamic panel indicators to establish that enhanced creditor rights, contract enforcement and accounting practices tend to fast-track financial development and economic growth. Importantly, for Pakistan, Levine et al (2000) provide compelling evidence that the faltering point is not the laws in themselves – which very much address creditor rights; rather, it is the lack of *enforcement* of laws and contracts which compromises financial development, and eventually growth.

Meanwhile, Beck et al (2000) attempted to drill down further into the precise source of finance-induced growth, proposing that there was a strong connection between financial development and advances in total factor productivity (TFP); however, when it comes to promoting physical capital and private savings, the study remained inconclusive over the role of financial development. This formulation was further refined by Rioja and Valev (2004), who maintained that the 'financial development begets TFP-led growth' model was applicable only to middle-income and developed countries; in low-income countries, financial development primarily tends to boost capital accumulation instead, and it is through this channel that growth is stimulated – not via TFP gains. Rioja and Valev (2014) reckoned that this distinction has important policy implications, both of which happen to be relevant for Pakistan. Firstly, the authors claim that for low-income countries pursuing growth via capital accumulation, some forms of directed lending may be a worthwhile strategy. Secondly, they maintain that channeling of finance to large firms in less developed countries may give greater returns than extending the same financing to small firms; by contrast, in developed countries – looking to achieve growth via advancements in TFP/technology – facilitating access to finance for tech start-ups and small firms has relatively greater payoffs.

III. The Role of Bank Finance in Pakistan's Economic Growth

> *"It is unlikely that economic growth of the level prevalent in the 1960s could have taken place without the active role and participation of the banking sector. This relationship was, moreover, mutually beneficial"*
>
> \- Zaidi (2015)

In the initial years post partition, while commercial banking in Pakistan was gradually holding ground, it was the country's development finance institutions (DFIs) that really propelled the industrial growth. From 1960s up to mid-1980s, these DFIs were major channels for routing development funds to the private manufacturing sector and achieving multiple socio-economic objectives, like broadening the industrial ownership, facilitating and encouraging new entrepreneurs, and providing employment opportunities in less developed areas of the country. The DFIs' main function was to provide industrial development credit finance and some agricultural finance for farm machinery and chemicals.[2] However, in keeping with import substitution policies of those times, DFIs also helped establish industries in textiles, cement, sugar, fertilizers, and petrochemicals sectors. Commercial banking industry also grew steadily in 1960s, when new banks were established and the branch network was spread out. Thus, private credit rose from only 11.1 percent of GDP in 1960 to 25 percent at end 1970 (**Figure 3**).

This momentum was disrupted by two major policy decisions that were taken in early 1970s. In fact, these decisions completely transformed Pakistan's private credit market:

(i) In May 1972, Banking Reforms were introduced, which imposed certain restrictions on lending to a single client/corporate and on the unsecured lending to bank executives. Besides, National Credit Consultative Council was set up with an objective to determine the real credit needs of the economy within the Annual Development Plan and monetary targets. Credit ceilings were prescribed for the commercial banks and it became obligatory on banks not to expand their credit beyond the limits.[3] This method of credit control left practically no room for banks to expand credit at a rate faster than what was stipulated by SBP.[4]

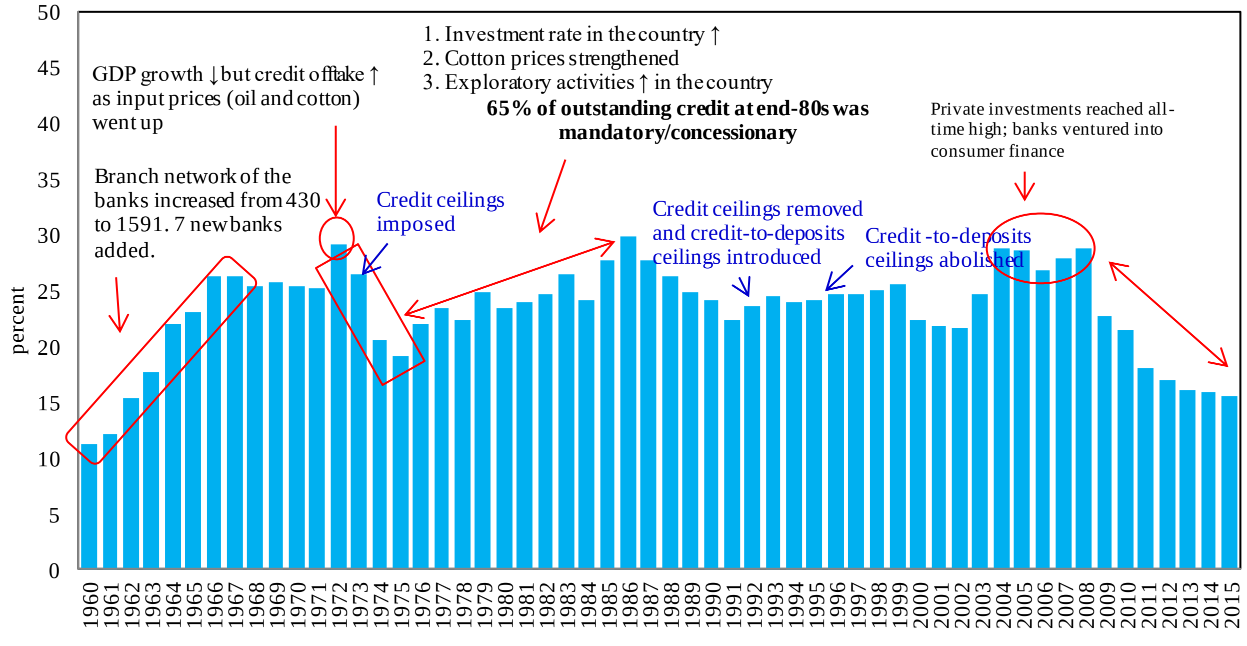
---

[2] Faruqi (2015) notes that the *newly minted* business houses like Adamjees, Saigols, Ispahanis and Dawoods got tremendous support from DFIs on the back of their characterized "transparency, accredited accountability, proven creditworthiness, profitability, sound management and solid performance all around."

[3] An important feature of credit ceilings was the imposition of separate credit limits prescribed for public sector enterprises and the private sector, taking into account their respective weights in the economy, their investments targets and the anticipated value-addition as projected in the Annual Plan.

[4] Since this measure only tackled the issue of *amount* of credit, it had least influence on the use and direction of credit in the economy. Credit ceilings on individual banks were first imposed in FY68 and this system of regulating credit remained in force till late FY71. These ceilings were re-imposed in October FY73 and since then (till July FY92) banks were being given quarterly limits up to which they could expand their credit.

Figure 3: Private Credit as percent of GDP



Source: Haver Analytics

(ii) In early 1974, major banks were put under the direct control of the government. The key objective of this nationalization was to direct banking activities towards broader socio-economic objectives of the country and also to protect depositors' funds. In addition, SBP prescribed annual mandatory targets for commercial banks, for production loans, tobacco marketing and loans both for production and development for small farmers. Simultaneously there were targets for fixed investments and refinancing of loans under locally manufactured machinery (LMM) and agro based activities.

What happened thereafter is a no-brainer. The banking industry experienced every form of government intervention – from administrative controls to asset portfolio management – in its day-to-day business. Banks began to lose on efficiency grounds due to excessive bank funding of budgetary deficits; suboptimal governance structures in predominantly government-owned banks; poor recovery of loans handed out on politically-motivated grounds[5]; burden of high taxes on the financial sector; and excessively high lending and low deposit rates.

Irrespective of these inefficiencies, the level of private credit-to-GDP ratio posted a steady increase, as the country witnessed high investment growth. From September 1977 onward, the government denationalized several agro-based industries and some small engineering units, while the Fifth Five-Year Plan launched in 1978/79 also consolidated efforts to boost investment and bring the private sector back into the forefront of economic activity (Zaidi, 2015).[6] However, since banks were directed to lend to certain sectors not on the basis of project viability, but on the basis of social returns, not all the credit was being lent out for productive

[5] Based on data for Pakistan between 1996 and 2002, Khwaja and Mian (2005) "show that politically connected firms receive substantial preferential treatment. Not only do such firms receive 45 percent larger loans, but they also have 50 percent higher default rates on these loans. Moreover, this preferential treatment is entirely driven by loans from government banks".

[6] The investment focus of the Fifth Five-Year Plan prioritized "producer and investment goods industries, with industry based on indigenous raw materials next in line. Apart from bringing back the private sector, the stress on the use of indigenous raw materials in industry was also seen as important to revive the sluggish performance of the agricultural sector" (Institute of Developing Economies, 1994, cited in Zaidi, 2015).

investments. This view gains support from the fact that nearly 65 percent of the outstanding credit was mandatory and/or concessionary at end-1980s.[7] More importantly, it was difficult to ensure that the credit was being used by intended (though unproductive) beneficiaries; since a large segment of the banking industry was state-owned, and continued to remain so till mid-1990s, some element of politically connected lending could not be ruled out. The subsequent deterioration in the asset quality of banks speaks volumes of this phenomenon.[8] Not only did the poor asset quality heighten the solvency risk for the banking industry, it also restricted the earning capacity of banks.

Taking stock of such dismal credit conditions, the government and SBP instituted a sweeping range of reforms aimed at financial liberalization and deregulation in the early 1990s. The reforms mainly encompassed privatization of state-owned commercial banks, corporate governance, capital strengthening, asset quality, liberalization of foreign exchange regime, legal reforms, prudential regulations, e-banking, credit rating, payment systems, supervision and regulatory capacity, and human resources. From the perspective of private credit growth, a number of measures were taken including: a steep fall in SLR requirements that let up significant amount of liquidity at the disposal of banking sector; removal of mandatory credit requirements (again freeing up liquidity for private lending); relaxation in licensing procedures for micro and rural credit institutions; removal of restrictions on consumer financing by nationalized banks; incentives to provide mortgage finance; and, most importantly, improvement in the legal framework for the recovery of defaulted loans. Clearly, the idea was that credit allocation would improve if left to market forces.

IV. Financial Sector Reforms: What went wrong?

The foremost fallout of financial sector reforms was that DFIs gradually faded into the background. As highlighted earlier, these institutions had been integral to the country's development in the past, particularly with respect to the development of industry and, to a lesser extent, agriculture. However, despite their earlier successes, the broad restructuring in the late 1990s saw the industry size shrink from 10 DFIs in 1997 to only 6 by end-2004 (SBP, 2004).[9] Crucially, the void that resulted from this contraction was not adequately filled.

That said, it is important to acknowledge that in terms of achieving efficiency and strengthening the financial health of the banking industry, the reform process was indeed beneficial. Hardy and Patti (2001) evaluated profitability and efficiency of Pakistan's banking system by estimating efficiency frontiers relative to the best available practice; they noted that the reform process allowed Pakistani banks to make progress in improving cost efficiency and expanding their revenue base. Similarly, using non-parametric data envelopment analysis, Ahmed (2011) concluded that the second phase of reforms was particularly helpful in improving the commercial banks' efficiency – especially the pure technical efficiency – in Pakistan.

In terms of credit allocation also, the banking industry took leaps from early 2000 onwards and significantly expanded the menu of services offered. For instance, banks aggressively took up the business of consumer finance and within a short span of time developed a reasonable customer base.[10] SME finance was another area where banks keenly ventured in. In hindsight, this active pursuit of banks for financing avenues in non-traditional sectors was quite likely the direct outcome of a huge influx of liquidity in the system in the aftermath of 9/11 – more so, because such an aggressive approach was non-optional: in the presence of the

[7] Source: SBP's Financial Sector Assessment Report 1991-2000.

[8] While gross NPLs to advances ratio was already high at 17.6 percent in 1990, it increased further to 22.0 percent by end 1999.

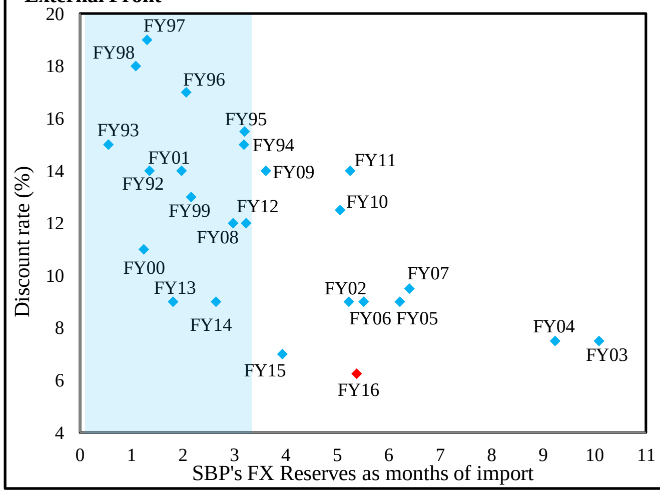
[9] Within DFIs, Banker's Equity Limited was initially privatized in 1996 and subsequently liquidated in 1999. Meanwhile, the National Development Finance Corporation (whose equity had turned negative in 1999 after heavy losses in second half of 1990s) was merged with National Bank of Pakistan in 2001 (SBP, 2002). In addition, Regional Development Finance Corporation and Small Business Finance Corporation – which were both serving the SME sector – were merged to create SME Bank in 2002. Among the few DFIs which survived this period of broad restructuring was the Pakistan Industrial Credit and Investment Corporation Ltd (PICIC) – which was the first DFI to be formed in 1957 with the help of the World Bank – and some foreign sponsored DFIs, which had generally performed better on the back of "strong support of their sponsors, sound capital structure and consistent profitability" (SBP, 2004). However, PICIC was also privatized in 2007.

[10] The share of consumer finance in total bank finance increased from only 9 percent at end 2004 to 14 percent by end 2007.

government's subdued appetite for budgetary funding, banks were desperate to park their funds anywhere.[11] An important role around this period was played by easy monetary policy that ensured an ample demand for bank loans.

However, things began to change course from 2008 onwards, following the deterioration in the overall macroeconomic and investment climate. Not only did the global financial crisis (GFC) trigger a sense of uncertainty, but the growing security concerns and energy shortages in the country significantly dented domestic business prospects.[12] Importantly, and despite these conditions, counter-cyclical macroeconomic policies could not be deployed as vulnerabilities in the external sector had been morphed into a full-blown BoP crisis (by mid-2008). For the next 5 years, interest rates remained in double-digits contributing to an anemic credit growth. This pattern of unraveling was quite familiar, as was its fallout: repeated strains on Pakistan's balance of payments and a subsequent recourse to demand compression and stabilization policies over the years (prescribed primarily by the IMF) have time and again undermined the envisaged market-based interest rate determination which was a key component of deregulation and liberalization measures (**Figure 4**).

Figure 4: Accomodative Monetary Policy Needs Comfort on the External Front



So a case can be made that had the macroeconomic environment remained favorable, banks might have consolidated upon initial gains in the post-reform credit market. Probably this is true; but first, it is important to set two things straight. One, the macroeconomic environment does not evolve on its own, but is inevitably influenced by the broader economic management. When weaker links in the economic structure remain unaddressed for long, these nullify potential gains stemming from more efficient sectors. And two, the extent of counter- or pro-cyclicality in bank behavior (lending decisions) is governed by the regulatory and legal environment under which they operate; this environment in turn was to be shaped by the reform process.

Simply put, we cannot say that the credit momentum of 2004-07 was lost entirely due to 'exogenous' developments in the macroeconomic environment which were entirely beyond our control to foresee or prevent. It would be more accurate to concede that incomplete reforms left the macro economy vulnerable to shocks, and this inherent fragility was duly exposed from 2008 onward. Essentially, the reform process was found wanting on some key dimensions, mostly on account of unintended consequences, implementation gaps, and improper sequencing of interventions. The same are discussed in the following subsections:

[11] Not only was the budget deficit subdued during the FY01-FY07 (only 3.7 percent on average compared to 6.2 percent during 1980s and 1990s), but the ample availability of external funding significantly reduced the financing burden on banks.
[12] The annual investment rate (as percent of GDP) declined from 18.8 percent on average during FY00 to FY08 to only 15.5 percent during FY09 to FY17. At its peak, the investment rate had been as high as 20.6 percent in FY06.

a) <u>Reforms Overlooked the Inclusion Dimension – the liability side</u>

> *"At the end of 1989, a reform program was initiated to reduce market segmentation, instill competition, and switch over to market-based and relatively more efficient monetary and credit mechanism. However, this reform process gathered momentum since 1997, when a crucial set of reforms aiming at institutional strengthening, restructuring of banks and DFIs, and improvement in regulatory framework was introduced."*
>
> \- SBP Financial Sector Assessment Report, 2000

Financial sector reforms that were launched in Pakistan in early 1990s were focused primarily on strengthening the regulatory framework and improving the overall stability profile of the banking industry. **Improving depth was also at the forefront, but this was considered almost a *certain* outcome of anti-repressive measures like the privatization of financial institutions; liberalization of interest rates; and the termination of credit controls and mandatory lending. What was missing from the agenda was a deliberate policy push to ensure access of individuals and businesses to useful and affordable financial products and services.**

In fact, if we dig a little deeper, we would find that the restructuring of financial sector was actually disadvantageous from the inclusion standpoint – at least in the beginning. Specifically, an expected outcome of privatization was that banks would take several cost cutting measures to improve their bottom lines; this meant downsizing and closure of loss-making bank branches. Between June 1997 and 2004, as many as 1,656 bank branches and 4.7 million accounts were closed down – around 4.1 million were small sized accounts (i.e., < Rs 5,000).[13] In subsequent years, **although banks expanded their outreach and opened up new branches, their penetration in the un-banked areas remained scanty. As a result, the number of small-sized accounts shrank by another 3.1 million between 2004 and 2015.[14] In effect, the efficiency in Pakistan's banking industry improved *inter alia* at the cost of inclusion.** Thus, it is not surprising to see that the ranking of the country's financial institutions in terms of efficiency is far superior to its ranking in terms of access (**Table 1**).

Table 1: Pakistan's Ranking in Financial Development (2013)

Financial Institutions Access						Financial Institutions Efficiency					
Rank	Country	Score	Rank	Country	Score	Rank	Country	Score	Rank	Country	Score
2	Brazil	1.000	100	China	0.316	3	Japan	0.749	40	Sri Lanka	0.667
15	Japan	0.869	106	Sri Lanka	0.284	4	China	0.747	43	Bangladesh	0.66
28	Korea	0.700	107	Bhutan	0.278	7	Malaysia	0.726	48	Myanmar	0.645
36	Greece	0.640	119	Philippines	0.207	11	Korea	0.711	49	Philippines	0.644
38	Thailand	0.633	120	India	0.198	18	Singapore	0.692	**52**	**Pakistan**	**0.642**
44	Turkey	0.578	126	Vietnam	0.15	23	U.A.E.	0.69	53	Indonesia	0.641
72	Argentina	0.428	129	Nepal	0.135	28	Vietnam	0.684	68	South Africa	0.609
78	Mexico	0.404	**130**	**Pakistan**	**0.134**	30	Nepal	0.681	103	India	0.534
80	Singapore	0.4	135	Bangladesh	0.12	31	Thailand	0.68	114	Turkey	0.515
83	Malaysia	0.395	137	Egypt	0.11	34	Egypt	0.676	125	Kenya	0.502
98	Indonesia	0.321	138	Kenya	0.11	36	Bhutan	0.673	137	Argentina	0.484

Source: IMF Working Paper (Svirydzenka, 2016)

Here it must be pointed out that not only in Pakistan, but on the global level also, the realization of the importance of financial inclusion came quite late. Most emerging countries who took up a financial reform agenda had taken their cues from the IFI-led financial sector assessment programs that were rolled out in the

[13] Source: Banking Statistics of Pakistan, Handbook of Statistics on Pakistan Economy – 2015 (SBP)

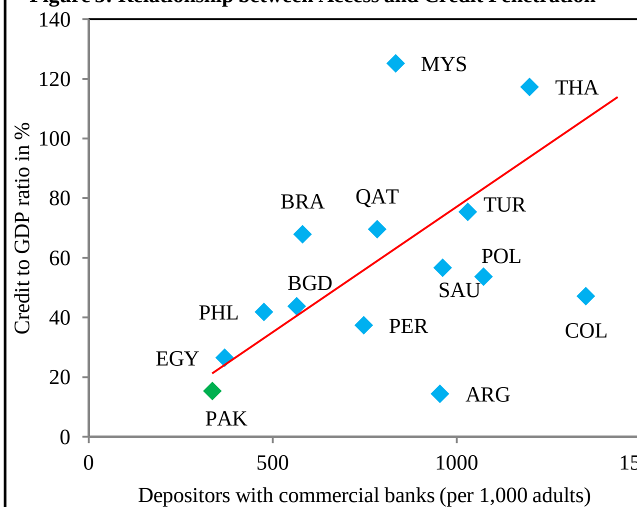
[14] The number of small depositors declined in spite of measures taken by the SBP, which included: regulation preventing banks from refusing to open accounts for prospective clients; provision of free services by banks for the opening and maintenance of regular savings accounts; exemption from maintaining a minimum balance for such accounts; no charges to be required by banks at the time of account closure etc. (Zaidi, 2015, pp 406).

aftermath of the 1997 Asian financial meltdown.[15] These programs were primarily focused on identifying financial system's vulnerabilities; strengthening supervision; risk management; and ensuring market competition. Inclusion was repeatedly ignored as regulators were skeptical due to higher credit risks and lack of documentation associated with small borrowers.[16]

That said, the important distinction in case of Pakistan is that the state of financial depth and access in the country is much worse than other emerging and regional economies. **Pakistan has one of the lowest proportions of adult population with access to a transaction account, and one of the highest ratios of currency to deposits.** It does not imply that households in Pakistan necessarily spend more and save less, but that their savings are mostly in the form of physical assets like livestock, gold, hard cash, and real estate; the culture of financial savings has failed to catch on in the country over the years. This had two major implications for credit penetration. Firstly, the deposit base of banks did not grow the way it did in other EMs, which limited the pool of loanable funds available with banks. And secondly, a large segment of the population failed to develop its banking history. The second point merits further discussion, as this represents the basic premise of financial inclusion.

Having a basic transaction account with commercial banks is considered as the first step towards broader inclusion. Developing a *basic* relationship between bank and customers opens up a room for additional services like funds transfers and credit. Importantly, this can overcome the lack of credit history in the unbanked and underserved segments of the economy. **More specifically, small businesses and individuals with no *credit history* and coverage in credit registries can at least start building their *banking history* by opening and using basic accounts.** Gradually, this banking history, coupled with other innovative techniques,[17] can be used by banks in evaluating their credit worthiness. In this context, it is not surprising to see a strong positive correlation between access of population to financial services and credit penetration across countries (**Figure 5**). That said, there are some exceptions like China, Vietnam and Thailand that have been able to increase credit depth in their economies without necessarily being inclusive. In their cases, other factors made up for this lacking, like a dominant role of the state in directing and allocating bank credit in various sectors of the economy (more on this later). In case of Pakistan, such recompense was missing.

Figure 5: Relationship between Access and Credit Penetration



Source: World Development Indicators

[15] Interestingly, the concept of financial development itself was devoid of inclusivity. It was not until the mid-2000s, that the concept of financial inclusion started gaining some traction and eventually became one of the key pillars of the broader financial development. Not only that, but the concept of inclusion was also given a broader perspective: initially the concept was focused almost entirely on credit; later on, it started giving equal emphasis to deposit taking, insurance and other services. In 2008, the World Bank Group declared the achievement of universal financial access by the year 2020 as its inspirational goal.

[16] Khan (2011) cited a number of ways in which increased financial inclusion can contribute negatively to financial stability. The most obvious example is if an attempt to expand the pool of borrowers results in a reduction in lending standards. Second, banks can increase their reputational risk if they outsource various functions, such as credit assessment, to reach smaller borrowers. Finally, if MFIs are not properly regulated, an increase in lending by that group can increase financial system risks.

[17] Innovative firms can leverage big data analytics – based on mobile phone usage and activity on social media platforms like Facebook, Twitter and LinkedIn – to lower the information costs of determining whether applicants with little to no prior credit history are creditworthy (Costa & Ehrbeck, 2015).

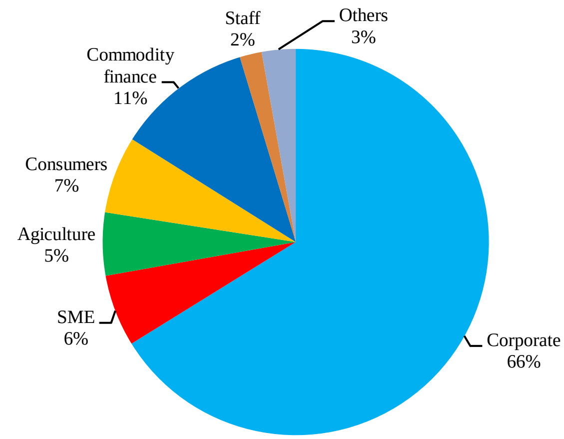
b) Stringent Rules and Scrutiny Dented Inclusivity – the asset side

"Although aggressive lending to areas other than the corporate sector has helped banks in diversifying their loan portfolio, concentration risk as evidenced by the proportion of lending to top 20 corporate borrowers continues to be an overriding concern. Furthermore, only 0.5 percent of the total number of bank borrowers with loans sizes of more than Rs 10.0 million each, utilize 71.7 percent of banks' aggregate loan portfolio".

\- Financial Stability Review, SBP 2008-09

In Pakistan, the growth in bank credit depends heavily on the credit appetite of the corporate sector, which currently receives nearly 70 percent of the total bank lending (**Figure 6**). While the overall investment climate in the country (that encompasses business cycles, macroeconomic stability and policies) does shape broad credit conditions in the economy, leveraging decisions of these corporates set off actual credit expansion. There are several repercussions of this heavy concentration: (i) in focusing exclusively on the corporate sector, banks have marginalized other niche segments like SMEs, agriculture and housing; (ii) systemic risk for banking system has increased, as reflected in its concentration on few conglomerates (banks have an exposure of 30 percent on only 20 business groups in the country); and (iii) the overall credit growth in Pakistan has remained subdued as a number of big, cash-rich conglomerates have increasingly begun using their own resources to fund growth, rather than borrowing from commercial banks.

Figure 6: Break-up of Advances of Scheduled Banks in Pakistan - end June 2016



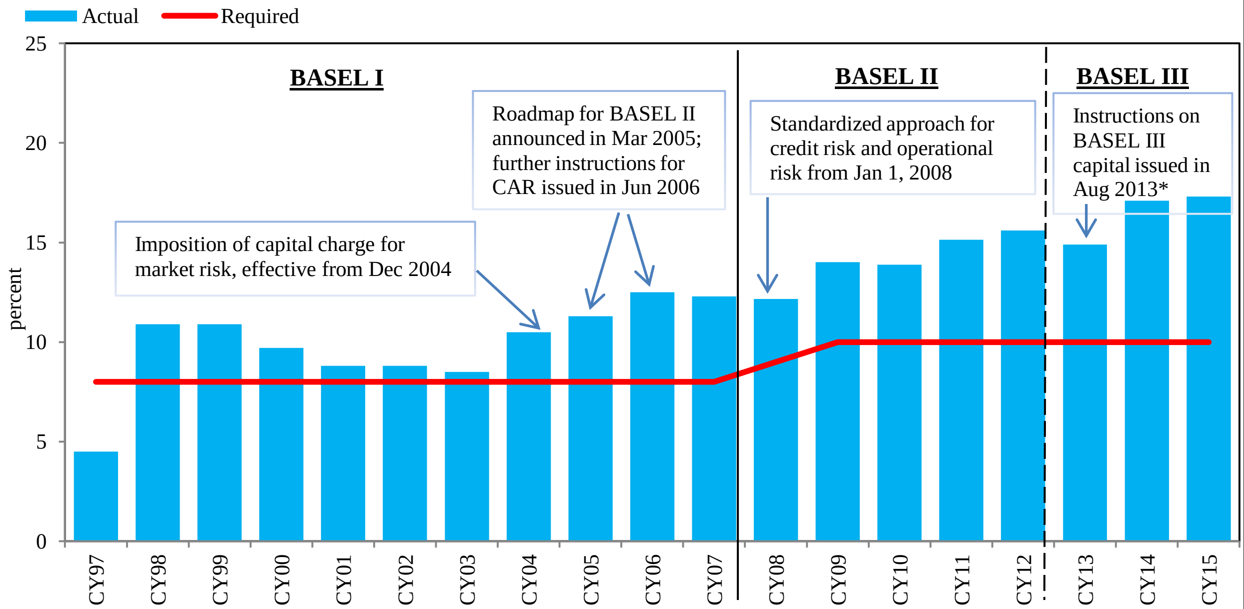
Source: State Bank of Pakistan

In our opinion, three major factors explain such a large concentration of banks on corporate sector: (i) stringent capital requirements; (ii) weak process of recovery and write-off of bad loans; and (iii) a passive attitude of banks towards development finance. Firstly, following the adoption of Basel framework, SBP imposed risk based capital requirements under which banks were required to maintain capital no less than 8 percent of their risk-weighted assets. Initially, the guidelines set by SBP accounted for banks' credit risk only;[18] later on, in 2004, the guidelines were revised to account for market risk as well, by specifying the criteria for the calculation of risk-weighted assets (**Figure 7**).[19]

While these regulations have certainly improved the stability outlook of Pakistan's banking sector, it can be argued that higher capital requirements may have dissuaded banks to lend to private sector, especially to those sectors that carry high default risk due to inadequate collateral and/or uncertain cash flows. The above argument is also supported by the available empirical evidence which suggests a potential role for bank capital regulation in determining banks' lending decisions.[20] Certainly, this relationship may vary across countries – and over time – depending upon the overall macroeconomic environment; the extent of market failures (especially asymmetric information); substitutability of competing assets, etc. In case of Pakistan, apparently all the factors turned the tide against the private sector.

[18] Vide BPRD Circular No. 36 of November 4, 1997
[19] Vide BSD Circular No. 12 of August 25, 2004
[20] For example, Macroeconomic Assessment Group (2010); Basel Committee on Banking Supervision (2010); Slovik, P., Cournède, B., (2011); Elliott, D., Salloy, S., Oliveira Santos, A. (2012); Miles, D., Yang, J., Marcheggiano, G. (2013); Oxford Economics (2013); and Cohen and Scatigna (2015). Detailed references are provided at the end of the Note.

Figure 7: Capital to Risk Weighted Asset Ratio of Banks in Pakistan



* As part of the phased implementation plan, the requirements for capital adequacy ratio (CAR) and capital conservation buffers are to be gradually raised from 10.0 percent to 12.5 percent by Dec 31, 2019

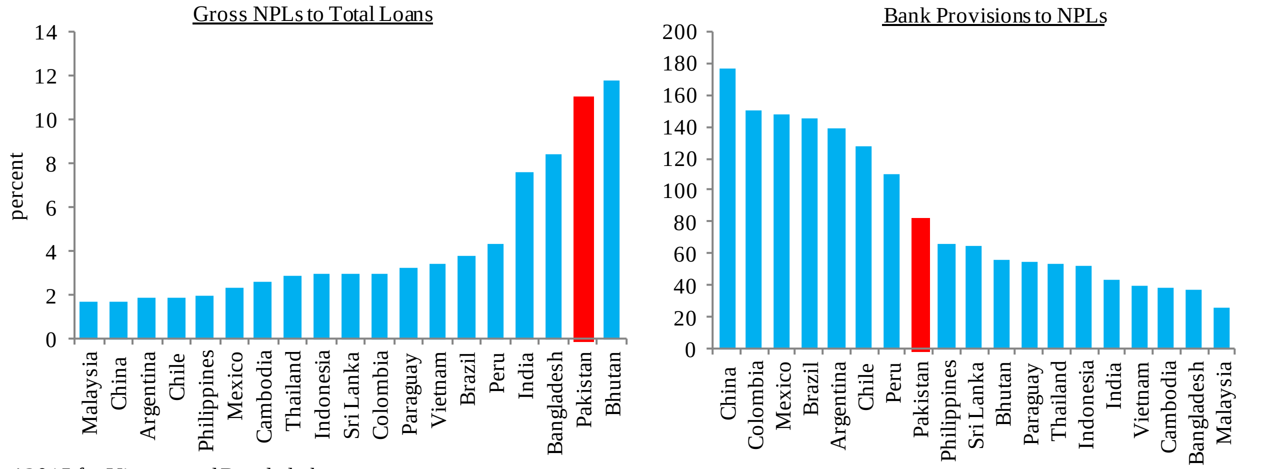
Source: State Bank of Pakistan

Secondly, weak implementation of foreclosure laws has dampened lending in sectors where the provision of collateral should have helped allay banks' concerns – most notably mortgage lending. While foreclosures are discussed later in detail, suffice it to say here that recovery of bad loans has historically been an arduous, time-consuming, and costly task in the country. **As for loan write-offs, bouts of judicial activism in the country have intimidated banks from cleaning up bad loans from their books, although on regulatory grounds, it is permissible for them to make such write-offs.**[21] In some respects, judicial activism itself mirrors a lingering perception in society that loan write-offs are often suspect, rather than a routine course of business as far as bank lending is concerned. **It is quite possible that this perception is a continuing legacy with roots in the pre-reform era, when lending and write-off decisions made by public banks periodically came under fire for being motivated by political, rather than economic, considerations.**

As a result, banks have been unable to clean up their balance sheets from irrecoverable loans over the past few years. A large chunk of irrecoverable loans remains on banks' books, especially those which were classified in the aftermath of the 2008 crisis; this is reflected in a much higher infection ratio in assets of Pakistani banks compared to banks in other developing countries (**Figure 8**) [importantly, however, this does not represent a major solvency risk for domestic banks, as most of these bad debts have already been provided for: by end December 2016, banks' coverage ratio had reached 85 percent – higher than most Asian countries. A very low *net* NPLs ratio (1.6 percent at end December 2016) also signifies the same].

[21] Vide BID Circular No. 4/94 (dated 5th July 1994), banks were allowed to make write-offs against bad/irrecoverable loans themselves, with the approval of their respective Board of Directors. Previously, for cases exceeding Rs 0.50 million for branches of foreign banks and Rs 1.5 million for all other banks, the banks were required to obtain approval for write-offs from SBP's Banking Inspection Department (as prescribed by BID Circular No. 3/93, dated 22nd September, 1993).

Figure 8: Cross-country Comparison of Gross Non-Performing Loans and Provisioning Thereof (2016*)



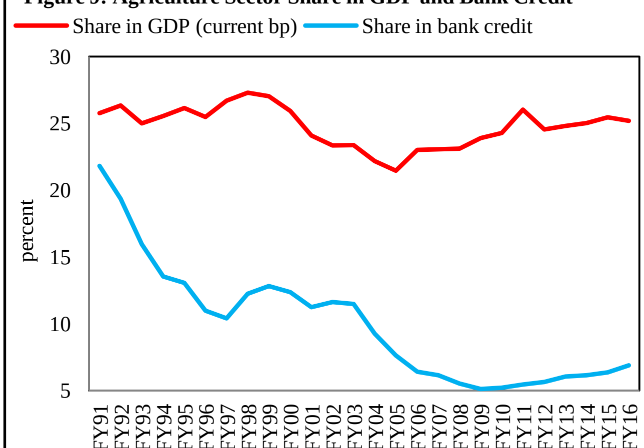
*2015 for Vietnam and Bangladesh

Source: Global Financial Stability Report

Thirdly, and probably as a result of the above two factors, banks' attitude towards underserved sectors of the economy can best be described as aloof. Especially since 2008, banks have been averse to lending to non-corporate sector, even though the loan demand from corporate sector was also not forthcoming. This was because, unlike the period 2001-07, banks had an access to a profitable avenue from 2008 onwards where they could park their liquidity: voracious government appetite for bank funding (discussed in sub-section **IV.e**). In effect, treasury operations have lately become central to banks' money making, whereas lending operations have become secondary.

Agriculture has been one such sector that seem to have hurt from banks' cautiousness; as shown in **Figure 9**, while the share of agriculture in Pakistan's GDP continued to hover around 25 percent since FY91, its share in the overall bank credit has dropped quite sharply through this period. Loans to SMEs have also met a similar fate; while estimates put their contribution to Pakistan's GDP between 30 and 40 percent, these enterprises get only 6 percent of the bank credit.

Figure 9: Agriculture Sector Share in GDP and Bank Credit



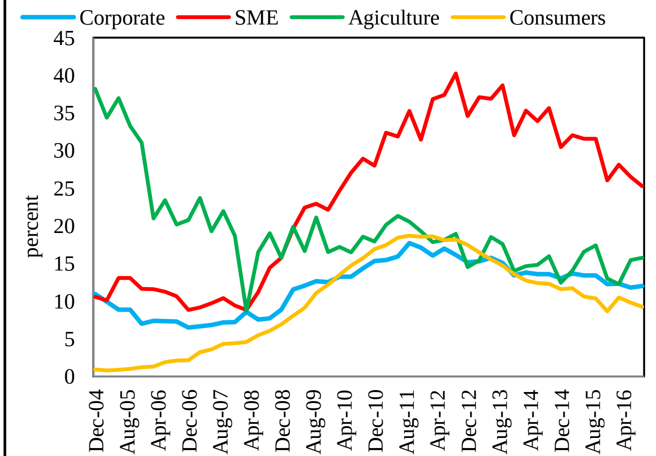
Source: SBP and PBS

In case of SMEs, an important distinction has been a very high loan delinquency that banks faced between FY08 and FY13; severe energy shortages in the country, and slowdown in both domestic and international economy had a very strong, negative impact on financial position of SMEs, which led to a rise in default rates (**Figure 10**). Since then, banks have been extremely cautious in lending to this sector, prompting domestic institutions and IFIs alike to place special emphasis on the SME sector in their development agendas.[22, 23]

[22] Encouragingly, steady progress has been made to counter these deficiencies via SBP's targeted interventions, including (but not limited to): (i) Credit guarantee schemes: The main aim of credit guarantee schemes is to encourage participating financial institutions to extend collateral free loans to segments of the population which would otherwise face severe constraints in obtaining access to finance; (ii) Livestock insurance scheme: provides a risk-mitigating tool to encourage banks to extend credit to underserved livestock farmers. The scheme also safeguards farmers from losses incurred due to death of animals under exceptional circumstances. (iii) Capacity building/awareness programs.

That said, commercial banks might blame low credit activity on demand-side factors as well – a stance which is not completely unfounded. In the Access to Finance (A2F) Survey 2015, a majority of unbanked respondents (53 percent) identified a lack of knowledge about banks and bank accounts as the key obstacle to account ownership.[24] Regarding credit, only 14 percent of respondents cited bank loans as a prime source of credit, although this was up from 3 percent in the comparable A2F 2008 survey. Instead, majority of respondents (56 percent) preferred to obtain credit from neighbors and friends.

Figure 10: NPLs as percent Total Loans - Sector wise



Source: State Bank of Pakistan

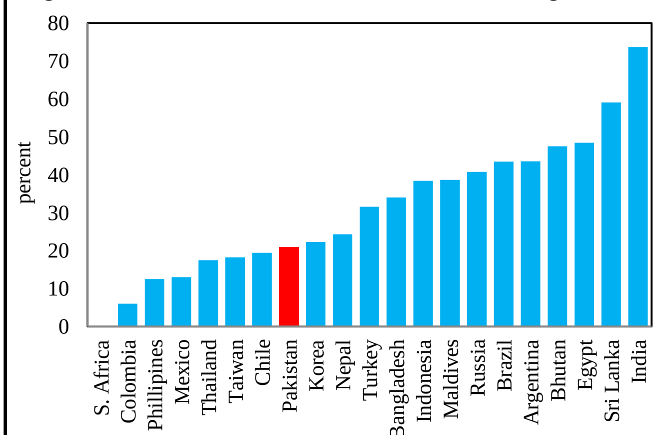
c) <u>State Interventions are Still Common in Other EMs</u>

"Pakistan is one of the few developing countries where the public sector banks went to the private hands in a very short span of time."

- Dr Ishrat Hussain, ex-Governor SBP

One common factor in all financial reform programs across countries was the deregulation and privatization of financial institutions. The government ownership of banking system's assets has declined in the developing world over the past few decades. From an average of 67 percent in 1970, the share of state-owned banks relative to the total assets of banking system has fallen to only 22 percent in 2009. However, in some countries like China, India, Egypt, Sri Lanka, Vietnam and Bhutan, the state-owned banks still dominate nearly half of banking assets (**Figure 11**).[25] Their presence in Brazil, Argentina, Indonesia, Bangladesh, Russia, and Turkey is also prominent, with shares ranging between 30 to 40 percent of banking assets. In Pakistan, however, the share of state-owned banks has been reduced drastically from 90 percent in 1990 to only 20 percent by end 2015.

Figure 11: Share of State-owned Banks in Overall Banking Assets



Source: Bank Regulation and Supervision Survey presented in the Global Financial Development Report 2013, The World Bank

The reason why EMs continued with a large size of state-owned banks is because these institutions fulfill development roles by compensating for market imperfections, especially in the provision of long-term credit, infrastructure finance, and access to finance for underserved sectors like SMEs and agriculture. Furthermore, empirical evidence

[23] The World Bank Group (WBG) country partnership strategy for Pakistan for the period FY2015-19 aims to "increase access to finance for (micro, small and medium enterprises) MSMEs by 25 percent with a focus on women borrowers… WBG would also seek to increase overall financial inclusion by 10 percent..." This would include support to strengthen credit information, product development for MSMEs, assistance for businesses and support for commercial banks to increase access to finance for SMEs via guarantees.

[24] Only 7 percent of non-banked respondents in A2F 2015 survey cited conflict with personal beliefs as the reason for not having a bank account, which debunks the popularly held notion that religious considerations (a stigma attached with interest) holds individuals back.

[25] In case of Vietnam, this information has been taken from "Vietnam Financial Sector Assessment, Strategy and Roadmap" prepared by Asian Development Bank dated July 2014.

suggests a low responsiveness of lending operations of state owned commercial banks to economic fluctuations (Duprey, 2015). Particularly in the periods of economic downturn, public banks are able to cut back on their new loans to a lesser extent when hit by a negative macroeconomic shock; however, as the size of the negative shock increases, the ability of public banks to absorb the shock reduces. The so-called agency cost and embedded inefficiencies in their operations has been the major reason why a reduced role of public banks is pursued in reform programs.

A somewhat related indicator of the extent of liberalization is the mandatory lending to priority sectors. In the post-reform period, **Pakistan withdrew from the use of directed credit, but this practice is still in place, in various forms, in a number of Asian countries**. For instance, banks in India are directed to lend to the so-called priority sectors no less than 40 percent of their total loan portfolio.[26] In Brazil, the earmarked lending constitutes nearly half of the overall bank credit;[27] importantly, banks are required to direct 65 percent of the liquidity from savings accounts for housing finance – of this, 80 percent of loan value is at subsidized interest rates.[28] Similarly in Indonesia, 20 percent of banks' total credit portfolio must be allocated to SMEs. In Thailand, banks' allocation of credit to SMEs must equal at least 20 percent of their deposits. In Philippines, lending to SMEs must constitute at least 8 percent of the lending portfolio.[29]

This raises an important policy question: in the presence of deeply ingrained credit market failures, has Pakistan liberalized the banking industry too much? The answer is not straightforward. It is true that by intervening directly in the credit market, the government could have mandatorily directed needed credit to sectors that are considered unworthy in the eyes of commercial banks. But this would have come at a huge cost from efficiency and productivity standpoint.

Meanwhile, there remains a debatable element to the efficacy of such approaches: even among countries that have achieved economic growth in the presence of directed credit, there is some resistance to the idea of forced lending. India is a classic example of this phenomenon. Priority sector lending (PSL) was a key element of the country's financial reforms during the 1990s, and continues – with some modifications – even today. Yet, despite the fact that GDP growth in India averaged around 6.5 percent in the twenty-five years from 1991-2015, the PSL element has been criticized on the grounds that the country's performance could have been *even*

[26] This requirement is in place since 1980, when commercial banks were advised to raise the proportion of their advances to priority sector to 40 percent of aggregate bank advances by March 1985. These priority sectors included agriculture, micro and small enterprises, education, microcredit, housing, export credit to certain sectors, etc. Some sub-targets were also specified for lending to agriculture and the weaker sections within the priority sector. Since then, there have been several changes in the scope of priority sector lending and the targets and sub-targets applicable to various bank groups (source: Reserve Bank of India https://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=9815)

[27] In Brazil, the government intervenes in the credit market through government-owned banks and earmarked loans. Firms may receive earmarked loans through programs designed to stimulate investment, exports or agriculture, among others. Those loans are either directly granted by government-owned banks or channeled via private banks. Earmarked loans for investment and exports are either granted directly by the Brazilian National Development Bank or channeled to commercial banks, which select their recipients. Interest rates charged on those loans are regulated and are substantially lower than those charged in the non-regulated loans market. Government-owned banks also participate in the non-regulated loans market, but, on average, charge lower rates than their private competitors (source: Bonomo and Martins, 2016).

[28] If sufficient demand is not available for housing loans, banks are required to place non-invested liquidity with central bank of Brazil; this typically becomes the source of loss for financial institutions. Therefore, some institutions actually end up giving credit to customers with higher risk, thereby increasing the probability of default. Source: IDB (2011) and IMF (2013).

[29] In retrospect, the government-directed priority sector lending has a history in Asian region. High performing Asian economies (HPAEs) leveraged this approach to good effect in the latter half of the 20th century. These HPAEs tended to have strong civil services and professional public institutions, which channeled funds on the basis of economic (rather than political) criteria (Birdsall et. al, 1993). Innovative and export-oriented firms were given preference, and borrowing firms were effectively monitored as a safeguard against non-performing loans. Moreover, selection of such firms for government lending programs often served as a signal for private financial institutions to extend incremental funds, resulting in a net rise in investment. That said, not all directed schemes were successful. The saving grace for HPAEs in instances where directed credit did not deliver desired results was that their governments were quick to disband the programs in the face of failure and reorient their approach. The failures also underscored a key point: directed credit schemes are not a one-size-fits-all approach, and need to be tailored to the specific needs of each economy

better in its absence.[30] Similarly, weaknesses in Vietnam's financial sector are also seen to be emerging from excessive state interventions in banks' credit and investment decisions.[31]

The above discussion suggests that there is a possibility that Pakistan might have achieved greater credit depth if it continued with direct state interventions in credit allocation, but that would have been a compromise on the overall financial stability. Essentially, financial liberalization and repression tend to have their own set of trade-offs; neither regime is necessarily a panacea for developing countries. Given that Pakistan's financial system has experienced efficiency and stability gains under the liberalized regime – notwithstanding the fast pace at which reforms were ushered in – it appears that the country has not over-extended itself, in terms of the extent of reforms. As such, there is no need to roll back measures; what is required instead is fine-tuning.

The next task is to make it more conducive for banks to lend to currently excluded segments so that, rather than being orchestrated by top-down directives, the drive for inclusion is premised on underlying, favorable economics. To this end, branchless banking and information and communication technologies (ICT) offer banks the means to attract and serve niche clientele in a cost effective manner, and their disruptive potential can reshape the banking ecosystem.

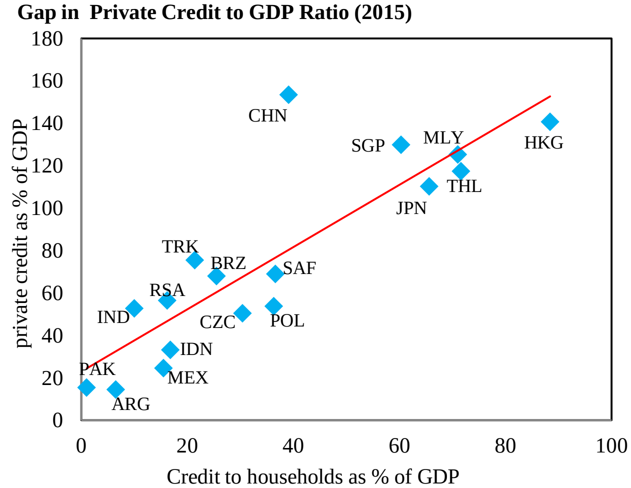
d) Delayed Enactment of Non-judicial Foreclosures Proved Costly

"In Pakistan, nonperforming assets have been plaguing the banking system, notably because of an inefficient judicial system for recovering defaulting loans (encumbered courts)."

- Chiquier and Lea (2009)

An important characteristic of countries with high credit penetration is the access of households to bank credit (**Figure 12**). Mortgages, in particular, hold a dominant portion of overall private credit in a number of Asian countries like Korea, Singapore, and Malaysia, where the overall household debt ranges between 60 percent and 80 percent of GDP. In Thailand, mortgage ratios are high but most of the household lending is for consumption purposes (i.e., car loans and credit cards). Banks in BRICS also have a large household credit portfolio where this ratio lies within the range of 10 percent to 37 percent. In Pakistan, however, banks are confronted by various hurdles relating to recoveries – ranging from specific legal constraints to broader issues that have societal and cultural origins; thus, lending to households has not lived up to its potential in the country, compared to other Asian nations.

Figure 12: Household Loans Explain Most of the Cross-country Gap in Private Credit to GDP Ratio (2015)



Source: Haver Analytics; Bank for International Settlements; and SBP

Historically, in addition to a weak valuation mechanism for real estate, legal glitches faced by

[30] It is contended that PSL in India had a negligible impact on production, and can be likened to a transfer program for agriculture and small scale industry (Caprio et al, 2006). Moreover, in the absence of forced lending, these funds might have been channeled more optimally to productive firms in the corporate sector, resulting in more output, job creation, and potentially higher tax revenues, which could address the government's welfare objectives better than directed credit schemes (Farrell et al, 2006).

[31] As the World Bank (2014b) puts it "The weak performance of (Vietnam's) financial sector is due to a complex array of institutional and regulatory factors. These factors have included episodes of interference by central and local authorities on the investment and credit decisions of state owned enterprises and state owned commercial banks; inadequate governance structures and risk management capacity in these institutions; connected lending in several joint-stock banks; weaknesses in financial infrastructure, including poor financial reporting standards; and deficiencies in financial regulation and supervision. In this context, credit growth has often been excessive and credit allocation poor".

commercial banks in exercising their right to collateral have been one of the major restrictive factors in Pakistan. In the absence of a strong non-judicial foreclosure framework in the country, it took a huge amount of time and money for the banks to take possession of, and sell the collateralized properties upon borrowers' default.[32] In theory, recovery, foreclosure and eviction laws were clearly laid out in the 2001 Financial Institutions (Recovery of Finances) Ordinance (section 15[2] and 15[4]), with the law empowering lending institutions to foreclose on a mortgage property in the event of a default without recourse to the courts.[33] Unfortunately, these provisions were termed as inconsistent with the constitution[34], and the Supreme Court initially invalidated the entire section 15 of the FIRO.[35] However, as of August 2016, a new and improved section 15 has been enacted, which addresses the earlier objections.[36] The judicious application of this new section 15 is expected to bring positive impact on credit expansion to households, especially mortgage loans.[37]

Further impetus to domestic mortgage financing would be provided by the Pakistan Mortgage Refinancing Company (PMRC), which becomes operational in 2017.[38] Facilitated by SBP, the PMRC aims to develop the primary mortgage market by: (i) providing financial resources so that primary mortgage lenders can grant more loans to households at fixed/hybrid rates for longer tenure; (ii) reducing the mismatch between house loan maturities and source of funds; and (iii) ensuring loan standardization across primary lending institutions. Simultaneously, it would also help develop capital markets – by providing more private debt securities and asset backed securities to raise funds – and create a benchmark yield curve.

These are welcome measures, since the country already has much catching up to do. In contrast to Pakistan, housing finance in Sri Lanka is 6 percent of GDP – the highest in the South Asian region. Sri Lanka had put in place necessary legislations back in 1990 to extend power of *parate*[39] execution enjoyed previously only by state-owned banks, to the other licensed commercial banks. In India, the 2002 Securitization and Reconstruction Act was passed to facilitate out-of-court settlement, whereby a creditor is allowed to acquire the mortgaged property if a defaulter fails to pay within 60 days of being informed of possible foreclosure/auction. Malaysia and Thailand also have in place convenient procedures for post-default recoveries and foreclosures since the mortgage reforms of late 1990s.[40]

---

[32] Consider that, in general (not specific to mortgages), the time it takes to resolve a case – from filing it to obtaining a decree from a banking court – is approximately up to 3 years for the majority of cases; in exceptional circumstances, complicated cases can take as long as ten years for resolution (though this rare). Also, in terms of money at stake, an amount of over Rs 440 billion was held up in unresolved banking court cases as of 30 June, 2016 (even though this represented a decline from the Rs 500 billion-mark breached earlier). For context, this amount of funds held up in unresolved cases is equivalent to approximately 69 percent of outstanding banking sector NPLs (Rs 634.5 billion), as of end-June 2016. Source: SBP

[33] "Where the mortgagor fails to pay the amount as demanded within the period under sub-section (2), and after the due date given in the final notice has expired, the financial institution may, without the intervention of any court and subject to any rules made by Federal Government under sub section (5), sell the mortgaged property or any part thereof by public auction and apply the proceeds thereof towards total or partial satisfaction of the outstanding mortgage money.."

[34] One of the clauses that were added in the Constitution of Pakistan post Eighteenth Amendment (2010) was clause 10A, which emphasizes the right to fair trial to every citizen. The clause states "for the determination of his civil rights and obligations or in any criminal charge against him a person shall be entitled to a fair trial and due process".

[35] The Supreme Court had primarily invalidated section 15 on following constitutional grounds: (i) absence of Reserve Price concept (ii) non-transparent way of auctioning / Due Process; (iii) inability of debtor to challenge sale of property if a fraud is committed; (iv) derogation of courts' jurisdiction; and (v) financial institutions acting as seller, purchaser, auctioneer and the beneficiary at the same time.

[36] Amongst the stakeholders, the IMF showed a keen interest and supported the enactment of non-judicial foreclosure laws in Pakistan.

[37] Thus, banks in Pakistan can now opt for one of four options when confronted by a case of willful default: (1) foreclose under the new section 15 of FIRO; (2) file a recovery suit in the banking courts; (3) employ recovery agents to persuade the defaulter to honor his/her payments; (4) file a criminal case with the National Accountability Bureau.

[38] The PMRC was incorporated in 2014 with the objective of promoting mortgage finance.

[39] Parate rights refer to the ability of the lender to foreclose and sell a defaulted property without going to court.

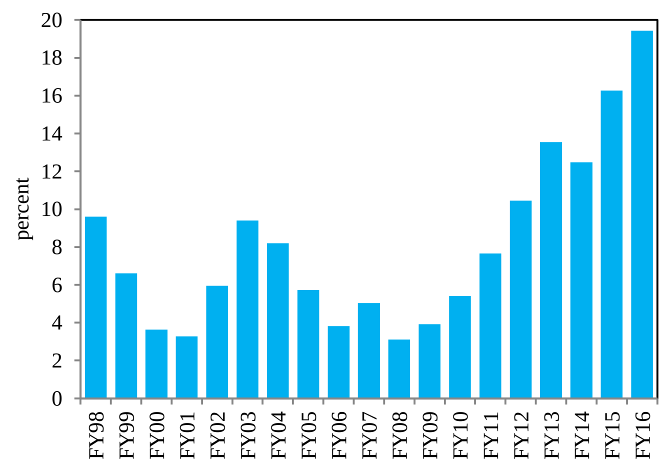
[40] Following the East Asian crisis, Malaysia deployed a three-pronged institutional approach to distressed loans in 1998, comprised of: *Danaharta*, to acquire NPLs; *Danamodal*, to provide fresh capital; and a Corporate Debt Restructuring Committee to assist in restructuring the loans of large corporations. With respect to non-judicial foreclosures, *Danaharta* was legally empowered to appoint special administrators without having to approach the courts, and could abrogate underlying contracts in cases where it foreclosed on collateral (IMF, 1999). Similarly, Thailand established the Thai Asset Management Corporation (TAMC) in 2001. To resolve

e) <u>Reforms' Sequencing Backfired</u>

> *"Financial reforms undertaken to stimulate growth could be self-defeating without a previous fiscal adjustment…weaknesses in the government's budget have to be addressed before financial repression can be eliminated; that is, stabilization should precede domestic financial reform"*
>
> \- Montiel (2011)

As mentioned earlier, in the pre-reform period, high SLR requirements, direct monetary controls, administered interest rates and the establishment of NCCC were meant to limit the flow of bank credit to the private sector, and simultaneously increase bank lending to the government. Thus, it was expected that by doing away with these repressive measures, banks would not be 'forced' to lend to the government and instead would deploy their funds in the private sector.[41] Up until 2008, it appeared that these expectations were not entirely misplaced, as banks' investment in government papers was contained to a fair extent (**Figure 13**). However, it appears that more than anything else, this improvement stemmed from low fiscal deficits that the government incurred owing to higher receipt of non-tax revenues. This argument gets support from the fact that as soon as fiscal deficits began to increase again from FY08 onwards, bank claims on the government also took a steep turn and by end June 2016, reached to an all-time high.

Figure 13: Net Budgetary Borrowing from Scheduled Banks (as % of GDP)



Source: State Bank of Pakistan and Pakistan Bureau of Statistics

This anomaly can be explained by two factors:

(i) In the pre-reform period, NSS instruments used to finance the bulk of budgetary requirements.[42] However, heavy public investments in these instruments were a major source of disintermediation, and were also causing distortions in the government securities markets. Therefore, the reform process gradually reduced returns offered on these instruments and ultimately linked them with yields on PIBs (introduced in December 2000).[43] Other incentives on NSS investments were also withdrawn during the process.[44] As a result, these instruments lost the investment pull and their size began to shrink as percent of both GDP as well as domestic debt. Ultimately, the government had to rely more on other resources to fund its deficit; the handiest was the banking sector. Thus, **while it might be true that rationalizing the profit structure of NSS in line with the banking sector did lead to re-intermediation of bank deposits, its impact on private credit was sizably offset by an increased recourse of government borrowing from the banking system;** and

---

distressed loans, the TAMC could foreclose on collateral or initiate business reorganization proceedings, with "special legal powers to bypass weaknesses in the existing court-based framework for debt restructuring" (IMF, 2001).

[41] The required SLR was gradually reduced from 45 percent to 35 percent in October 1993, and further to 25 percent in May 1994. In May 1997, this ratio was further brought down to 20 percent, to 18 percent in January 1998 and to 15 percent in June 1998.

[42] The average share of NSS instruments in the total budgetary financing increased from about 12 percent in the second half of 1970s to 67 percent in the second half of 1980s. This high reliance mainly represented a variety of tax incentives and relatively high returns (up to 15 percent per annum tax-free) at zero-risk that were offered to investors. In comparison to these instruments, financial institutions were providing only 7 to 9 percent per annum on time deposits.

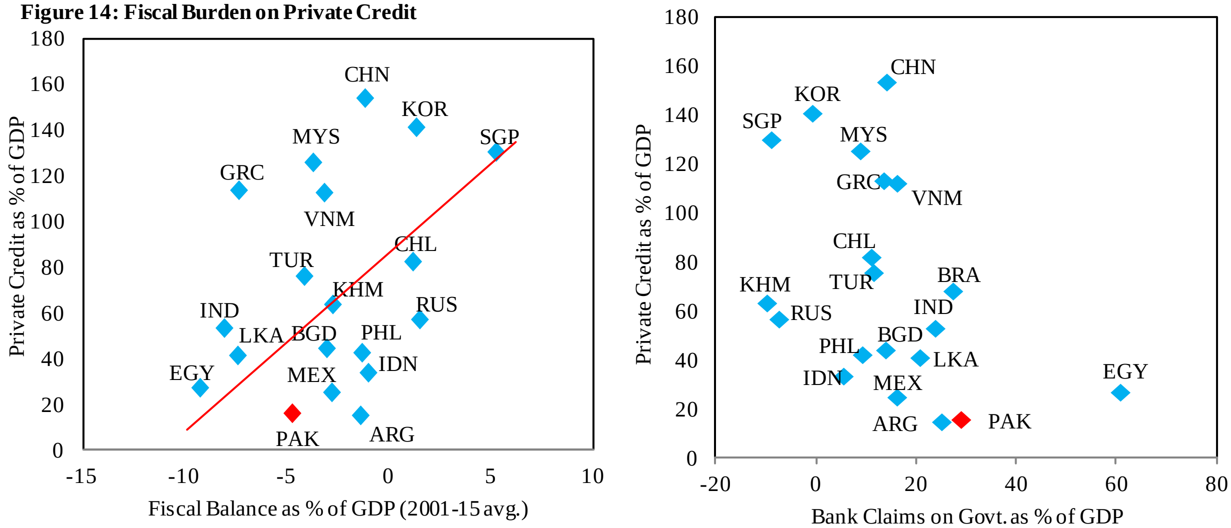
[43] As SBP's Financial Sector Assessment 1990-2000 puts it, "While NSS were offering a variety of tax incentives and relatively high returns (up to 15 percent per annum tax-free) at zero-risk to the end investors, the financial institutions were providing 7 to 9 percent per annum on time deposits. Consequently, NSS was able to attract a large amount of funds away from the financial institutions. As a result, not only banks' share in financial savings declined, but also SBP's role as a monetary authority was weakened".

[44] The government also imposed a 10 percent withholding tax on profits from NSS with effect from July 1, 2001, to bring uniformity in tax treatment of government securities

(ii) Only if fiscal and/or domestic debt market reforms had previously (or even simultaneously) been rolled out, the government's appetite for bank funding would have been contained: low fiscal deficits would have kept the overall borrowing requirements under check; if not, then a deep and diversified debt market would have generated alternative financing resources for the government. However, as things panned out, the government's reliance on bank funding continued to grow and, as empirical research substantiates, led to the crowding-out of private sector credit (Khan et al.,2016 and Zaheer et al., 2017).

From a cross-country perspective, however, it appears that high fiscal deficits and higher allocation of bank liquidity on budgetary lending cannot explain such a low level of private credit to GDP ratio for Pakistan. More specifically, India, Sri Lanka, Egypt, Turkey and Malaysia ran a persistently high level of fiscal deficits over the past 15 years, and yet their credit growth all through these years has been nothing short of enviable (**Figure 14**). More importantly, India, Egypt and Brazil even have a very high level of bank claims on government; still their banks managed to contribute meaningfully to the private sector growth. Khan et al (2016) boils this down to the following: "… a high share of government borrowing from commercial banks alone is not so bad for the economy. Countries like US, Japan and Canada also have a very high share of public borrowing in total borrowing from commercial banks. The key is the relationship between public credit share and banking spread of a given economy".

Figure 14: Fiscal Burden on Private Credit



Source: Haver Analytics

This suggests that the fiscal deficits *per se* and/or the government's borrowing from banks do not entirely explain the cross-country differences in private credit penetration. Instead, structural factors like the overall size of the banking industry and depth in the domestic debt market are more dominating factors that determine *the extent* of the fallout of fiscal-related borrowings on private credit.[45] In other words, it is this dearth of financial liquidity in Pakistan that strongly imposes a binding constraint on lending abilities of banks; this takes us back to more perennial issues of suboptimal savings pattern in the country, social exclusion of a large segment of population, and cash preferences of the economy as a whole. The extent of credit market failures in the country and banks' risk aversion then shift the asset mix further away from private lending.

[45] Balance of payment constraints also have a sizeable impact on financial system liquidity in Pakistan. The country's NFA-to-GDP ratio averaged only 5 percent during the decade 2006-2015, compared to other countries like Thailand (42 percent), Malaysia (36 percent), India (18 percent) and Bangladesh (8 percent) [data for NFA and GDP (in current local currency units) has been taken from World Development Indicators].

f. Credit Bubbles in EMs Post Global Financial Crisis (GFC)

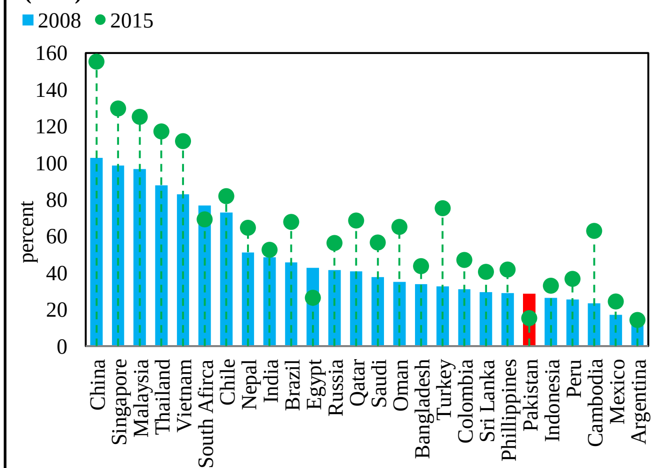
"Private sector debt has risen rapidly in key EMs in the last decade, surpassing government debt levels and potentially exposing their economies, financial systems and sovereign credit-worthiness to downside risks."

- Fitch Ratings (2016)

Unrelated to banking reforms but nevertheless an important factor that explains the widening gap in credit penetration between Pakistan and other EMs is the policy-driven aggressive bank lending in the EMs, post-GFC. On the eve of the crisis, i.e. 2008, Pakistan's standing was better than many Latin American countries, Indonesia and even Cambodia (**Figure 15**). It was even comparable to credit depth in the Philippines, Sri Lanka, Colombia, Turkey and Bangladesh. However, in the aftermath of GFC, monetary authorities in most EMs initiated massive stimulus programs that centered on levering up the private sector lending. China, Turkey, Malaysia, Thailand, Brazil and Vietnam particularly showed extraordinary increases in their credit-to-GDP ratios. Cambodia was also able to more than double its credit penetration over the same period.

The emerging markets bubble began in 2009, shortly after China pursued an aggressive credit-driven infrastructure-based growth strategy to boost its economy during the GFC. China's economic growth immediately surged as construction activity increased dramatically, driving a global raw materials boom that created a windfall for commodity exporting countries such as Australia and emerging markets. Emerging markets' improving fortunes began to attract the attention of global investors who were seeking to diversify away from Western nations that were at the epicenter of the GFC. As the bubble progressed, even developing countries that were not significant commodities exporters (such as Turkey) began to benefit from the growing interest in this investment theme.

Figure 15: Private Credit to GDP Ratio at the Start of GFC (2008) and 2015



Source: Haver Analytics

Rock-bottom interest rates in the U.S., Europe, and Japan, combined with the U.S. Federal Reserve's multi-trillion dollar quantitative easing programs, encouraged a $4 trillion torrent of speculative "hot money" to flow into emerging market investments over the last several years. A global carry trade arose in which investors borrowed at low interest rates from the U.S. and Japan, invested the funds in high-yielding emerging market assets, and pocketed the interest rate differential or spread. Soaring demand for EM assets led to a bond bubble and ultra-low borrowing costs, which resulted in government-driven infrastructure booms, alarmingly fast credit growth, and property bubbles in numerous developing nations.

Importantly, these countries used varying strategies to increase bank lending. For instance, the most significant feature of the Chinese stimulus program was a directive to state-owned banks to loosen up on credit to finance investment in industrial capacity, real estate development and infrastructure projects. In contrast to that, over 80 percent of the credit growth during this period in Thailand was driven by household sector, which climbed to 82 percent of GDP at end-2015.[46] In Brazil and Malaysia also, consumer credit pushed the overall

[46] Among other initiatives, Thailand introduced a first time car-buyer scheme to revive the automobile industry following the heavy floods of 2011. The scheme offered tax refunds as an incentive to boost demand for domestically manufactured cars, especially among lower income segments of the population. However, following a short-lived recovery for the automobile industry in 2012, the scheme ran into problems the following year, with consumer default rising rapidly once the subsidy expired.

credit growth in the country, but unlike Thailand, it was driven by mortgages.[47] More importantly, the bulk of the lending seen in the post GFC period in Brazil was earmarked (i.e., subsidized and government driven); as a result of this, the share of these loans has increased from only 32 percent at end December 2007 to 50 percent by end December 2017.[48]

Naturally, the policy measures required to tackle risks from rapid growth in credit vary depending on the source of risk. If the risks emanate from growth in corporate credit, then containment measures may include more thorough stress testing of corporate balance sheets, and regulations which fast-track NPL restructuring (Ohnsorge, F. and Yu, S., 2016). It is, however, the high level of household debt and its fast increase relative to disposable income which has emerged as a particular source of concern; Büyükkarabacak and Valev (2010) claim that rapid expansion of household credit tends to increase the likelihood of a banking crisis to a greater extent than comparable expansions in enterprise credit. Given this view, the pace of increase in household debt relative to income in Thailand has been very pronounced – much faster than that in Korea or the United States – and therefore, more worrying. Meanwhile, China's credit to GDP ratio has lately been increased to 150 percent, which many analysts view as a direct outcome of repeated monetary stimulus.[49]

V. Concluding Thoughts

Theory and empirical evidence amassed in the last two decades supports the notion that the financial sector can play a growth-enhancing role. Harnessing this finance-growth nexus was, inter alia, an aim of Pakistan's financial sector reforms in the 1990s. In terms of credit to private sector, it was envisaged that leaving credit allocation to market forces would be a better strategy compared to the directed credit schemes of the pre-reform era.

However, while the reforms improved the efficiency and profitability of the banking system, the state of credit remained unsatisfactory. For one thing, the shrinking footprint of DFIs left a gap in terms of institutions that could provide long term finance for the development of vital industries and agriculture. In addition, access of underserved individuals and businesses to affordable finance did not pick up – and in fact, may have been undermined – since the deliberate policy push for financial inclusion was missing at the time. Furthermore, the risk-based capital requirements imposed by SBP, in keeping with Basel Accords, played a part in narrowing the commercial banks' lending focus to large corporations, at the expense of riskier sectors like agriculture and SMEs. Delays in the provision of non-judicial foreclosures in the country also proved costly. Similarly, empirical research leaves little doubt that the crowding out phenomenon holds true for Pakistan; only the scale of crowding out and its detrimental impact on foregone economic output is debatable. Thus, in retrospect, it may have been a better idea to introduce comprehensive reforms in the fiscal domain and domestic debt market *prior* to reforms in the financial sector.

Meanwhile, a number of other emerging markets persisted with directed credit or priority sector lending mandated by the state in order to tackle market failures – with a mixed degree of success. While Pakistan could have adopted a similar approach, the increase in credit depth achieved by such means might have entailed a compromise on financial stability. Unfortunately, there is no way to conclusively resolve this counterfactual beyond a reasonable conjecture.

[47] From 2011 onwards, in turn, they primarily reflected the government policy of responding to the loss of GDP dynamism by stepping up earmarked credit through public debt-funded transfers to public banks: BNDES lending directly and through on-lending via other banks to non-financial corporations; the two largest government-owned commercial banks providing higher amounts of rural credit and residential housing finance.

[48] Total private credit posted CAGR growth of 14 percent between December 2007 and December 2017, whereas the growth in earmarked loans has been much higher at 19 percent. Source: Banco Central Do Brasil.

[49] Key beneficiary was the non-financial corporate sector, comprised mainly of state-owned firms that borrowed heavily from government-backed banks.

In light of the above, the way forward warrants a path between two extremes, i.e. the exclusively market-driven approach to credit adopted at present, and the directed schemes of the pre-reform period. Furthermore, while it is instructive to learn from the experiences of other EMs, the goal of such analysis is primarily to identify the strengths and weaknesses of different approaches and their associated outcome for credit. Building on these insights, the country needs to formulate a customized mix of policies, keeping in mind its own distinct comparative advantage and limitations.

Importantly, financial inclusion has now become a key national objective and is also being actively pursued by SBP. Performance benchmarks have been set and strategies have been clearly laid out. The National Financial Inclusion Strategy (NFIS) aims to enhance access to formal financial services for 50 percent of adult population by 2020. Encouragingly, the A2F Surveys have documented some improvement in indicators during 2008 and 2015, in terms of the proportion of banked population as a whole and also with specific regard to bank loans being taken as a prime source of credit by individuals. To consolidate these early gains, financial institutions must overcome the limitations of brick and mortar branches by tapping into the potential of branchless banking (BB). SBP is particularly emphasizing the setting up of a tier of simplified accounts – namely m-wallets – and extending the BB agent network.[50]

A key insight is that the piecemeal approach to reforms has held Pakistan back from realizing its full potential. Going forward, a holistic approach is needed which factors in the ground realities of all sectors of the economy – real, monetary, fiscal, external – and their inter-linkages. Since recurring balance of payment crises have been a perennial thorn in the side for the country, the future policy course must include special precautions to prevent such crises. A stable macroeconomy is a prerequisite to inspire household and investor confidence and related saving, borrowing and investment activity. Pakistan can ill-afford repeated boom-bust cycles and subsequent growth-retarding spells of stabilization, since these are exactly the kind of episodes which derail sentiments and confidence in the economy.

In the final analysis, the over-arching frame of reference for policymaking would be the country's development agenda. After all, increasing credit to private sector is not the ultimate aim in itself. The end goal is to ensure that deserving entrepreneurs and households, who are currently excluded from access to finance, can avail credit on equitable terms. This would empower them to expand their businesses and improve their living standards. In doing so, they would be contributing to the country's development and also reaping a due share of the benefits. Until this end goal becomes a reality, any reform process is necessarily incomplete.

References

Ahmed, U., 2011. *Financial Reforms and Banking Efficiency: Case of Pakistan*, MPRA Paper No. 34220, dated November 2011.

Basel Committee on Banking Supervision, 2010. *An assessment of the long-term economic impact of stronger capital and liquidity requirements*, August.

Beck, T., Levine, R. and Loayza, N., 2000. Finance and the Sources of Growth. *Journal of Financial Economics*, 58(1), pp.261-300.

Birdsall, N.M., Campos, J.E.L., Kim, C, Corden, W.M., MacDonald, L. [editor], Pack, H., Page, J., Sabor, R., and Stiglitz, J. E., 1993. *The East Asian miracle: economic growth and public policy: Main report*. A World Bank policy research report. New York: Oxford University Press.

[50] The number of BB accounts had increased to 14.6 million by end-June 2016; the average deposit size in these accounts was Rs 769. The number of agents responsible for opening and maintaining these accounts rose to 346,716.

Bonomo, M. and Martins, B., 2016. *The Impact of Government-Driven Loans in the Monetary Transmission Mechanism: what can we learn from firm-level data?* Banco Central Do Brasil Working Paper No. 419, dated May 2016.

Büyükkarabacak, B. and Valev, N.T., 2010. The role of household and business credit in banking crises. *Journal of Banking & Finance, 34*(6), pp.1247-1256.

Caprio, G., Honohan, P. and Stiglitz, J.E., 2006. *Financial liberalization: how far, how fast?* Cambridge University Press.

Chiquier, L. and Lea, M. 2009. *Housing Finance Policy in Emerging Markets*. World Bank.

Cohen, B.H. and Scatigna, M., 2015. Banks and capital requirements: channels of adjustment. *Journal of Banking & Finance*.

Costa, A. and Ehrbeck, T., 2015. A Market-Building Approach to Financial Inclusion. *Innovations, 10*(1-2), 53-59.

Cull, R., Demirgüç-Kunt, A. and Lyman, T., 2012. *Financial Inclusion and Stability: What Does Research Show?* (No. 9443). The World Bank.

Duprey, T., 2013. *Bank Ownership and Credit Cycle: The Lower Sensitivity of Public Bank Lending to the Business Cycle*. Banque de France Working Paper No. 411

Demirguc-Kunt, A. and Maksimovic, V., 1996. *Financial constraints, uses of funds, and firm growth: an international comparison* (No. 1671). The World Bank.

Elliott, D., Salloy, S., and Santos, A.O., 2012. Assessing the cost of financial regulation, International Monetary Fund Working Paper, WP/12/233, September.

Faruqi, S., 2015. The Role of DFIs in Industrial Growth and Transformation: Why the East Asian Countries Succeeded and Pakistan Did Not. *The Lahore Journal of Economics*, 20, p.13.

Farrell, D., Lund, S., Greenberg, E., Rosenfeld, J. and Morin, F., 2006. Accelerating India's Growth Through Financial Sector Reform. *McKinsey Global Institute*. San Francisco, CA. USA.

Financial Action Task Force (FATF), 2011. Anti-money laundering and terrorist financing measures and financial inclusion. *FATF/OECD Guidance*.

Fitch Ratings, 2016. *Emerging Markets Risks Abound In 2016; Private Debt Key Challenge*. Web. 28 Feb. 2017.

Hamilton, A., 1781. Quoted from Hammond, 1991. Banks and Politics in America: From the Revolution to the Civil War.

Hardy, D. and Bonaccorsi di Patti, E., 2001. Bank reform and bank efficiency in Pakistan. Institute of International Finance, 2011. *The cumulative impact on the global economy of changes in the financial regulatory framework*.

Inter-Amercian Development Bank, 2011. "Housing Finance in Brazil: Institutional Improvements and Recent Developments". IDB Working Paper No. IDB-WP-269

International Monetary Fund, 2013. Brazil*: Technical Note on Consumer Credit Growth and Household Financial Stress*. IMF Country Report No. 13/149, June 2013.

International Monetary Fund, 1999. *Malaysia: Selected Issues*. IMF Staff Country Report No. 99/86, August 1999.

International Monetary Fund, 2001. *Thailand: Selected Issues*. IMF Country Report No. 01/147, August 2001.
Janjua, M.A., 2004. *History of the State Bank of Pakistan:(1988-2003)*.

Jayaratne, J. and Strahan, P.E., 1996. The finance-growth nexus: Evidence from bank branch deregulation. *The Quarterly Journal of Economics*, pp.639-670.

Khan, S., Pasha, F., Rehman, M. and Choudhary, M.A., 2016. *The Dominant Borrower Syndrome: The Case of Pakistan* (No. 77). State Bank of Pakistan, Research Department.

Khwaja, A.I. and Mian, A., 2005. Do lenders favor politically connected firms? Rent provision in an emerging financial market. *The Quarterly Journal of Economics*, *120*(4), pp.1371-1411.

Khan, H.R., 2011. *Financial Inclusion and Financial Stability: Are They Two Sides of the Same Coin?*. Address presented at BANCON 2011, organized by the Indian Bankers Association and Indian Overseas Bank, Chennai, 4 November 2011.

La Porta, R., Lopez-de-Silanes, F., Shleifer, A., and Vishny, R.W., 1998. Law and Finance. *Journal of Political Economy*, 106, 1113}1155.

Levine, R. and Zervos, S., 1998. Stock markets, banks, and economic growth. *American Economic Review*, pp.537-558.

Levine, R., Loayza, N. and Beck, T., 2000. Financial intermediation and growth: Causality and causes. *Journal of monetary Economics*, *46*(1), pp.31-77.

Macroeconomic Assessment Group, 2010. *Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements: Interim report*, August.

Khan, M. and Riazuddin, R., 2009. *Concentration and competition in banking sector of Pakistan: empirical evidence*. State Bank of Pakistan.

Menkhoff, L., Neuberger, D. and Rungruxsirivorn, O., 2012. Collateral and its substitutes in emerging markets' lending. *Journal of Banking & Finance*, *36*(3), pp.817-834.

Miles, D., Yang, J., and Marcheggiano, G., 2013. Optimal bank capital. *The Economic Journal*, 123, 1–37.

Mohanty, M.S., Schnabel, G. and Garcia-Luna, P., 2006. Banks and aggregate credit: what is new? *BIS papers*, *28*(2), pp.11-39.

Montiel, P.J., 2011. *Macroeconomics in Emerging Markets*. Lahore: Cambridge University Press.

Ohnsorge, F. and Yu, S., 2016. Recent Credit Surge in Historical Context. *Policy Research Working Paper; No. 7704*. World Bank, Washington, DC.

Oxford Economics, 2013. *Analyzing the impact of bank capital and liquidity regulations on US Economic Growth*, The Clearing House Association, April

Prasad, E.S., 2010. *Financial sector regulation and reforms in emerging markets: An overview* (No. w16428). National Bureau of Economic Research.

Rajan, R.G. and Zingales, L., 1998. Financial Dependence and Growth. *The American Economic Review*, 88(3), pp.559-586.

Rioja, F. and Valev, N., 2004. Finance and the sources of growth at various stages of economic development. *Economic Inquiry*, 42(1), pp.127-140.

SBP, 2002. Financial Sector Assessment 2001-2002.

SBP, 2004. Financial Sector Assessment 2004.

SBP, 2015. Financial Stability Review 2015.

Slovik, P. and Cournède, B., 2011. Macroeconomic impact of Basel III, OECD Economics Department Working Paper, No. 844, February.

Svirydzenka, K., 2016. Introducing a new broad-based index of financial development.

Access to Finance Survey, 2015. Retrieved from http://www.a2f2015.com/

World Bank, 2014a. *Financial Inclusion – A Foothold on the Ladder Toward Prosperity?*

World Bank, 2014b. Financial Sector Assessment Vietnam, June 2014.

Zaheer S., Khaliq F., Rafiq, M., 2017. *Does Government Borrowing Crowd out Private Sector Credit in Pakistan* (No. 83). State Bank of Pakistan, Monetary Policy Department.

Zaidi, S.A., 2015. Issues in Pakistan's economy. OUP Catalogue.