Chapter 7

Understanding Low Private Credit Penetration in Pakistan-Contextualizing Recent Policy Reforms

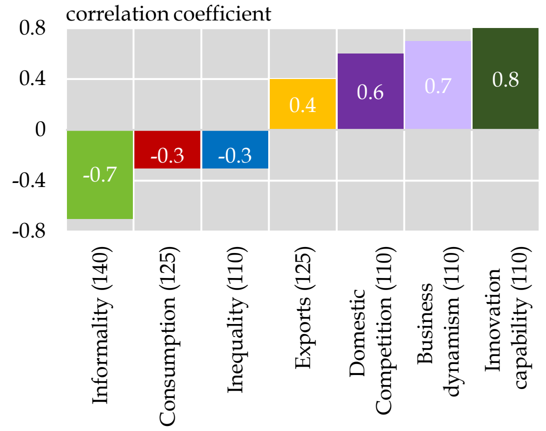
Private sector credit penetration and the state of access to finance in Pakistan is one of the lowest among emerging markets, characterized by persistent supply- and demand-side challenges. The financial sector reforms of the 1990s, aimed at addressing financial repression and leaving the credit offtake to market forces, proved successful in enhancing the efficiency and overall financial health of the sector, but gains in the domestic credit market remained limited. This was because the prevailing market failures (information asymmetries) in the absence of credit registries and private credit bureaus made commercial banks averse to lend to underserved segments of the economy. This risk aversion was reinforced by the high borrowing appetite of the government, which, in the presence of low savings and weak financial inclusion, put upward pressure on banking spreads and crowded out the private sector. Lack of suitable product development by the specialized institutions and their eventual phase-out also contributed to this end. Going forward, however, coordinated efforts by the government and the SBP to resolve issues related to affordable housing finance; create a secured transaction registry; develop private credit bureaus; and support the growing use of digital financial services, hold the potential to substantially improve credit penetration and overall access to finance in Pakistan.

7 Understanding Low Private Credit Penetration in Pakistan: Contextualizing Recent Policy Reforms[1]

7.1 Introduction

The growth-enhancing role of the financial sector has widely been evaluated and acknowledged on theoretical and empirical grounds. In pure theoretical terms, efficient financial systems influence economic growth in the following ways: (i) channelization of savings of diverse households into investment; (ii) allocation of resources to projects with higher marginal product of capital; (iii) provision of liquidity to individual investors with more profitable but illiquid projects; (iv) risk mitigation, by spreading investors' savings across many diversified investment opportunities; and (v) promotion of technological innovation.

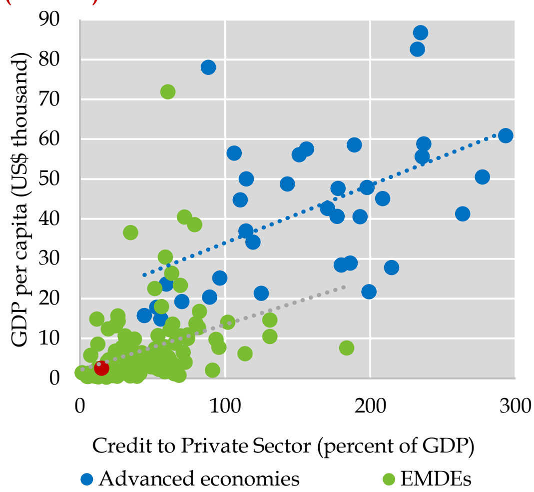
Cross-country Relationship between Financial Inclusion and Other Macroeconomic Variables **Figure 7.1**



Note: Bracket values indicate number of countries for which comparable data was available; all data is average for 2011-14 to match the availability of financial inclusion index numbers, except for competitiveness indicators, for which 2018 data was used.
Source: see Footnote 2

Thus, given the sufficient opportunities for capital formation available to households and firms, it is not surprising to find a negative correlation (cross-country) between financial inclusion and consumption (**Figure 7.1**).[2]

Relationship between Credit to Private Sector and Economic Growth (2010-19) **Figure 7.2**



Based on 173 AEs and EMDEs.
Red dot denotes Pakistan
Source: World Bank

A similar relationship is found between financial inclusion and the economy's level of informality, as the increased use of formal channels for savings/financing purposes can potentially push businesses and households towards documentation. Furthermore, a positive correlation is observed between financial inclusion and export-orientation of

[1] The authors acknowledge Talha Nadeem for his excellent support in the preparation of this chapter. The authors also acknowledge efforts of SBP's Development Finance Group for providing technical input and valuable feedback.

[2] Data sources for the graph: Financial inclusion index from Park, C., and R.V. Mercado, Jr. (2018). *Financial Inclusion: New Measurement and Cross-Country Impact Assessment*. DB Economics Working Paper Series, No. 539. Manila: Asian Development Bank; shadow economy numbers from Medina, L., and F. Schneider (2019). *Shedding Light on the Shadow Economy: A Global Database and the Interaction with the Official One*. CESifo Working Papers, No. 7981. Munich: Center for Economic Studies and Ifo Institute; data on domestic competition, business dynamism and innovation capability from WEF Global Competitiveness Rankings (2018); consumption to GDP ratio and GINI index numbers from World Bank open data.

the economy, as businesses can tap external funding to gain on innovation and productivity fronts. This, coupled with narrowing difference in scale, scope and growth of the established large players and small firms, would lead to an improvement in the overall competition environment of the country.

Improvement on all these fronts can then lead towards sustainable economic development and growth. For example, 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;[3] indeed, cross country data lends support to this idea (**Figure 7.2**).

Furthermore, we also find sufficient evidence in the literature that supports a strong connection between financial development and advances in total factor productivity (TFP) growth; however, a more refined evaluation of this phenomenon maintained that this relationship 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 the growth is stimulated – not via TFP gains.[4]

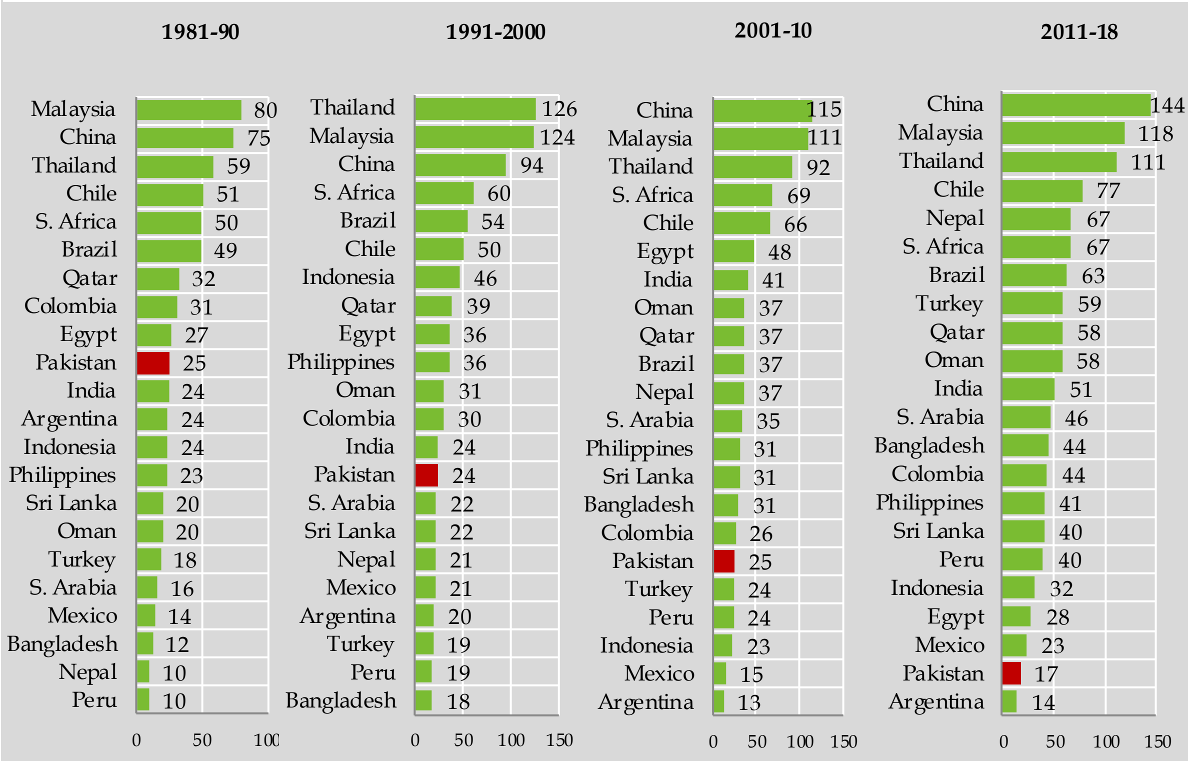
When it comes to Pakistan, it appears that the intermediary role of the financial sector in terms of resource allocation and mobilization has remained fairly limited, especially during the past few decades. In contrast, other emerging market and developing economies (EMDEs) leveraged heavily on this intermediary role during this period. As shown in **Figure 7.3**, the overall credit penetration in Pakistan, as measured by private credit to GDP ratio, is one of the lowest among EMDEs, and has actually shrunk in absolute terms over the past 3 decades. This looks particularly disconcerting, as in other EMDEs, households and firms significantly increased their dependence on bank credit for consumption and investment purposes to the tune of 10 – 20 percent of GDP over the same period. Even if we attribute weak credit penetration in Pakistan to an overall subdued macroeconomic performance, which might have suppressed overall financing needs, the indicators representing access to finance suggest deeper concerns at play. As becomes evident from **Figure 7.4**, the economy is still characterized by a weak and distant bank-firm relationship, as most businesses, especially micro, small and medium enterprises, resort to internal finance for working capital and capex needs (as these enterprises are often collateral-deficient and lack documented financials/business turnover), with banks catering to the financing needs of just a handful of firms and entrepreneurs.

Other than the more profound impact on capital accumulation, productivity and overall growth, an important fallout of inadequate access to finance is that it can potentially weaken the policy outreach to unserved sectors and firms, especially in the time of downturn and/or crisis. For instance, banking systems have become the major conduit of supply-centric government support to businesses in nearly all the countries affected by Covid-19 and the associated containment

[3] Levine, R. and S. Zervos (1998). "Stock Markets, Banks, and Economic Growth," *American Economic Review*, 88: 537-558.

[4] There is a growing empirical literature that highlights the importance of the finance-growth nexus in an economy. For example, please see Levine, R. and S. Zervos (1998). "Stock Markets, Banks, and Economic Growth," *American Economic Review*, 88: 537-558; Rajan, R. G., and L. Zingales (1998). "Financial Dependence and Growth," *American Economic Review*, 88: 559-586; Demirgüç-Kunt, A. and V. Maksimovic (1999). *Financial Constraints, Uses of Funds, And Firm Growth: An International Comparison*. Policy Research Working Paper 1671. Washington, DC: World Bank; Beck, T., Levine, R. and N. Loayza (2000). "Finance and the Sources of Growth," *Journal of Financial Economics*, 58(1-2), 261-300; and Rioja, F. and N. Valev (2004). "Finance and the Sources of Growth at Various Stages of Economic Development," *Economic Inquiry*, 42(1), 127-140. Recent literature also reveals that a nonlinear and inverted U-shaped relationship exists between credit and economic growth as private credit exceeds a certain threshold level. Law, S. H. and N. Singh (2014). "Does Too Much Finance Harm Economic Growth?" *Journal of Banking & Finance*, 41: 36-44.

Pakistan's Relative Standing in Credit-to-GDP Ratio Across Decades Against Selected EMDEs **Figure 7.3**



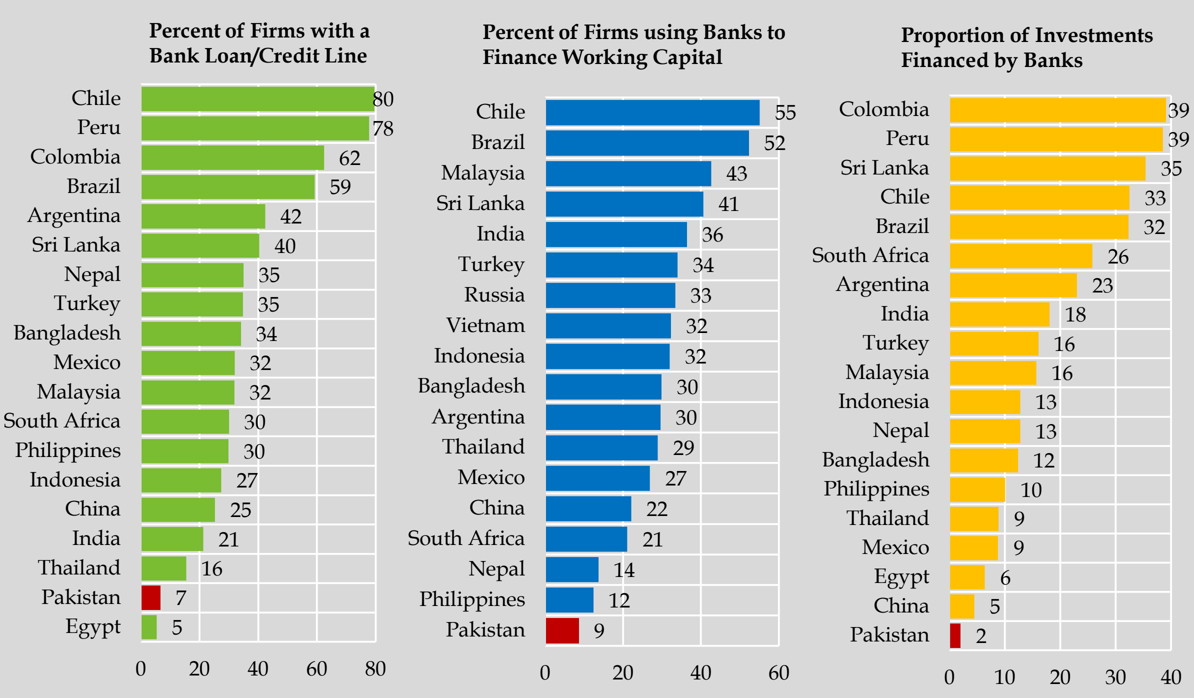
Source: World Development Indicators, World Bank

measures. Payment deferral programs, mark-up subsidies and easing capital regulatory restrictions for private lending, have all been positioned to ease credit conditions for firms and make up for their cash constraints. This was done to limit the transformation of a potential liquidity problem into a solvency crisis. However, sufficient outreach and effectiveness of this toolkit warrants a strong credit penetration and a close bank-firm relationship in the economy. Countries lacking on this front are likely to struggle with the scope and breadth of the recovery efforts, since it is too much to expect banks to develop fresh relationships in the middle of a crisis. In this context, while the finance-growth nexus was already weak in Pakistan, the Covid-19 pandemic has exacerbated the challenge, as it triggered serious liquidity concerns for many businesses, particularly those operating in the informal economy.

This chapter analyzes the reasons behind the underwhelming state of private credit and investment, and an overall weak access to finance in Pakistan's economy. In particular, it attempts to shed light on factors that impeded the development of a well-functioning credit market, even after it took a fairly reasonable start in the first few decades of industrialization. Importantly also, it analyzes the state of credit penetration in the context of a paradoxical weakening after the financial sector reforms, which were aimed at deregulating and liberalizing the market, alleviating financial repression of all kinds, and leaving the allocation of banking assets to market forces. The findings can be viewed along four dimensions.

First, in an economy as informal and savings-starved as Pakistan's, a strong deliberate push for promoting financial inclusion was unavoidable. But similar to the trend in other EMDEs, this did not gain much prominence in the reforms' design until much later. Second, efforts to address credit market failures proved insufficient and, coupled with stringent capital requirements and a fragmented approach towards incentivizing lending to micro, small and medium enterprises (MSMEs), resulted in marginalization of the unbanked and the underserved segments of the economy. Third,

The State of Access to Finance in Pakistan **Figure 7.4**



Source: World Enterprise Survey (latest available for each country). In case of Pakistan, business owners and top managers in 1,247 firms were interviewed from May, 2013 through May, 2015.

persistent uncertainties around loan write-offs and non-judicial foreclosures made banks increasingly risk-averse. Mortgages, which comprise nearly a third of EMDE's credit portfolio, were particularly sidelined, as this sector struggled with additional supply-side concerns from issues like land titling/registry, land management, etc. Fourth, the incomplete reforms in the fiscal and domestic debt market also weighed in: the ample supply of zero risk-weighted assets in the form of government papers explains banks' general lack of willingness to diversify and expand their lending portfolio.

In the later part of the chapter, we identify recent developments in the credit market with a potential to significantly increase credit penetration in the country. In particular, we highlight the establishment of the Secured Transactions Registry (STR), which will help banks to create charge on the movable assets of the micro, small and medium enterprises. This would enable MSMEs to acquire loans from the commercial banks using movable assets as collateral. This, in addition to the licensure of a couple of credit bureaus in the private sector, can significantly help address the major supply-side constraints to loan acquisition by such enterprises. In addition, the renewed focus on low-cost housing finance can rev up mortgages, especially because this is being complemented by government efforts to overhaul the complete supply side, from regulation and land entitlement to incentivizing builders and developers. Finally, advancements in digital connectivity and payments infrastructure, as well as the increased usage of digital financial services, can provide a big boost to financial inclusion. In particular, the underserved segments of the economy, where data regarding credit worthiness and banking history is lacking, should benefit heavily from the growing penetration of e-commerce, fintech and mobile wallets.

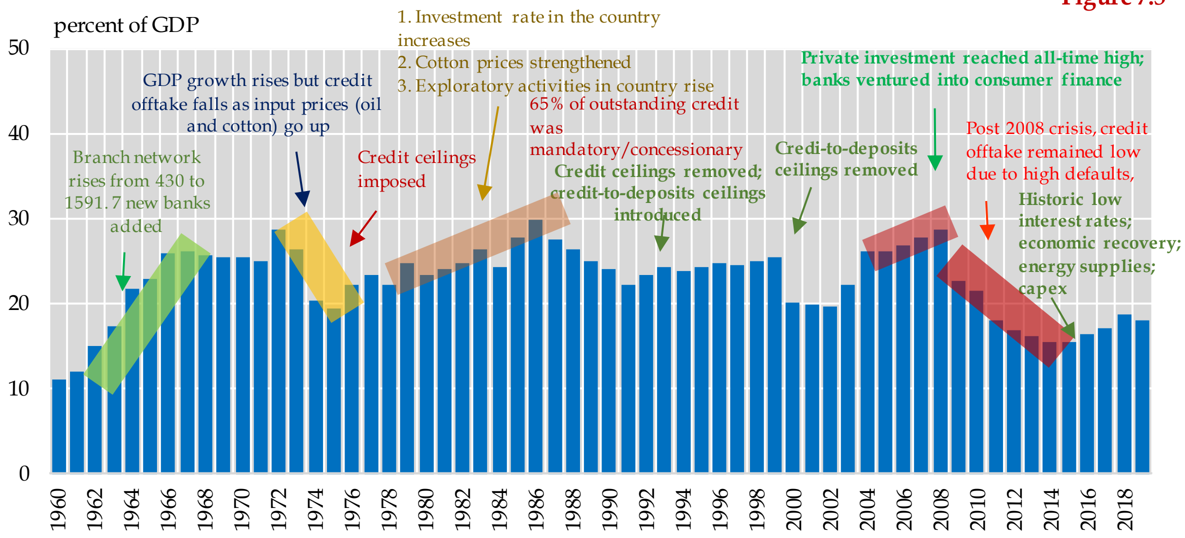
7.2 A Brief Review of Private Credit Offtake in Pakistan

The financial sector played an important role in the initial years of industrialization, with major contributions coming from specialized development finance institutions (DFIs). The DFIs came into the spotlight because they provided a way out of market failures in credit allocation and provided the necessary funds to the underserved or nascent yet policy-wise strategic sectors of the economy.

Prior to the 1960s, for example, the commerce sector had the biggest share of private sector credit in Pakistan. This was because of the relatively non-existent industrial base in the country. However, when the manufacturing sector became a priority for the government, as envisaged in the Five Year plans of the Planning Commission, DFIs were the envisioned medium for development finance for the sector, and they performed well.[5] Through the 1960s up to the mid-1980s, these DFIs were major channels for routing development funds to the private manufacturing sector and achieving multiple socio-economic objectives, such as broadening industrial ownership, facilitating and encouraging new entrepreneurs, and providing employment opportunities in less developed areas of the country (**Box 7.1**). The DFIs' main function was to provide industrial development credit finance and some agricultural finance for farm machinery and chemicals. Importantly, in keeping with the import substitution policies of those times, the DFIs also helped establish firms in textiles, cement, sugar, fertilizers, and petrochemicals sectors. Commercial banking industry also grew steadily in the 1960s, when new banks were established and the branch network began to spread out. Thus, private credit rose from only 11.1 percent of GDP in 1960 to 25 percent by end-1970 (**Figure 7.5**).

This momentum was disrupted by two major policy decisions taken in the early 1970s. First, the National Credit Consultative Council (NCCC) was set up to determine the real credit needs of the economy within the Annual Development Plan and the monetary targets. Mandatory credit ceilings were introduced for the commercial banks – practically leaving no room for banks to expand credit at a rate faster than what was stipulated by the SBP. Second, major banks

Credit to Private Sector in Pakistan - Historical Context **Figure 7.5**



Source: World Bank

[5] For instance, Faruqi (2015) notes that the newly minted business houses like the 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."[S. Faruqi (2015). "The Role of DFIs in Industrial Growth and Transformation: Why the East Asian Countries Succeeded and Pakistan Did Not," *Lahore Journal of Economics*, 20: 13-30.]

Box 7.1: DFIs in Pakistan - Inception, Prominence and Diminution

In the Second Five Year Plan of Pakistan (1960-65), the government increased the focus on the industrial sector. According to the plan, "Basic industries are to be encouraged where economically feasible. Special emphasis is placed on the development of small-scale industries, both because of their intrinsic merits and because of their employment potential. In particular, those major industries are to be encouraged which stimulate agricultural development or which support small scale industries. Private investment in industry is to be given maximum encouragement" (MoF, 1960).

The expenditure allocation of the industrial sector was increased by 51 percent as compared to the First Five Year Plan and was the highest in the Second Plan, with the semi-public sectors, the newly-introduced classification in the plan, envisioned to contribute the most. The Semi-Public Sector was to "consist of government-sponsored corporations which draw their finances both from the public and private sectors".

The Second Five Year plan was considered an "undoubted progress", as all the major benchmarks were achieved or surpassed (Griffin, 1965). Pakistan Industrial Credit and Investment Corporation Ltd (PICIC) was the first DFI to be formed in 1957 with the help of the World Bank, with the objective of providing finance to medium and large industries and to act as a channel for foreign currency funds from multinational agencies for industrial projects. After that, the 1960s and 70s saw the formation of the Industrial Development Bank of Pakistan (IDBP), the National Development Finance Corporation (NDFC, to provide investment capital to state enterprises), the National Investment Trust (NIT), the Investment Corporation of Pakistan (ICP), the Pak Kuwait Investment Company (PKIC), Pak-Libya Holding Company (PLHC), Saudi Pak Investment Company (SAPICO), Regional Development Finance Corporation (RDFC), Small Business Finance Corporation (SBFC), and the Banker's Equity Ltd (BEL).

During the 1960s and 1970s, the DFIs performed appreciably and helped spur the growth in the industrial sector of the country. However, problems started emerging in the later years, with political interferences, poor governance issues and low recovery rates hurting their efficiency and effectiveness. Foreign aid dependence was another factor, as the DFIs over time were not able to effectively seek out adequate domestic sources to be channelized. Resultantly, when the foreign inflows started to deteriorate, the institutions experienced a cash squeeze. Exacerbating the situation was the inception of investment banks and leasing companies during the 1980s, considering that there was a significant overlap between the objectives and mandates of the two types of institutions (SBP, 2004).

As a result of these factors, the DFIs gradually faded into the background. Within DFIs, the Banker's Equity Limited was initially privatized in 1996 and subsequently liquidated in 1999. Meanwhile, the NDFC (whose equity had turned negative in 1999 after heavy losses in the second half of the 1990s) was merged with the National Bank of Pakistan in 2001. In addition, RDFC and the SBFC – which were both serving the SME sector – were merged to create the SME Bank in 2002. Among the few DFIs that survived this period of broad restructuring was the Pakistan Industrial Credit and Investment Corporation Ltd (PICIC) 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, the PICIC was also privatized in 2007.

References:
MoF (1960). *Highlights of Pakistan's second five-year plan 1960-65*. Rawalpindi: Economic Advisor, Ministry of Finance.
Griffin, K. B. (1965). "Financing Development Plans in Pakistan," *Pakistan Development Review*, 5(4): 601-630.
SBP (2004). *Financial Sector Assessment 2004*. Karachi: State Bank of Pakistan.

were put under the direct control of the government in early 1974.

The key objective of this nationalization was to direct banking activities towards broader socio-economic objectives of the country and also to protect the depositors' funds. In addition, the SBP prescribed annual mandatory targets for commercial bank loans for specific sectors, and also for fixed investments and refinancing of loans for locally manufactured machinery and agri-based activities.

Following these steps, government interventions became a major feature of the banking sector. Ultimately, the banking industry began losing its efficiency due to suboptimal governance structures in predominantly government-owned banks; excessive funding of budgetary deficits; poor recovery of loans handed out to "politically-connected firms"; burden of high taxes on the financial sector; and excessively high lending and low deposit rates.[6] Irrespective of these inefficiencies, the level of private credit-to-GDP ratio posted a steady increase, as the country witnessed high investment growth. However, since banks were directed to lend to certain sectors not on the basis of project viability, not all the credit was being lent out for productive investments. This view is supported by 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 the intended beneficiaries.[8] The subsequent deterioration in the asset quality of banks may be an indication of this phenomenon.[9]

Not only did the poor asset quality heighten the solvency risk for the banking industry, it also restricted the earning capacity of banks. Then in the early 1990s, the government and the SBP embarked on a sweeping reforms agenda aimed at deregulation and liberalization of the country's financial sector. The reforms mainly encompassed privatization of state-owned commercial banks, instillation of corporate governance practices, strengthening of capital adequacy, improvement in asset quality, liberalization of foreign exchange regime, overhaul of the legal landscape, and the introduction of prudential regulations. From the perspective of private credit growth also, a number of measures were taken. These included: reduction in SLR requirements, which was expected to place significant amount of liquidity at banks' disposal; removal of mandatory credit requirements; relaxation of licensing procedures for micro and rural credit institutions; and removal of restrictions on consumer financing by nationalized banks. These reforms were clearly premised on the notion that the volume and quality of credit allocation would improve if left to market forces.

7.3 Despite Liberalization, Credit Penetration remained Weak

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 and noted that the reform process allowed Pakistani banks to improve cost efficiencies and expand their revenue base.[10] Similarly, using non-parametric data envelopment analysis, Ahmed (2011) concluded that the second phase of reforms was particularly

[6] 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". Also, the SBP's Financial Sector Assessment Report 1990-2000 noted: "the ratio of nonperforming loans to gross advances increased from less than 17 percent in 1990, to 27.7 percent in 1999. This was due to substantial loans provided by NCBs (nationalized commercial banks) on political grounds, especially during the early and mid-1990s." [Khwaja, A. I. and A. Mian (2005). "Do Lenders Favor Politically Connected Firms? Rent Provision in an Emerging Financial Market," *Quarterly Journal of Economics*, 120(4): 1371-1411.]

[7] Source: State Bank of Pakistan (2002). *Financial Sector Assessment Report 1991-2000*. Karachi: State Bank of Pakistan.

[8] As noted in the State Bank of Pakistan (2002) (pp 22): "the higher share of directed credit programs resulted in investments with low rates of return, which subsequently burdened banks with large non-performing loans. The effectiveness of such programs was also questionable on the ground that it was difficult to ensure that the credit was being used by actual intended beneficiaries".

[9] 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.

[10] Hardy, D. and E. Bonaccorsi di Patti (2001). *Bank Reform and Bank Efficiency in Pakistan*. IMF Working Paper No. 01/138. Washington, DC: International Monetary Fund.

helpful in improving the commercial banks' efficiency – especially the pure technical efficiency – in Pakistan.[11]

In terms of credit allocation also, the banking industry took leaps from the early 2000 onwards and significantly expanded the menu of services offered. For instance, banks aggressively took up consumer finance, and within a short span of time developed a reasonable customer base. SME finance was another area where banks keenly ventured in. But in hindsight, this active pursuit of banks into financing avenues in nontraditional sectors appears merely a direct outcome of a liquidity influx in the system in the aftermath of 9/11, amid a subdued appetite for budgetary funding during the period. While banks were on the lookout for avenues to park their funds, the easy monetary policy 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 morphed into a BoP crisis (by mid-2008). For the next 5 years, interest rates remained in double-digits, contributing to an anemic credit growth. Furthermore, severe energy shortages in the country, growing security concerns, and a slowdown in both the domestic and international economy, had a strong and negative impact on the financial position of SMEs, which led to a rise in their default rates. At this point, the resultant risk aversion from banks was reinforced by the growing government appetite for borrowing from the banking sector to meet the expenditure demands to stimulate the economy.

Here, it is important to acknowledge that in addition to the cyclical factors, there are deep-rooted structural challenges, such as low financial literacy and awareness, preference for cash, and cultural and religious factors, that suppress the demand for financial services in general, and credit in particular (**Box 7.2)**.

That said, the there are multiple major supply-side constraints for low financial penetration; these are discussed in detail in the following sub-headings (a-e).

a. The inclusion dimension and deepening was overlooked

The broader financial sector reform agenda that swept across the EMDEs in the late 1980s and the 1990s, had taken its cues from the IFI-led financial sector assessment programs. These programs focused primarily on identifying the financial system's vulnerabilities, strengthening supervision, risk management and ensuring market competition.[13] It was not until the mid-2000s, that the concept of financial inclusion started gaining traction and eventually became one of the key pillars of the broader financial development.[14] As things stand, both financial inclusion and financial stability appear high on the agenda of international policymakers. But conceptually, the nexus between the two is still evolving.

[11] Ahmed, U. (2011). *Financial Reforms and Banking Efficiency: Case of Pakistan*. MPRA Paper No. 34220. Munich: MPRA.

[12] The annual investment rate (as percent of GDP) declined from 17.7 percent on average during FY00 to FY08 to only 15.7 percent during FY09 to FY20. At its peak, the investment rate had been as high as 20.6 percent in FY06.

[13] As the World Bank (2007) puts it, "The World Bank Group has long recognized that well-functioning financial systems are essential for economic development. The work of its financial sector has, over the years, emphasized the importance of financial stability and efficiency. Promoting broader access to financial services, however, has received much less attention despite the emphasis it has received in theory. The access dimension of financial development has often been overlooked, mostly because of serious data gaps in this area". [A. Demirguc-Kunt, T. Beck and P. Honohan (2007). *Finance for All? Policies and Pitfalls in Expanding Access*. World Bank Policy Research Report No. 41792. Washington, DC: World Bank.]

[14] Source: same as in footnote 13.

Box 7.2: Access to Finance – The Demand-Side Dynamics

In Pakistan, demand-side factors are important to assess while explaining the low activity on the credit front. According to the SBP-Gallup Pakistan Access to Finance Survey (A2F) 2015, 53 percent of the population was financially excluded in the country. A key factor was the high and persistent use of cash in the economy. The A2F survey revealed that around 95 percent of the respondents received income in cash, and 86 percent stated preferring paying for goods and services face-to-face due to increased certainty of transactions. Overall, close to three-fourth of the respondents stated that there was no need for a bank account, and just 8 percent of the non-banked said that it would be useful to open a bank account. This was down from 38 percent in the A2F 2008.

Another reason for the lower demand for banking services is the low level of financial literacy. According to the A2F 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. Similarly, more than 30 percent of the respondents cited lack of knowledge for not making domestic P2P transfers using banks, mobile money, and post office.

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, a majority of respondents (56 percent) preferred to obtain credit from neighbors and friends.

Religion is another factor that plays a key role in determining the demand for financial services. According to the 2017 World Bank Global Findex database, Pakistan ranked seventh highest out of 123 countries in terms of share of respondents (15 and above) not having a bank account due to religious reasons (11.5 percent). Islamic banking can help in this regard to bring the faith-sensitive financially excluded population into the formal channel. However, the issue of literacy and awareness is prevalent here as well.

According to the 2013 SBP-DFID study of Knowledge, Attitudes and Practices (KAP) of Islamic Banking in Pakistan, 95 percent of the unbanked population did not understand the Islamic Banking model, while for the banked population, the share was 89 percent. That said, there is a strong interest in Islamic Banking, as the KAP survey revealed that 89 percent of the Islamic banked participants were satisfied with their banking services, with the most cited reasons being products not based on interest, religious satisfaction and comfort, and helpful Islamic banking employees. Things were similar on the corporate front, as 86 percent of enterprises cited religious motivation for choosing Islamic banking.

First, growing body of literature is suggesting that the impact of improvements in financial access on financial stability depends on how these improvements are achieved and managed. For instance, Mehrotra and Yetman (2015) maintain that larger risks seem to prevail if greater financial inclusion results from rapid credit growth, and importantly, "if relatively unregulated parts of the financial system grow quickly".[15] Similarly, in context of the devastating impact of financial innovation on financial stability amid the global financial crisis of 2008, Hannig and Jansen (2010) advised policymakers to crucially "avoid backlash against financial inclusion while designing stricter regulations".[16] The study maintained that the potential costs of financial inclusion are compensated by the important dynamic benefits that enhance financial stability over time through a deeper and more diversified financial system.

The latter view was also supported by Han and Melecky (2013), who empirically established that financial inclusion can directly enhance stability: employing proxies for access to deposits and the use of bank deposits, the study found greater access to bank deposits

[15] Mehrotra A. N. and J. Yetman (2015). "Financial Inclusion: Issues for Central Banks." *BIS Quarterly Review*, March 2015: pp 83–96. Basel: Bank for International Settlements.

[16] Hannig, A., and S. Jansen (2010). *Financial Inclusion and Financial Stability: Current Policy Issues*. ADBI Working Paper 259. Tokyo: Asian Development Bank Institute.

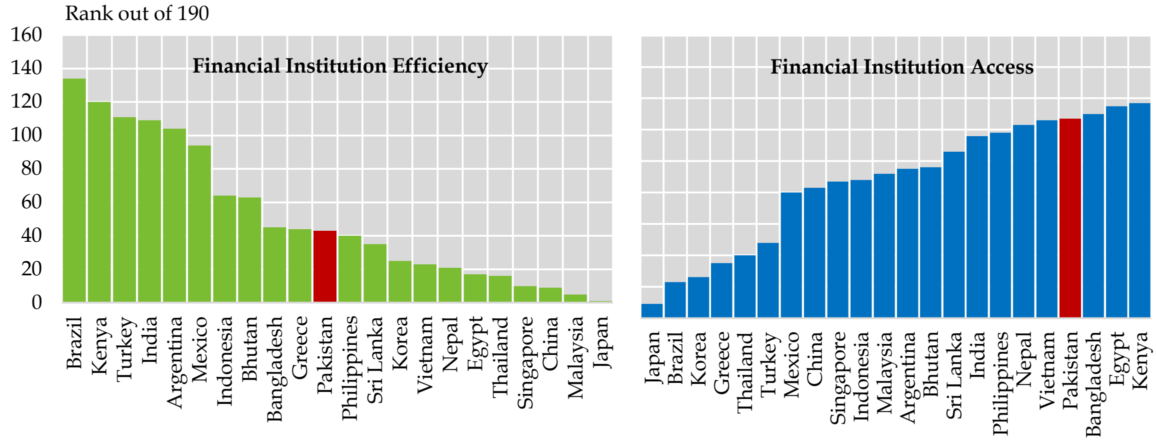
making the funding base of banks more resilient in times of financial stress.[17]

Therefore, it argued that the "policy efforts to enhance financial stability should not only focus on macro-prudential regulations, but also recognize the positive effect of broader access to bank deposits on financial stability". Prasad (2010) postulated a similar mechanism, suggesting that higher financial inclusion in savings enhances the financing of domestic investments by decreasing reliance on foreign financing, thus leading to greater stability.[18] Hawkins (2006) suggest that the central bank's objectives of financial stability and financial service access may be mutually reinforcing, and promoting access to finance enhances financial stability both in the short and long runs.[19] An important dimension gaining traction is that excessive emphasis on financial stability can prolong involuntary financial exclusion (BIS, 2015).[20] The bottom-line is that complex interlinkages (trade-offs and synergies) exist between financial inclusion and stability, and when ignored, these can potentially deliver unwarranted results – such as costly financial crises or continued financial exclusion.[21]

When it comes to Pakistan, strengthening the regulatory framework and improving the overall stability profile of the banking industry was the cornerstone of the comprehensive reform process of the 1990s and early 2000s. However, a deliberate policy push to ensure access of individuals and businesses to useful and affordable financial products and services was not keenly pursued in the process. This was true for both the liability and asset sides of the financial system.

From the liability side, the financial sector's restructuring was, in fact, disadvantageous initially from the inclusion standpoint. 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 June 2004, as many as

Pakistan's Ranking in Financial Institutions' Efficiency and Access (2008-18) **Figure 7.6**



Source: Revised 2018 database of R. Sahay, M. Čihák, P. N'Diaye, and A. Barajas (2015). "Rethinking Financial Deepening: Stability and Growth in Emerging Markets," Revista de Economía Institucional, 17(33): 73-107

[17] Han, R. and M. Melecky (2013). *Financial Inclusion for Stability: Access to Bank Deposits and the Deposit Growth during the Global Financial Crisis*. Policy Research Working Paper, 6577. Washington, DC: World Bank
[18] Prasad, E.S. (2010). *Financial Sector Regulation and Reforms in Emerging Markets: An Overview*. IZA Discussion Paper 5233. Bonn: Institute for the Study of Labor
[19] Hawkins, P. (2006). *Financial Access and Financial Stability in Central Banks and the Challenge of Development.* Basel: Bank for International Settlements.
[20] BIS (2015). *Range Of Practice in the Regulation and Supervision of Institutions Relevant to Financial Inclusion*. Basel: Bank for International Settlements.
[21] Martin. C, Davide S.M, and M. Martin (2016). *The Nexus of Financial Inclusion and Financial Stability: A Study of Trade-offs and Synergies*. Policy Research Working Paper 7722. Washington, DC: World Bank

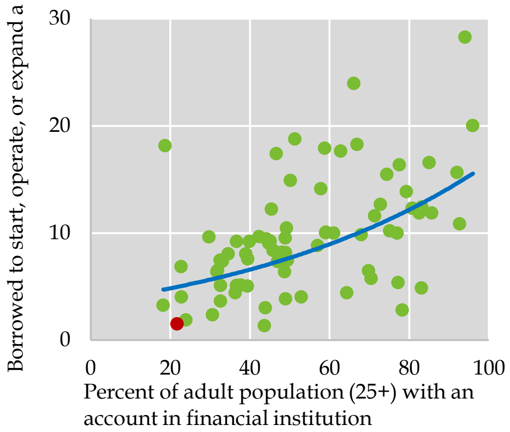
1,656 bank branches and 4.7 million accounts were closed down – around 4.1 million were small-sized accounts (i.e., with balances lower than Rs 5,000). In subsequent years, while banks expanded their outreach and opened new branches, their penetration in the underserved areas remained low. As a result, the number of small-sized accounts shrank by another 2.7 million between 2004 and 2019.

While Pakistan was not alone in terms of focusing on financial inclusion late as opposed to increasing regulatory measures, what made the situation more challenging here was the state of financial depth and access as compared to other emerging and regional economies. In particular, the country had (and still 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 (**Chapter 3**) – major reasons why the country's ranking for efficiency of financial institutions remains far ahead of its ranking for access (**Figure 7.6**).[22] This had two major implications.

First, the deposit base did not grow the way it did in the other EMDEs, which limited the pool of loanable funds available with banks. Second, a large segment of the population does not have an adequate level of banking history. The latter point is important, because having a basic transaction account with commercial banks is considered as the first step towards broader inclusion. This is because 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, can be used by banks to evaluate 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 7.7**).

With a large share of the population devoid of any relationship with financial institutions,

Relationship between Financial Access and Credit Penetration **Figure 7.7**



Red dot denotes Pakistan

Source: World Bank Findex Database for Middle Income

information asymmetries (while evaluating credit worthiness of potential borrowers) remained deeply engrained in the domestic credit market. This, in the presence of tightened regulatory conditions and contract enforcement issues, dented inclusivity in the provision of financing solutions to a large part of the economy. Details are presented in the following section.

b. Unaddressed credit market failures amid stringent regulations exacerbated challenges

The overall state of information and contractual infrastructure is crucial for the financial sector to achieve a broader clientele. Imperfections in these areas weigh particularly heavily on individuals and enterprises that lack collateral, credit/banking history, and connections, as the absence of a reliable collateral and legal ease of foreclosures increases loss potential for banks in the event of a default. Therefore, institutional reforms that secure property rights, ensure creditors' rights, and build credit registries are often cited as long-term prerequisites for well-functioning financial systems.

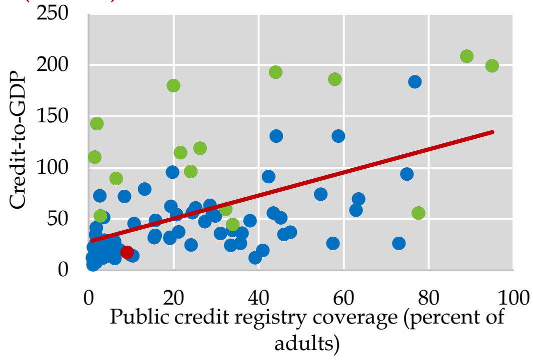
In particular, the success of credit bureaus may be gauged from the fact that their presence and coverage size in an economy is

[22] Revised 2018 database of R. Sahay, M. Čihák, P. N'Diaye, and A. Barajas (2015). "Rethinking Financial Deepening: Stability and Growth in Emerging Markets," *Revista de Economía Institucional*, 17(33): 73-107.

positively correlated with the magnitude of private sector credit (**Figure 7.8**). When banking history is not available, non-bank third party data of first-time borrowers – such as the information on the customer's utility payments, telecom-related transactions, etc. – can work as important elements for risk assessment and loan appraisals, especially for unserved or under-served households and businesses. Without access to such information and/or appropriate collateral, banks are reluctant to extend financing. Here, alongside individual-level information, availability of sector- or group-level data can also be equally important in lending decisions of the commercial banks. Choudhary & Jain (2020) find that after the e-CIB, the only public sector credit bureau in Pakistan, stopped providing the group-level information of firms in 2006,[23] banks that had more private information ("informed banks") about other firms in a borrower's group lent more to that firm than other, less-informed banks. Importantly, this was found to be true even for banks that had pre-existing relationships with that firm. This suggests that past relationships cannot compensate for the information imperfection. Furthermore, businesses that borrowed from informed lenders were found to borrow 12.3 percent more than counterparts who borrowed from less-informed lenders. The paper also found that small firms were most disadvantaged by this information asymmetry.[24]

MSMEs are at a particularly disadvantageous position probably because their capital stock is concentrated mostly in movable assets, such as receivables, intellectual property, inventory, agricultural produce, petroleum or minerals, motor vehicles, etc. Such assets typically do not work as a working collateral for borrowing in most EMDEs, either because the law may

Correlation of Credit Registry Coverage and Private Credit (2010-19) **Figure 7.8**



Note: Based on 88 AEs (green) and EMDEs (blue) public registry coverage of at least 1 percent of adults. Red dot denotes Pakistan.
Source: WDI; World Bank Doing Business Database

not recognize them as security instruments, or the assets might not provide adequate protection for the lenders. Under such conditions, the role of credit registries becomes more important, as they alleviate the risk for a bank that the borrower will use the same movable property as collateral to secure loans from other banks without the knowledge of the original lender.

Empirical evidence shows that credit registries are positively associated with credit growth (Miller, 2003).[25] From the supply side, the presence of credit bureaus was found to reduce processing time, costs and defaults for more than 50 percent of the firms (World Bank, 2004).[26] Meanwhile, on the demand side, 40 percent of firms were reported to be able to avail financing in economies with credit bureaus, compared to just 28 percent in countries without one (Love & Mylenko, 2003).[27] Similarly, when credit reports were available and accessible, businesses were found to rely less on internal financing,

[23] Group was defined by the e-CIB as all firms that shared at least one director with each other.
[24] Choudhary, M. A and A.K. Jain (2020). "How Public Information Affects Asymmetrically Informed Lenders: Evidence From a Credit Registry Reform," *Journal of Development Economics*, 143: 102407.
[25] K. Cowan, and J. De Gregario (2003). "Credit Information and Market Performance: The Case of Chile". In M.J. Miller (Eds.) *Credit Reporting Systems and the International Economy*. Massachusetts: MIT Press.
[26] World Bank (2004). *Doing Business in 2005: Removing Obstacles to Growth*. Washington, DC: World Bank.
[27] Love, I. and N. Mylenko (2003). *Credit Reporting and Financing Constraints*. Policy Research Working Paper 3142. Washington, DC: World Bank.

thereby reducing credit constraints (Galindo & Miller, 2001).[28]

In Pakistan, the movable assets' issue is more profound, given that around 70 percent of the country's MSMEs operate in the retail and other services' segments. For these businesses, acquiring immovable assets such as real estate is challenging. Furthermore, given the high level of informality among domestic MSMEs and their limited banking history, loan appraisals in these segments has been a cumbersome process, requiring acquisition and assessment of non-banking and alternate information.[29] On a regulatory level, the only information set available to banks for evaluating any loan-requesting entity has been the state-owned electronic Credit Information Bureau (eCIB) – launched in 1998 and operating under the SBP – and two privately owned bureaus, which maintain a credit database of individuals and businesses. But despite a periodic improvement in their performances, the coverage of these bureaus has remained minimal; the bureaus maintained data of only 10-20 percent of the borrowers and very few SMEs (requiring loans smaller than Rs 6 million).[30]

This low coverage is primarily because of the generally weak state of financial inclusion and also because these bureaus did not collect information from the telecom and utility companies, which could substantially contribute to building a credit history for MSMEs. Furthermore, Pakistan has a sizable credit registry only in the public domain (the SBP's eCIB); the main goal of such public registries is generally to support the regulation and supervision of the overall banking system. As such, they are geared for use by regulators like central banks, and do not cater to the needs of the commercial banks.

For example, just 14 percent of the public credit registries offered services like credit scoring, compared to 90 percent of private bureaus.[31] According to the Doing Business indicators 2020, registries and bureaus in a number of economies that collected third-party data (such as information from retailers and utility providers) were able to achieve an average coverage ratio (as percent of adults) of 67 percent. Therefore, the delayed focus on officially recognizing and licensing private credit registries proved costly for the country. Most of other regional economies, meanwhile, started to or expanded focus on this front after the Asian Financial Crisis (Hong Kong, Malaysia, Vietnam),[32] and/or the rapid credit expansion in the early 2000s (Singapore, India, Thailand, South Korea).[33] Pakistan, however, lags behind other countries in terms of credit coverage and strength of legal rights, despite showing progress on the depth of credit information collection (**Table 7.1**).

Furthermore, even in sectors where the provision of collateral should have helped allay banks' concerns, weak implementation of foreclosure laws kept lending suppressed. This particularly affected mortgages, which

[28] Galindo, A., and M. Miller (2001). *Can Credit Registries Reduce Credit Constraints? Empirical Evidence on the Role of Credit Registries in Firm Investment Decisions*. In Inter-American Development Bank Seminar, "Towards Competitiveness: The Institutional Path". Santiago: Inter-American Development Bank.

[29] For instance, a 2014 trader-agent intermediation lending (TRAIL) case study conducted by the SBP found that on average it took about 17 working days for a bank to finalize a loan. In addition, interactions with the treasury and revenue departments added 7 more working days to the process. Finally, delays due to factors such as weekends, law and order situation, and inadequate availability of public transport for growers, resulted in a single transaction needing 52 working days in total for completion. Reference: Baluch K. A., and M.A. Choudhary (2014), *Agent Intermediated Lending: The Matiari Case Study*. Occasional Research Papers. Karachi: State Bank of Pakistan.

[30] Nenova, T., C. Thioro Niang, and A. Ahmad (2009). *Bringing Finance to Pakistan's Poor: A Study on Access to Finance for the Underserved and Small Enterprises*. Report No. 48672. Washington, DC: World Bank.

[31] World Bank (2004). Doing Business in 2005: Removing Obstacles to Growth. Washington, DC: World Bank.

[32] Chakravarti, R., Chea, B. H., Citibank, N. A., & Bank, A. P. C. (2005). *The Evolution of Credit Bureaus in Asia-Pacific*. New York: Citi Bank, N.A.

[33] Federal Reserve Bank of San Francisco (2011). *Asia Focus: Credit bureaus in Asia*. Asia Focus Newsletter Oct 2011 Issue. San Francisco: Federal Reserve Bank of San Francisco.

Ease of Getting Credit - A Comparison* **Table 7.1**

Strength of Legal Rights (0-12)	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Egypt	3	3	3	3	2	2	2	2	2	5	5
India	8	8	8	8	6	6	6	6	8	9	9
Indonesia	5	5	5	5	4	4	5	6	6	6	6
Malaysia	10	10	10	10	7	7	7	7	7	7	7
Pakistan	**5**	**5**	**5**	**5**	**2**	**2**	**2**	**2**	**2**	**2**	**2**
Philippines	4	4	4	4	1	1	1	1	1	1	1
Sri Lanka	4	4	4	5	2	2	2	2	2	2	2
Thailand	5	5	5	5	3	3	3	3	7	7	7
Vietnam	7	7	7	7	7	7	7	7	8	8	8

Depth of Credit Information Index (0-8)	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Egypt	6	6	6	6	8	8	8	8	8	8	8
India	5	5	5	5	7	7	7	7	7	7	7
Indonesia	5	5	5	5	6	6	6	6	7	8	8
Malaysia	6	6	6	6	7	7	7	8	8	8	8
Pakistan	**2**	**2**	**2**	**2**	**3**	**3**	**3**	**7**	**7**	**7**	**7**
Philippines	0	0	0	4	6	6	6	7	7	7	7
Sri Lanka	5	5	5	5	6	6	6	6	6	6	6
Thailand	5	5	5	5	6	6	6	7	7	7	7
Vietnam	4	4	4	4	6	6	7	7	7	7	8

Coverage of Credit Bureau/Registry (percent of adults)**	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Egypt	8	10	14	16	20	22	21	22	25	27	31
India	10	10	15	15	20	22	22	21	44	56	63
Indonesia	22	25	32	36	41	46	49	52	55	58	40
Malaysia	82	100	83	82	77	79	77	76	83	87	89
Pakistan	**6**	**6**	**7**	**7**	**8**	**7**	**7**	**9**	**10**	**11**	**12**
Philippines	1	1	1	7	7	7	8	10	11	12	14
Sri Lanka	14	19	29	34	39	45	50	57	35	47	49
Thailand	33	36	42	44	49	53	60	53	57	60	57
Vietnam	19	26	30	38	39	42	42	42	51	55	59

*Change in methodology from 2015 onwards; 2010-13 figures based on old methodology. Lighter shade represents lower scores and darker shade denote higher scores (higher is better).

** Higher of either bureau or registry coverage is taken

Source: Doing Business Indicators, World Bank

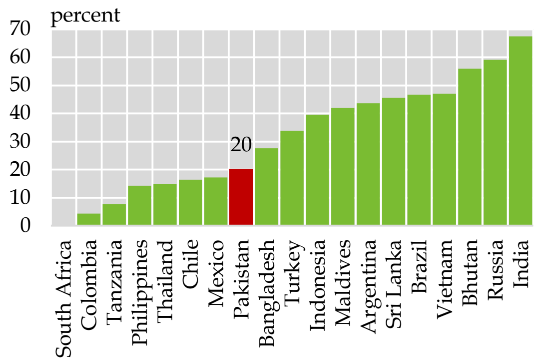
constitute the bulk of lending to households in developed and EMDEs alike (more on this later). Furthermore, recovery of bad loans has historically been an arduous, time consuming, and costly task in the country. As for loan write-offs, despite being permissible on regulatory grounds, implementation issues have held back commercial banks from cleaning up the accumulated bad loans from their books.

c. State intervention is still common in other emerging markets and may explain some of the cross-country differences in credit penetration

Importantly, the combination of these supply-side issues – large information asymmetries and banks' constraints with respect to write-offs and foreclosures – has a strong tendency to exacerbate pro-cyclical elements in private credit growth. This means that the prospects for using bank credit to stimulate growth in times of downturn or a crisis are fairly limited. In this context, it is important to note that in many EMDEs, the state is still engaged in rolling out counter-cyclical policies through selected institutions, and it also actively pursues a development finance agenda.

Following the liberalization and deregulation process starting in the late 1980s, the share of

Share of State-Owned Banks in Overall Banking Assets **Figure 7.9**



Source: Bank Regulation and Supervision Survey 2019 Database, World Bank; Figure are for 2016

state-owned banks relative to the total assets of the banking system in the world has fallen to only 14 percent in 2016, from an average of 67 percent in 1970.[34] However, some countries, such as China, India, Russia, Vietnam and Brazil, chose to retain state control on around half of the banking system's assets (**Figure 7.9**). The presence of state-owned banks in Argentina, Indonesia, Sri Lanka, and Turkey is also prominent, with shares ranging between 30 to 50 percent of banking assets.

In contrast, Pakistan chose to significantly reduce the state's role in the banking system, along the lines of most East Asian, European and Central Asian countries.[35] Compared to 90 percent in 1990, the share of state-owned banks has been reduced to only 20 percent by 2020.

The reason why some EMs continued with a large share of state-owned banks is because these institutions fulfill development roles by compensating for market imperfections, especially by providing long-term credit, infrastructure finance, and access to finance for underserved sectors like SMEs and agriculture. Furthermore, empirical evidence suggests a low responsiveness of lending operations of state-owned commercial banks to economic fluctuations (Duprey, 2015).[36] Lending by state banks is less pro-cyclical than that by private banks – especially if the bank operates in a country that ranks high in the scale of governance (Bertay et al, 2015).[37] Nonetheless, governance issues and political interventions in state-owned institutions often lead to resource misallocation and inefficiencies, and this pushed many countries (including Pakistan) towards private ownership.[38] Past experiences of many developing economies also suggest that "cronyism in lending may build up large fiscal liabilities and threaten public sector solvency and financial stability, as well as misallocate resources and retard development in the long run".[39] Pakistan's experience was no different.[40]

In terms of development finance also, while Pakistan withdrew from the use of directed credit in the post-reform period, this practice remained in place in a number of Asian countries. For instance, banks in India are directed to lend no less than 40 percent of their total loan portfolio to the so-called priority

[34] Cihak, M. and A. Demirgüç-Kunt (2013). *Rethinking the State's Role in Finance*. Policy Research Working Paper 6400. Washington, DC: World Bank.
[35] The share of state-owned banks reduced from 23 and 48 percent in 1994 in East Asia and Europe and Central Asia respectively, to 13 and 14 percent in 2010 [Cull, R., M.S.M. Peria, and J. Verrier (2018). *Bank ownership: Trends and implications*. Policy Research Working Paper. Washington, DC: World Bank.]
[36] Duprey, T. (2015). "Do Publicly Owned Banks Lend Against the Wind?" I*nternational Journal of Central Banking*, 11: 65-112.
[37] Bertay, A. C., A. Demirgüç-Kunt, and H. Huizinga (2015). "Bank Ownership and Credit Over the Business Cycle: Is Lending by State Banks Less Procyclical?" *Journal of Banking and Finance*, 50: 326-339.
[38] Cull, R., M.S.M. Peria, and J. Verrier (2018). *Bank Ownership: Trends and Implications*. Policy Research Working Paper 8297. Washington, DC: World Bank.
[39] Reference: same as in footnote 34.
[40] As noted in the State Bank of Pakistan (2002), "the state-owned banks were finding it difficult to maintain their market shares in terms of assets, deposits, advances and investment. In addition, political intervention, over-staffing, over-branching and inefficiencies in this group had led to the problems of large non-performing loans, high administrative expenses, huge losses, and eroding capital base."

sectors.[41] In Brazil, the earmarked lending constitutes nearly half of the overall bank credit;[42] 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. Similarly, in Indonesia, at least 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.

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 6.3 percent in the 28 years from 1991-2019, the PSL element has been criticized on the grounds that the country's performance could have been even better in its absence.[43] Similarly, weaknesses in Vietnam's financial sector are also seen to be emerging from excessive state interventions in banks' credit and investment decisions.[44]

The only kind of interventions Pakistan has seen over the last decade included: i) the SBP's concessionary refinance facilities to exporters and export-oriented investment projects, SMEs and special segments (such as women entrepreneurs and special persons); ii) managing donor-funded risk-sharing financing scheme & establishing the first credit guarantee company (the Pakistan Credit Guarantee Company Limited); iii) indicative targets for SME financing to commercial banks and DFIs by the SBP; and iv) enhancing banks' capacity and creating financial sector awareness among SMEs. The results have been mixed so far.

For instance, the SBP has launched various refinance facilities, along with risk coverage, in the past and assigned institution-wise financing targets, to address the financing constraints of the SME sector. Though the above-mentioned efforts have brought improvement in the banks' SME financing portfolios, a large number of SMEs remained financially excluded. Then in 2017, the SBP launched a comprehensive policy for the promotion of SME finance based on a holistic strategy, ranging from simplified procedures to regulatory framework and from capacity

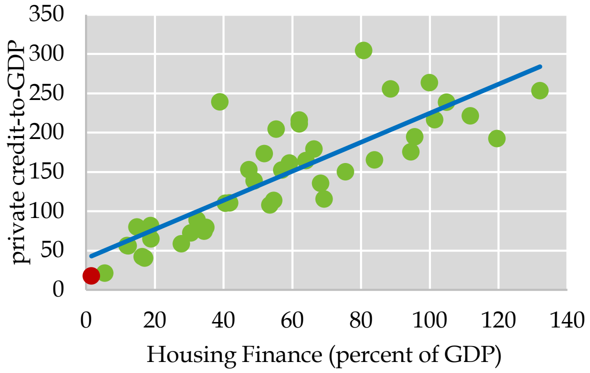
[41] This requirement is in place since 1980, when commercial banks were advised to raise the proportion of their advances to priority sectors to 40 percent of aggregate bank advances by March 1985. These priority sectors included agriculture, micro and small enterprises, education, microcredit, housing, export credit to certain sectors, etc. 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.

[42] The Brazilian 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. These loans are either directly granted by the government-owned banks or channeled via private banks. Interest rates charged on these loans are regulated and are substantially lower than those charged in the non-regulated loans market. [Bonomo, M., and B. Martins. (2016). *The Impact of Government-Driven Loans in the Monetary Transmission Mechanism: What Can We Learn From Firm-Level Data?* Working Paper 419. Brazilia: Banco Central do Brasil.

[43] 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. For details, see J.A. Hansen (2006). "Indonesia and India: Contrasting Approaches to Repression and Liberalization". In G. Caprio, P. Honohan, and J.E. Stiglitz (Eds.). *Financial Liberalization: How Far, How Fast?* Cambridge: Cambridge University Press. 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. For details, see Farrell, D., S. Lund, E. Greenberg, J. Rosenfeld, and F. Morin. (2006). *Accelerating India's Growth through Financial Sector Reform*. San Francisco: McKinsey Global Institute.

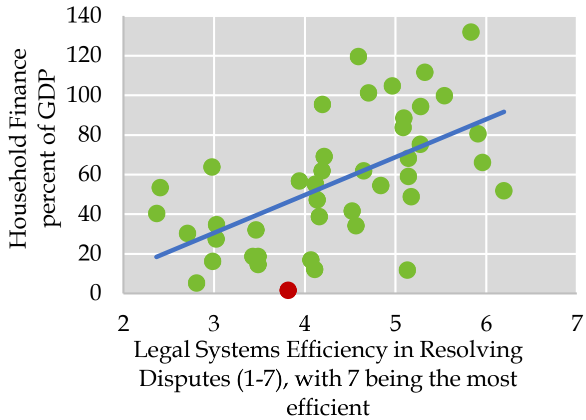
[44] Source: World Bank (2014). *Financial Sector Assessment: Vietnam*. Washington, DC: World Bank.

Relationship between Household Loans and Private Sector Credit (2019) **Figure 7.10a**



Note: Based on information of 43 AEs and EMDEs. Red dot denotes Pakistan
Source: BIS; SBP; WEF Competitiveness Report

Relationship between Household Finance and Dispute Resolution **Figure 7.10b**



building to handholding. The target was to increase SMEs' share in total private sector credit from 8 percent to 17 percent by 2020, and increase number of borrowers from then-174,000 to 500,000. As it turned out, the policy fell short of achieving its desired objectives. In case of export refinance facilities, however, the SBP's interventions have been effective. For instance, nearly half of the working capital activity in textiles in FY19 and FY20 was funded from the SBP's Export Finance Scheme (EFS).

d. Challenging dynamics in low cost housing and household finance

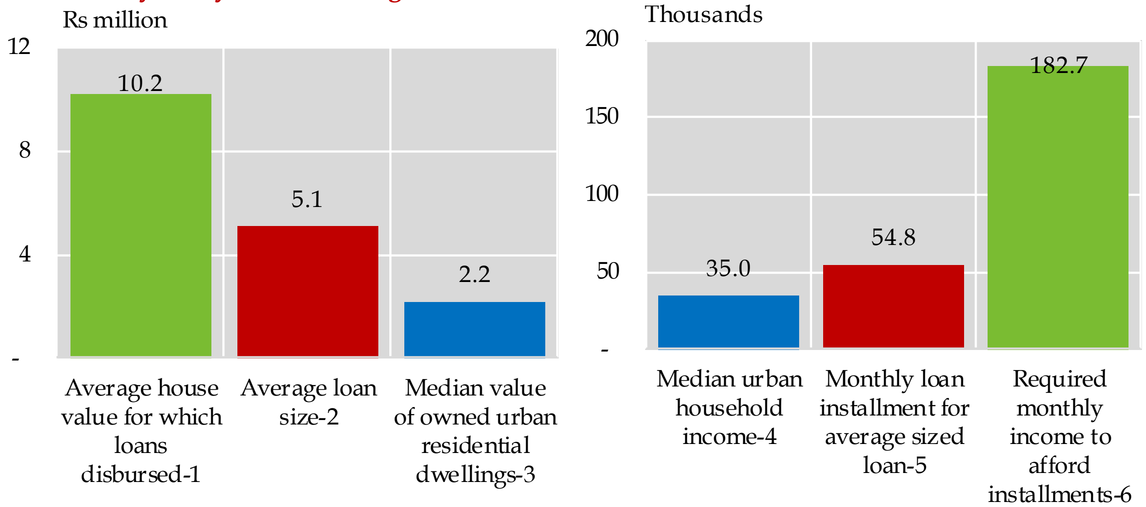
An important characteristic of countries with high credit penetration is the access of households to bank credit (**Figure 7.10a**). Mortgages, in particular, hold a dominant portion of overall private credit in a number of Asian countries like South Korea, Singapore, and Malaysia, where the overall housing finance ranges between 50 percent and 70 percent of GDP. Banks in the BRICS countries also have large household credit portfolios,

where this ratio lies within the range of 12 percent to 55 percent. In Pakistan, however, banks are confronted by various operational hurdles relating to recoveries. **Figure 7.10b** shows that not only is the level of household finance in Pakistan negligible, it is also lower than what should be expected given the current level of dispute settlement efficiency of the country's legal system (in the figure, this is represented by the vertical distance of Pakistan from the linear trend). Broadly speaking, there are four main reasons why housing finance growth has been sluggish in Pakistan.

The first pertains to land entitlement and registry. Land titling and registration can stimulate finance in two ways. First, it can lower search, transaction, and transfer costs of property by reducing processing time and standardizing procedures. Second, it can provide crucial information for third parties – commercial banks – about the ownership status, history and valuation.[45] This would lower risks for banks, thereby incentivizing them to expand credit supply using such properties as collateral. In Pakistan, land registration reforms were not focused upon adequately until very recently. The traditional way of land administration involved a lot of paperwork, significant bureaucratic bottlenecks, multiplicities of operations, and suboptimal awareness, transparency, and access. This discouraged banks from venturing into mortgage finance, and the usage of property as collateral for other types of loans for households and firms.

[45] Deininger, K, and A. Goyal (2010). *Going Digital: Credit Effects of Land Registry Computerization in India*. Policy Research Working Paper 5244. Washington, DC: World Bank.

Affordability Analysis of Housing Finance in Pakistan **Figure 7.11**



Source: 1 and 2: Based on average LTV ratio and average loan size from SBP Housing Finance Review Jul-Sep 2016

3 and 4: HIES 2018-19, PBS

5: authors' calculations based on LTV ratio of 50 percent, weighted average markup rate of 10 percent, and average maturity period of 15 years (fgures rounded); data from SBP Housing Finance Review Jul-Sep 2016

6: Assuming 30 percent of household income as housing expediture criteria as used in the March 8, 2018 official document of the Pakistan Housing Finance Project, World Bank

Second, apart from the absence of concrete know-your-customer requirements, the real estate sector has been characterized by weak regulatory oversight and very low official valuation rates of land and property. This essentially presented a legal avenue for under-documenting transactions, benefiting those looking to conceal their wealth and reduce their tax liabilities. Resultantly, the sector has been attracting significant amounts of speculative and/or under-disclosed investments, which, in turn, have contributed sizably to escalating property prices. Importantly, a noticeable amount of sales activity took place in plots, without corresponding activity in real estate development.[46] These factors played a substantial role in widening the housing backlog in the country, and crowding out genuine buyers from the property market. This means that even if such families were able to afford mortgage financing, adequate housing remained out of their reach.

This situation is exacerbated by the low-income levels of the majority of the households in Pakistan. According to the Household Integrated Economic Survey (HIES), the median household income is Rs 56,000. Within the existing mortgage portfolio of commercial banks (excluding DFIs), the average loan size is Rs 5.1 million, with the loan-to-value ratio of almost 50 percent. Assuming a 15-year maturity period, this roughly implies that the required monthly income to afford mortgage installments is over 3 times the average household income (**Figure 7.11**). In other words, those seeking to avail housing finance must have substantial existing savings for down payment, and they must also be able to meet the relatively high monthly payments.

Third, interest from the private sector builders and developers has been disproportionate and limited. Initially, the federal and provincial governments and urban development authorities were the main players in the urban

[46] Since June 2011, from where any estimates of property prices are available, plot prices in Pakistan nearly tripled till June 2018, whereas house prices grew by 139 percent during the same period. For details, see Special Section 1: Real Estate - Implementing the Announced Reforms, in the SBP's First Quarterly Report on the State of Pakistan's Economy for FY19.

housing market. However, the situation changed dramatically during the past two decades, with numerous private sector players coming into the market and creating residential housing schemes in major urban areas. This was due to repeated introduction of incentives from the government to help address the growing housing shortage. These incentives included tax leniency, building code relaxations, processing expediency, subsidized land, etc.

However, the private sector schemes were not able to effectively serve their original purpose. This is because builders and developers, seeking high profits and aiming to avoid challenges associated with providing low-cost housing, mainly set up housing projects targeted at high and upper-middle income households of the country. Furthermore, due to changes in government regimes, the announced incentive packages also lost support and faded into the background. Resultantly, such schemes had the opposite impact, where they increased speculative interest in the market, raised property prices, and further deepened the housing backlog in the country.[47]

Fourth, banks often shy away from lending to households due to a lack of effective legal framework. Recovery, foreclosure and eviction laws are 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 a mortgage property in the event of a default without recourse to the courts. However, courts' stay order on Section 15 has been one of the biggest bottlenecks impeding the growth of housing finance in Pakistan.

The SBP, in consultation with relevant stakeholders, has proposed amendments in the FIRO 2001. The SBP also facilitated the government in the drafting of rules as required under the amended act. The rules were notified by the federal government in July 2018, and they have been submitted to the court in compliance with its orders. In its final judgment in March 2020, the Lahore High Court did not hold Section 15 as unconstitutional. In October 2020, the Supreme Court also dismissed an appeal against this decision. Going forward, these developments should help allay banks' concerns while extending mortgages.

e. Incomplete fiscal and debt market reforms

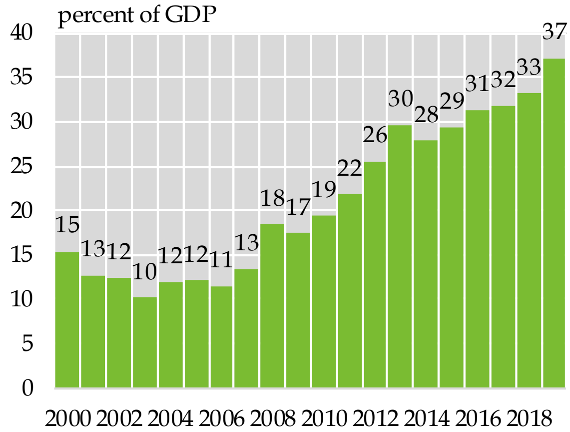
In the pre-reform period, high SLR requirements, direct monetary controls, administered interest rates and the establishment of the NCCC were aimed at directly controlling the flow of bank credit to the private sector, and simultaneously fulfilling the government's budgetary borrowing requirement from banks. 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.[48] Up until 2008, it appeared that these expectations were not entirely misplaced, as banks' investment in government papers was contained to some extent. 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 as well as privatization proceeds during this period. This argument gets support from the fact that as soon as the fiscal deficits began to increase again from FY08 onwards, banks' claims on the government also took a steep turn, and by end-2019, reached an all-time high (**Figure 7.12a**).

However, cross-country examination reveals that high fiscal deficits and higher allocation of bank liquidity for budgetary lending cannot entirely explain such a low private credit to GDP ratio. For instance, India, Sri Lanka, Egypt, Turkey and Malaysia ran persistently

[47] UN Habitat (2018). "Housing in Pakistani Cities". In *The State of Pakistani Cities 2018.* Islamabad: United Nations Habitat (pp. 59-68).

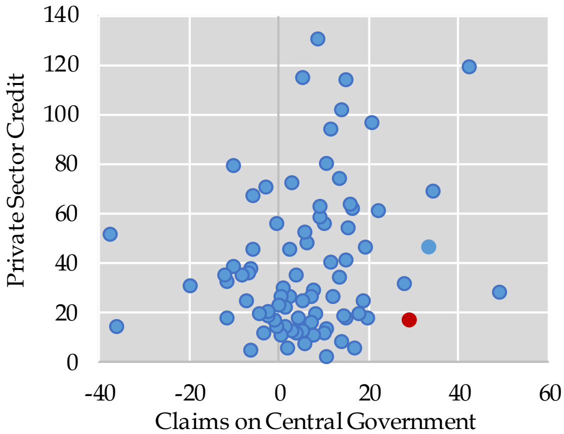
[48] The required SLR was gradually reduced from 45 percent to 35 percent in October 1993, and further to 25 percent in May 1994. In May 1997, this ratio was further brought down to 20 percent, and to 15 percent in June 1998.

Claims on Central Government in Pakistan **Figure 7.12a**



Source: World Bank

Relationship between PSC and Claims on Government in EMDEs **Figure 7.12b**



Red dot denotes Pakistan

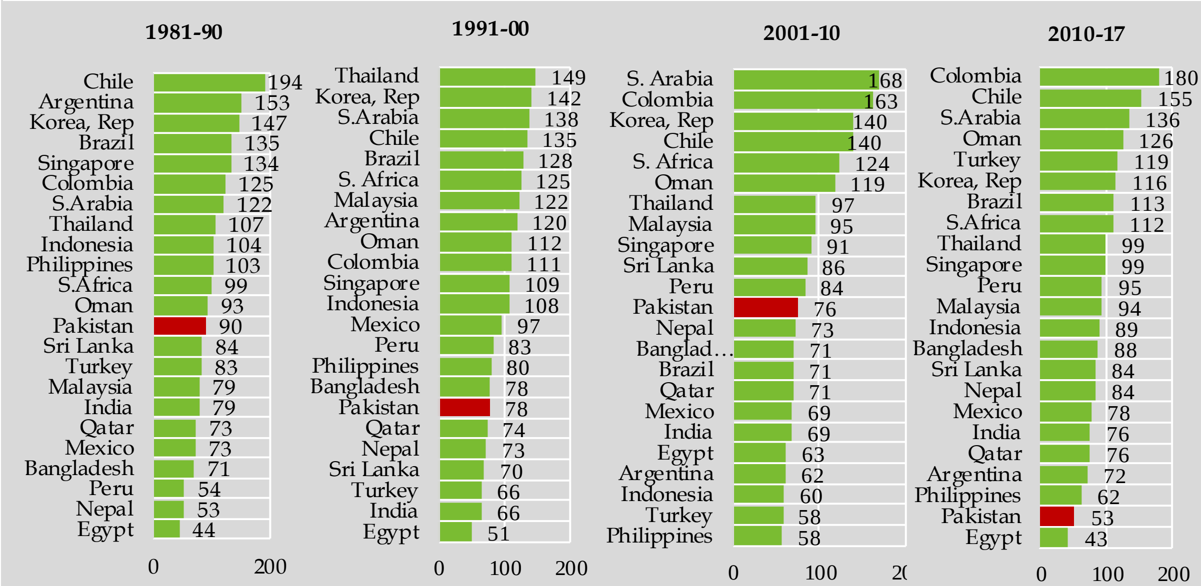
high fiscal deficits over the past 15 years, yet their credit growth through all these years was also substantially higher than Pakistan. More importantly, India, Egypt and Brazil even have a higher level of bank claims on government; still, their banks managed to contribute meaningfully to private sector growth, especially when compared to Pakistan (**Figure 7.12b**). While these comparisons are illustrative from a cross-country perspectives, they do not necessarily imply that private sector credit is not being crowded out in these economies. For example, Bouis (2019), in a multivariate analysis using data from 88 EMDEs, found that "higher banks' holdings of government debt are associated with a lower credit growth to the private sector and with a higher return on assets of the banking sector."

Furthermore, the study found that this negative relationship indicated the inclination of banks to rebalance portfolios towards safer assets during stress times.[49] Similar results are found in IMF (2015),[50] Altavilla et al. (2016),[51] and Bahal et al. (2015).[52] For Pakistan, the size of the banking industry and the depth in the domestic debt market appear to be important determinants of the extent of the fallout of fiscal borrowings on private credit. However, a crucial factor is the relationship between the share of government in banks' asset portfolio and the banking spread in the economy.

As mentioned before, the risk aversion of banks increased during the post-GFC period in Pakistan, as default rates of small businesses rose and the borrowing appetite of the government grew. By 2011, the government had become the dominant borrower of the banking system, and its share has continually risen ever since. Importantly, credit spreads in the country moved in the

[49] Bouis, R. (2019). *Banks' Holdings of Government Securities and Credit to the Private Sector in Emerging Market and Developing Economies*. Working Paper No. 19/224. Washington, DC: International Monetary Fund.
[50] IMF (2015). Arab Republic of Egypt, Staff Report for the 2014 Article IV Consultation, Country Report 15/33. Washington, DC: International Monetary Fund. The Fund noted that "low credit reflects crowding out from public sector borrowing, which pushes interest rates up and reduces incentives to lend to the private sector."
[51] Altavilla, C., M. Pagano, and S. Simonelli (2017). "Bank Exposures and Sovereign Stress Transmission," *Review of Finance*, 21(6): 2103-2139. Authors note that banks increase holdings of government securities during periods of high non-performing loans.
[52] Bahal, G., M. Raissi, and V. Tulin (2018). "Crowding-out or crowding-in? Public and private investment in India," *World Development*, 109: 323-333. The authors note that "… public investment 'crowded out' private investment in India over the period 1950-2012. In contrast, we found support for crowding in of private investment over the more recent period of 1980-2012. This change in the relationship can be attributed to the policy reforms which started during early 1980s and gained momentum after the 1991 Indian balance of payments crisis."

Bank Credit to Bank Deposit Ratio - A Comparison **Figure 7.13**



Source: Global Financial Development Data, IMF

same direction, and an increase in lending to the government was found to be positively correlated with higher spreads for new loans, thus leading to a decrease in private sector investment activities. As Choudhary et al. (2016) put it, this scenario becomes more likely during a recessionary phase, when the government has limited alternate avenues to raise finance.[53] This also prolongs and deepens the recessionary phase.

Zaheer et al. (2017) found that a one percentage point growth in the government borrowing led to an 8-basis point crowding out of the private sector credit in four months.[54] Controlling for a number of demand- and supply-side variables, including the policy rate and total deposits net of banks' balances with the SBP, the study regressed growth in private sector credit on the government's budgetary borrowing growth. The results showed that there was no significant difference in the relationship between the two variables before and after the implementation of the interest rate corridor.

This suggests that even though the thin deposit base of domestic banks contributed to weak level of private credit in Pakistan, its increased allocation towards government papers was crucial to further suppressing lending to the private sector. As shown in **Figure 7.13**, the bank credit to bank deposit ratio in Pakistan during 2011-17 stood at 53 percent, much lower than that in other regional and peer EMDEs. Importantly, the private credit penetration also significantly dipped during the post-GFC period. Here, it is important to acknowledge that the overall suppressed economic activity might have reduced the capex-related credit demand. However, it is noticeable that working capital finance did not increase either during the period, even though the commodity prices were on a rising trend after the Arab Spring, and businesses needed funding to support their day-to-day operations because of muted domestic and international demand. Furthermore, the opportunity cost of focusing less on the private credit front also proved negligible for the commercial banks, as evidenced by the fact that their assets

[53] Choudhary, M. A., S. Khan, F. Pasha, and M. Rehman (2016). "The Dominant Borrower Syndrome," *Applied Economics, 48(49): 4773-4782.*

[54] Zaheer, S., F. Khaliq, and M. Rafiq (2017). *Does Government Borrowing Crowd Out Private Sector Credit in Pakistan.* SBP Working Paper 83. Karachi: State Bank of Pakistan.

expanded by a CAGR of 13.3 percent, while their profit after taxes rose by a CAGR of 21.0 percent during CY09-13.[55] Thus, a more subtle impact of the government's funding appetite has been the lack of concentrated efforts by banks to venture into the underserved segments of the economy, including SMEs, agriculture and households, in the presence of credit market failures.

7.4 Recent Policy Interventions to Increase Credit Expansion in Pakistan

After putting Pakistan's current credit penetration in historical and cross-country contexts, we shift towards the way forward for the economy to enhance financial inclusion and credit expansion. Three elements hold the potential to change the landscape substantially: (i) the renewed emphasis on house financing by both the government and the SBP; (ii) the introduction of a secured transaction registry and private credit bureaus; and (iii) progress in digital payments and finance in the county.

a. Policymakers have started to actively focus on the housing sector

There has been renewed interest in the housing segment by government authorities in Pakistan, and progress is visible on all the four dimestions highlighted in the previous section (**Figure 7.14**). Take the land entitlement and registration issue, for example. First, the FBR has increased the valuation rates in the country (by as much as 100 percent in some urban areas), to bring them closer to the market rates.

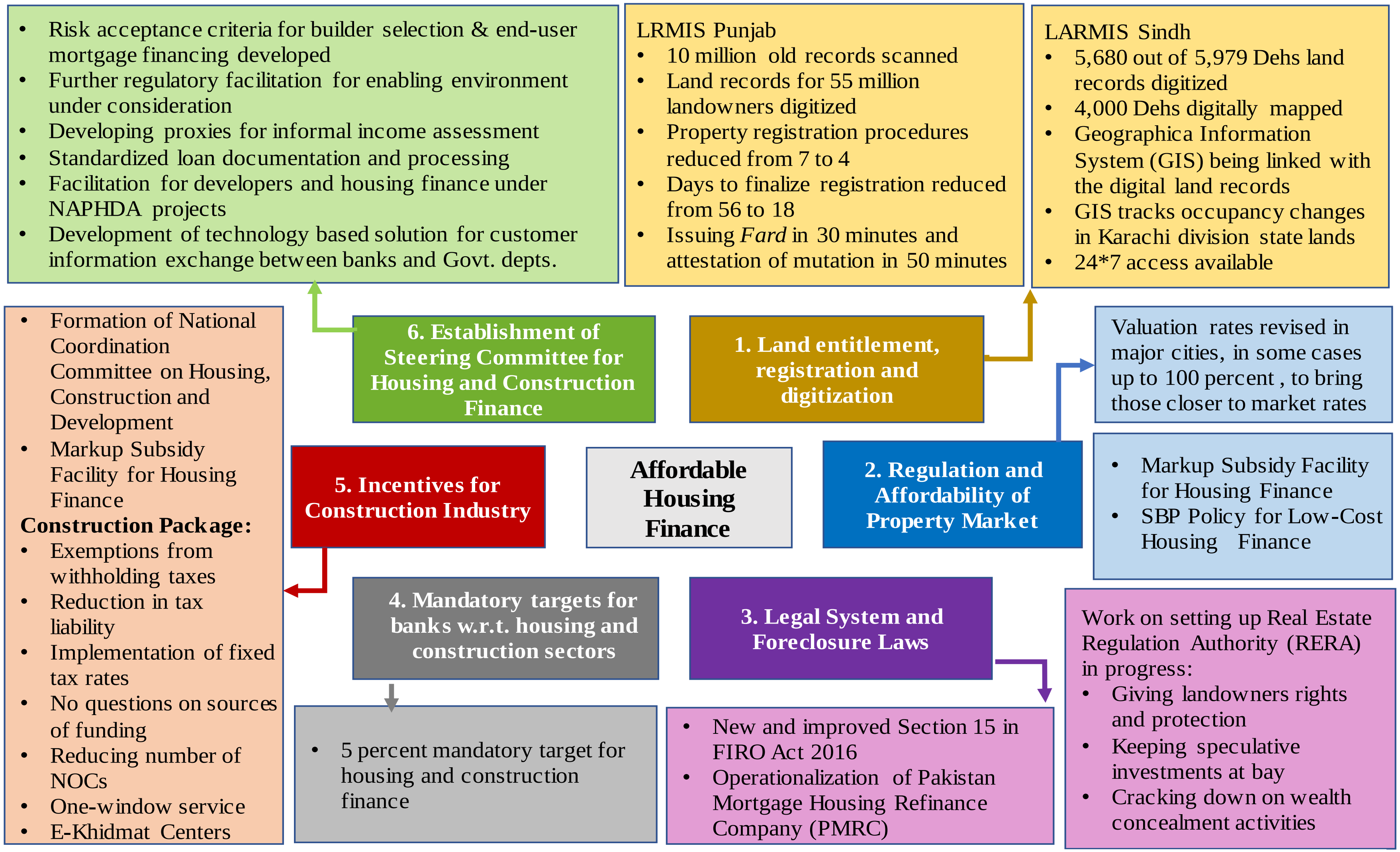
Second, there is an extensive focus on digitization of land records, especially in Punjab and Sindh, which will help on the data front. Within the first five years of introducing the Land Records Management and Information System (LRMIS) in Punjab, 10 million pages of old records were scanned, land records for over 55 million landowners were digitized, and land title information was digitized and uploaded online for easy access.[56] Resultantly, the time needed to complete a transaction significantly decreased from 2 months to just 50 minutes. In Sindh, under the Computerization & Establishment of Land Administration & Revenue

Management Information System (LARMIS), the record of 5,680 out of 5,979 Dehs has been computerized. Meanwhile, the development of the Geographical Information System (GIS) is also underway. So far, the mapping of 4,000 out of 5,979 Dehs has been completed, while progress on the remaining is underway. The digital maps are also being integrated with the computerized land records.[57] Both the increase in valuation rates and the digitization of land records are expected to reduce speculative buying and wealth concentration in the sector.

To tackle the issues on the affordability front, the government announced the Naya Pakistan Housing Project (NPHP) on October 10, 2018, aiming to establish 5 million dwelling units across the country to cater to the needs of the lower-income class. Moreover, the SBP has introduced a comprehensive policy package for low-cost housing finance – comprising a refinance facility for low-cost housing for special segments, regulatory relaxations to banks, and mandatory housing finance targets. Specifically, the SBP has assigned commercial banks mandatory targets to increase housing and construction financing to at least 5 percent of their private loan portfolios by December 2021 (**Figure 7.15**). As an incentive, from end-June 2020 onwards, the CRR requirement for complying banks in a quarter would be lowered by an amount equal to the increase in their housing and construction finance in the previous quarter.[58] Conversely, the banks

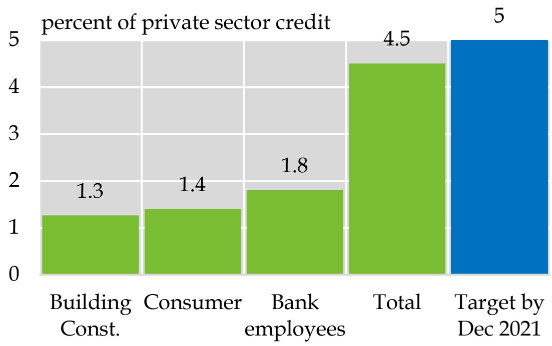
[55] Data source: Financial Soundness Indicators, SBP.
[56] https://pitb.gov.pk/lrmis_becomes_a_remarkable_success_story
[57] https://bor.sindh.gov.pk/land-administration-revenue-management-information-system-larmis
[58] This incentive, however, will be subject to a ceiling of 1 percent of the total demand and time liabilities based on which the CRR is calculated. Further, the banks will continue to maintain daily minimum CRR, which currently stands at 3 percent (source: https://www.sbp.org.pk/dmmd/2020/CL3.htm).

The Six-Pronged Strategy to Create an Enabling Environment for Affordable Housing Finance in Pakistan **Figure 7.14**



Source: Board of Revenues Sindh and Punjab; Punjab Information Technology Board; Ministry of Finance; Office of the Prime Minister's website; Federal Board of Revenue; Naya Pakistan Housing Program; World Bank; State Bank of Pakistan;

Construction Loans in Pakistan - FY16-20 Average and New Minimum Target **Figure 7.15**



Source: State Bank of Pakistan

falling short of the quarterly financing target would be penalized by the requirement of maintaining additional CRR equal to the deficit from the target.

Furthermore, to improve access for genuine buyers, the government recently announced a Rs 30 million subsidy to finance the down payment of the first 100,000 houses under the NPHP. The end-user interest rate for 5 marla units would be 5 percent for the first five years and 7 percent for the next five years, while that for 10 marla units would be 7 percent and 9 percent respectively.[59] The scheme would also benefit from the aforementioned measures (such as automation and computerization of land and property records for facilitation of clean title for bank lending), as well as other in-process reforms, like the reduction in time taken for the registration of title & creation/perfection of mortgages, creation of a Real Estate Regulatory Authority (RERA) to address banks' concerns over adequate standards for developers and builders, and reduction in transaction costs for property transfers.

The government is also providing incentives to builders and developers to participate in the low-cost housing initiatives. Under the recently announced construction package, builders and developers would be given exemptions from withholding taxes on various inputs, reduction in tax liability, and implementation of fixed taxation rates; there would also be no question on the source of funds being invested in the development projects given that such projects are approved by end-December, 2020. The government authorities are also in regular consultation with the private sector players, conducting weekly meetings to raise awareness, answer questions, and take into consideration demands and issues faced by the builders and developers. A special National Coordination Committee on Housing, Construction and Development has been formed in this regard. Its convener is the chairman of the Naya Pakistan Housing and Development Authority (NPHDA), and members include representatives from the ministries of housing, finance, petroleum, and law and justice, chief secretaries of the provinces, AJK, and Gilgit Baltistan, and the chairman FBR and deputy governor SBP. The SBP has also established a Steering Committee on Housing and Construction Finance. Key responsibilities taken up by the committee include the development of risk acceptance criteria for builder selection and end-user mortgage financing; standardization of loan documentation and processing; and the development of income proxies for informal income assessment of loan applicants.

Further impetus to domestic mortgage financing comes with the operationalization of Pakistan Mortgage Refinancing Company (PMRC). Facilitated by the 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

[59] The subsidy will be given on housing units whose price does not exceed Rs 3.5 million for 3-5 marlas, and Rs 6 million for 10 marlas. Rs 33 billion were allocated for the loan tenor of 10 years, with Rs 4.77 billion to be allocated in the current financial year for the payment of markup this year (source: PR No. 344, Ministry of Finance, dated July 22, 2020, http://www.finance.gov.pk/press_releases.html).

Box 7.3: Successful International Case Studies of Introducing Secured Transaction Reforms (STR)

Mongolia: STRs started in 2013 to help MSMEs improve access to finance. The Mongolian Pledge Notice Registry was launhced in 2017 under the Pledge Law 2017. The law allows enterprises to offer all types of movable and immovable assets as collateral to a financial institution. Of the 30,000 registrations just a quarter after launching, 38 percent covered equipment, 25 percent were related to livestock, 5.4 percent were regarding receivables, and 1.7 percent covered vehicles. Female-led buinesses accounted for almost one-fourth of the registrations.

Ghana: After the introduction of the STRs under the Borrowers and Lenders Law (Act 773, 2008), many MSMEs were able to avail credit facility using movable assets as collateral. A particular feature of the policy was to allow women entrepreneurs to use household assets (kitchen utensils, etc.) and equipment to apply for a business-starting or working capital loan. In the first four years of the launch, total registrations stood at 40,500 - more than five times the initial target. Over 5,000 SMEs and 22,000 micro businesses received loans amounting to more than US$ 3 billion, after registering movable assets as collateral.

Slovakia: The introduction of the Register of Pledges in 2003 by the Slovak Chamber of Notaries, which allowed registrations of movable assets as collaterals, the number of annual entries increased 50 percent on average during the first four years, from 7,508 in 2003 to 31,968 in 2007. The creation of the registry was termed by the World Bank as the main reason for Slovakia's success in the Doing Business rankings, where the eoncomy was the top performer in 2005.

Romania: Romania passed the Title VI legislation on Legal Treatment of Security Interests in Personal Property in May 1999. Among other reforms, it simplified the registration process for secured transactions, and expanded the scope of the kind of assets that could be used as a collateral, including products that could be aquired or manufactured/produced in the future (e.g. year-end crop harvest). From 2000 to 2006, the increase in registrations was around 60 percent per annum, taking the total entries from 65,227 in 2000 to 536,067 in 2006. The STRs also led to the creation of new financing products by the commercial banks, which made access to credit cheaper and efficient.

References:
K. Mathernova (2008). "The Slovak Secured Transactions Reform: Ingredients of a Successful Reform and Reflection on its Achievements" In F. Dahan, and J. Simpson (Eds.). *Secured Transactions Reform and Access to Credit*. London: European Bank for Reconstruction and Development (pp. 207-223).
De La Campa, A., E.T. Wohlers, Y. Baranes, and S. Simavi (2010). *Secured Transactions Systems and Collateral Registries* . Working Paper 112645. Washington, DC: World Bank.
Ouedraogo, A; I. Caruana, E. Rodriguez, and S. Tischendorf (2012). *It Started in Ghana : Implementing Africa's First Collateral Registry*. IFC Smart Lessons Brief. Washington, DC: World Bank.
World Bank (2019). *Secured Transactions, Collateral Registries and Movable Asset-Based Financing*. Knowledge Guide. Washington, DC: World Bank.

the capital markets – by providing more private debt securities (including asset-backed securities) to raise funds – and create a benchmark yield curve.

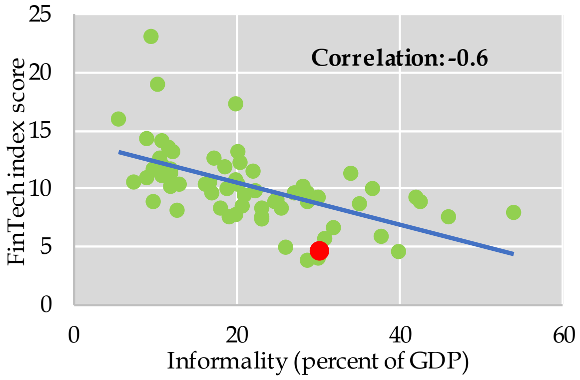
b. The introduction of the Secured Transactions Registry would help address market imperfections, particularly for the under-served segments

As mentioned above, in the absence of adequate information regarding creditworthiness, the already underserved sectors continue to be considered risky and get neglected by the commercial banks. However, there have been some positive developments in this regard as well to correct this trend.

First, the SBP in 2016 issued guidelines and licencing criteria for setting up credit bureaus in Pakistan; these bureaus would function in addition to the SBP's already functional e-CIB. As of July 2020, the SBP has granted licenses to two private sector bureaus, Data Check and AISL. This is expected to bode well for the credit expansion, especially for the under-served segments.

Second, the Financial Institutions (Secured Transactions) Act, 2016, has been enacted "for the promotion and conduct of banking business to provide for the creation of security interests over movable property to secure the obligations owed by a customer to a financial

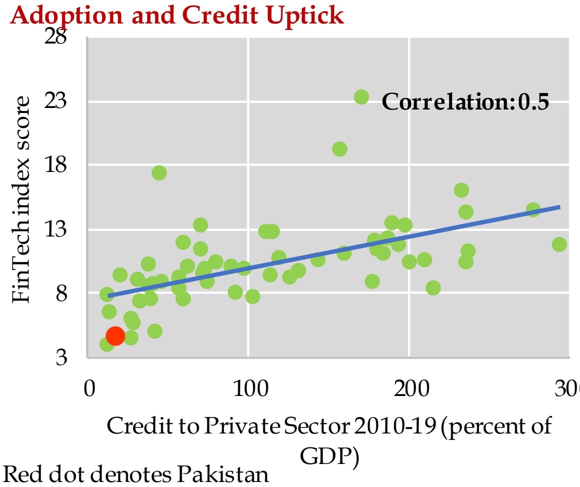
Relationship between FinTech Adoption and Informality — **Figure 7.16a**



Red dot denotes Pakistan

Source: The Global FinTech Index 2020, Findexable; Medina and F Schneider, "Shedding light on the shadow economy: a global database and the Interaction with the official one", CESifo Working Papers, no 7981, 2019

Relationship between FinTech Adoption and Credit Uptick — **Figure 7.16b**



Red dot denotes Pakistan

Source: The Global FinTech Index 2020, Findexable; World Bank

institution, clarify and expand for the purpose the meaning and scope of movable property, provide for the establishment of a secured transactions registry, define, ammend and codify certain laws relting to security interests over movable property and provide for matters connected therewith or incidental thereto."

Encouragingly, the Secured Transaction Registry (STR) has been operationalized under the Financial Institutions Act for unincorporated entities with the Securities and Exchange Commission of Pakistan (SECP). The registry will record charges/security interests created by entities on their movable assets. This would enable SMEs to aquire loans from the commercial banks using movable assets as collateral. Examples of eligble assets include receivables, intellectual property, inventory, and motor vehicles, etc. The SECP already maintains a security interests database created by companies for moveable and immovable assets under the Companies Act, 2017.

Together, these developments would help address the supply- and demand-side constraints and information gaps in the credit market. According to the 2017 World Bank Doing Business Report, over the past decade, 82 economies around the world reformed their legislation concerning secured transactions, and by mid-2016, 26 economies had operational modern collateral regstries. **Box 7.3** summarises case studies documenting the successful implementation of STRs and credit registries by four economies.

c. Digitization efforts under the National Financial Inclusion Strategy (NFIS) can enhance financial inclusion and credit expansion[60]

Digitization of financial services can provide a big boost to financial inclusion by enhancing the reach of financial services and increasing documentation of economic activities. This can prove particularly useful for the underserved segments of MSMEs and agriculture, where credit worthiness and banking history data is lacking. Indeed, high fintech outreach is negatively associated with the size of the informal economy (**Figure 7.16a**) and positively with the magnitude of private sector credit (**Figure 7.16b**).

However, three elements are important for the success of digital finance: (i) improvement in payment services; (ii) providing an adequate credit infrastructure (discussed above); and (iii) digital connectivity infrastructure.

[60] See **Special Section** in this report for more details.

Box 7.4: Initiatives under the NFIS

The SBP is pursuing financial inclusion as one of its strategic objectives to promote inclusive economic growth in the country. In this regard, it adopted a five-year comprehensive National Financial Inclusion Strategy (NFIS) in 2015, with a target of opening of digital transaction accounts for 50 percent of the adult population by 2020.

The NFIS has made significant developments for creating an enabling legal and regulatory environment for digital financial inclusion by introducing innovative products and services and initiating capacity building and awareness programs. As a result of these initiatives, unique account ownership in Pakistan has reached 66 million accounts, with 60 percent active unique accounts as of December 2019 - surpassing the NFIS' headline target well before the deadline. Some key initiatives taken under the NFIS include:

- Establishment of a public-private coordination mechanism that helped identify key reforms to push forward digital financial inclusion. These included reducing the cost of NADRA services, opening of unstructured supplementary service data (USSD) for financial transactions by the PTA, taxation reforms for Branchless Banking (BB) agents, and promotion of Government-to-Persons payments (cash transfers, salaries and pensions) through bank accounts, etc.
- Regulatory reforms to promote digital financial services, such as the issuance of Mobile Banking Interoperability regulations and revised regulations for Branchless Banking (BB).
- Development of the National Payment Systems Strategy (NPSS), which set a roadmap and listed an action plan for the design of a digital National Payments System that complied with international standards and best practices, and was tailored for the specific needs of a safe, efficient and inclusive national payment system in Pakistan.
- Development of the Asaan Mobile Account (AMA) scheme for interoperability of BB accounts on the USSD channel.
- Establishment of the Digital Financial Services Innovation Challenge Facility (ICF) to support financial service providers, financial technology providers and institutions to develop new or expand existing digital financial products, services and delivery platforms. This will increase financial access for the underprivileged and underserved segments of the population.
- Development of a scheme for the promotion of workers' remittances through mobile wallets ; this was launched by the Prime Minister in December 2017.
- Establishment of the Secured Transactions Law and E-Registry for the promotion of SME Finance.
- Launch of the National Financial Literacy Program (NFLP) to impart basic financial education among youngsters and the low-income segment.

The NFIS was revisited by the current government and prioritized as part of its 100-day agenda to achieve inclusive economic growth. The extended NFIS action plan is to be executed during 2019-23, and has set the vision to achieve inclusive economic growth through enhanced access to finance and deposit base, promotion of SMEs, easy and affordable access to finance to farmers, facilitation in low-cost housing finance, and provision of Shariah-compliant banking solutions.

In this connection, the government has set the following headline targets to be achieved by 2023:

i. Enhance usage of digital payments (65 million active digital transaction accounts, with 20 million accounts being of women);
ii. Increase the deposit base (the deposit to GDP ratio to be enhanced to 55 percent);
iii. Promote SME finance (extend finance to 700,000 SMEs; and SMEs to account for 17 percent of the private sector credit);
iv. Increase agricultural finance (serve 6 million farmers through digitalized solutions; enhance annual disbursement to Rs 1.8 trillion); and
v. Enhance the share of Islamic banking (to 25 percent of the banking industry; and increase branch network of Islamic banks to 30 percent of the banking industry).

Source: Agricultural Credit & Microfinance Department, SBP

Globally, digital payments by households and MSMEs in EMDEs in both volume and value terms have been rising appreciably over the past few years. These include both digital commerce (online shopping transactions paid for by non-cash methods) and Mobile Point of

Sale (MPOS) payments (via mobile wallets). Encouragingly, digital lending to consumers and SMEs has also been rising during the same period, reaching a total value of US$ 224.7 billion and 62.6 million loans across EMDEs.[61]

In Pakistan, the government and the SBP launched the National Financial Inclusion Strategy (NFIS) in 2015, to achieve universal financial inclusion in the country (**Box 7.4**). Although Pakistan was relatively late to the fintech boom and its outreach is modest so far, the potential for enhancing digital finance is sizable. The widespread use of digital payments could result in a 7 percent increase in the country's GDP, create 4 million jobs, mobilize over US$ 250 billion in deposits, and formalize a significant portion of the cash economy.[62]

Two developments bode well in this regard: the take-up of e-commerce, and the increased usage of mobile wallet accounts. E-commerce in Pakistan is consistently rising, with digital payments reaching Rs 93.8 billion by end-FY20. However, a sizable portion of the transactions (an estimated 60 percent in value) are via cash on delivery (COD) basis. A significant strengthening of consumer protection laws and better infrastructure is required for COD's share to fade.[63] On the demand side, mobile internet penetration is also on the lower end in Pakistan as compared to regional economies, with both usage and coverage gaps significantly high: 20 percent of the population is deprived of mobile internet access, while 54 percent has access but does not subscribe to internet service.

Mobile accounts have also risen substantially during the last eight years, with the number of total and active accounts at 52.5 million and 26.7 million, respectively, by end-June 2020. Encouragingly, m-wallets are also being used for payment of e-commerce sales as well as loan disbursements. Retail payments via branchless banking channels more than doubled to Rs 20.1 billion in FY20 from Rs 9.0 billion in FY19. Meanwhile, BB users have also been using this channel for financing services: during FY20, Rs 6.6 billion worth of loan disbursements were carried out.

However, all of these loans were disbursed via the over the counter (OTC) method, and government authorities as well as the m-wallet operators need to incentivize online financing facilities as well. The government has made digitization a priority focus area, launching the Digital Pakistan Policy in 2018 and the e-commerce policy in 2019. The five focus areas of the policies are access and connectivity, digital infrastructure, e-governance, digital skilling and training, and innovation and entrepreneurship. It is important to reiterate here that the government must focus on digital financial inclusion as an active objective and not as an expected return due to other digitization measures. This is crucial to avoid a repeat of the results following the 1990s reform policies.

7.5 The Way Forward

Theory and empirical evidence, especially over the last two decades, support the notion that the financial sector can play a growth-enhancing role. Harnessing this finance-growth nexus was an aim of Pakistan's financial sector reforms in the 1990s, as leaving the credit allocation to market forces was envisaged to be a better strategy as 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 – both in terms of its penetration and access.

The institutional infrastructure for project and long-term finance turned particularly unfavorable. This was because the lending

[61] Agur, I., S.M. Peria, and C. Rochon (2020). *Digital Financial Services and the Pandemic: Opportunities and Risks for Emerging and Developing Economies.* Special Series on COVID-19. Washington, DC: International Monetary Fund.
[62] Source: McKinsey (2016). *Digital Finance for All: Powering Inclusive Growth in Emerging Economies*. Report of McKinsey Global Institute.
[63] For details, see Chapter 7 in the SBP's FY18 Annual Report on the State of Pakistan's Economy.

capacity and portfolio management of the commercial banks, who were eventually delegated the responsibility to respond to both short- and long-term financing needs of the private sector, was strictly guided by their commercial concerns, risk appetite, as well as regulatory restrictions under the Basel Accord. As it turned out, large corporates continued to attract their focus, since lending to them drew a lower charge on banks' capital.

This narrow lending strategy was at the expense of agriculture, SME and household sectors, whose risk profile was relatively much weaker, and the loan loss probability higher due to prevalent information gaps and operational constraints that banks faced with respect to loan write-offs and foreclosures. Importantly also, unlike many other emerging markets, state ownership in the banking system as well as directed credit to priority sectors, has substantially declined in Pakistan.

Taken together, the contribution of the banking system to the country's development progress warrants some policy reassessment. In hindsight, one can argue that while banking institutions were prepared to conform to capital standards as laid out under the Basel Accord in terms of their data systems, technology adoption, internal risk assessment frameworks and overall organizational capacity, the economy was probably not.

On empirical grounds, there is only limited evidence on the direct link between capital regulation and economic growth.[64] But as observed in Peek & Rosengren (1995), Albertrazzi & Marchetti (2010), Berger & Udell (1994) and Popov & Udell (2012), sufficient evidence is available that banks' credit supply to the riskiest and most bank-dependent borrowers is most affected by capital regulations – the effect called flight to quality.[65] In the context of Pakistan, and particularly given its unique binding constraints – including low savings, perennial fiscal problems (especially low tax collection), and the level of informality – the required policy emphasis on deepening credit penetration and overall financial inclusion in the economy remained wanting.

Similarly, when it comes to state-driven credit and incentives, it appears that the way forward for Pakistan warrants choosing a clear dynamic path between the market-driven approach and the directed financing schemes, as the country moves along its reforms and development agenda. Here, it is important to highlight that the debate on selecting such a path is not unique to Pakistan. In fact, this debate is one part of the broader rethinking on neoliberalism and development strategies currently underway in both emerging market and advanced economies. Heterodox industrial policies have come back to mainstream economic thinking, as policies spawned by the Washington Consensus have increasingly been criticized for not delivering on the development front[66] – though the success of industrial policies and government interventions in the markets is also not clearly substantiated even in Japan, South Korea and Taiwan, which are cited as success stories. In fact, the global financial crisis of 2008-09 has contributed to a reevaluation of market efficiencies and the role of the government

[64] Martynova, N. (2015). *Effect of Bank Capital Requirements on Economic Growth: A Survey*. Working Paper No. 467, March 2015. Amsterdam: De Nederlandsche Bank.
[65] Popov, A., and G.F. Udell (2012). "Cross-Border Banking, Credit Access, and the Financial Crisis", *Journal of International Economics* 87: 147-161; Peek, J., and E. Rosengren (1995). "Bank Regulation and the Credit Crunch", *Journal of Banking and Finance* 19: 625–638; Albertazzi, U., and D.J. Marchetti (2010). *Credit Supply, Flight to Quality and Evergreening: An Analysis of Bank-Firm Relationships After Lehman*. Temi di Discussione (Working Paper) No. 756. Rome: Banca d'Italia; Berger, A.N., and G.F. Udell (1994). "Did Risk-Based Capital Allocate Bank Credit and Cause a "Credit Crunch" in the United States?, *Journal of Money, Credit and Banking* 26(3): 585-628.
[66] Rodrik, D. (2006). "Goodbye Washington Consensus, Hello Washington Confusion? A Review of the World Bank's Economic Growth in 1990s: Learning from a Decade of Reforms". *Journal of Economic Literature*. 44(4): 973-987

even in the advanced economies.[67] Meanwhile, the Brookings' report on *Beyond Neoliberalism* (2019) attributes this rethinking to China's successful model of state planning, concentration of corporate power, growing income inequalities, and unsuccessful efforts to avoid economic and financial crises.[68]

In Pakistan's case also, and strictly in the sense of development finance, a clear policy approach is needed. In the past, many incentive schemes (such as credit guarantees) were rolled out to encourage credit flow to SMEs, agriculture and other underserved segments, but their success remained limited. Lately, the government has taken a more holistic approach, and is actively focusing on enhancing financial inclusion under the broader ambit of the National Financial Inclusion Strategy. To ensure an effective implementation of this strategy, the SBP is currently working on more innovative and research-based interventions and incentives on both the demand and supply sides of the credit market. However, two aspects need to be highlighted. First, one lesson that we get from the experience of the Asian economies and other interventionist states is that development finance alone cannot help without the presence of quality institutions and governance framework. Also, for these policies to be effective and successful, the country must pursue sound macroeconomic policies and provide an overall conducive investment environment to businesses. Second, the continuation of such interventionist policies cannot be entrenched – especially at a large scale – given the associated fiscal and quasi-fiscal costs.

Thus, given the unique set of macroeconomic challenges Pakistan is currently facing – especially the size of the population that is currently excluded from financial services – it is important to highlight that policy interventions cannot completely be avoided. But side by side, interventions *alone* must not be viewed as *the* solution for access and outreach problems in the credit market; a clear and coordinated monitoring and evaluation approach should become an integral part of these policies, a consistent progress must be made to address the prevailing demand-side constraints.

Furthermore, the scale and duration of incentive schemes needs to be fine-tuned, as they have a direct bearing on the country's fiscal position. In the meantime, banks must be encouraged to make active use of newly established collateral registry and private credit bureaus to plug information gaps and improve their perception of the risk profile of businesses and households. Then, as the economic reforms agenda progresses, credit infrastructure strengthens and macroeconomic stability takes hold, the credit market will gain considerably on the inclusion front and will attain greater penetration in the economy.

67 For instance, see J.E. Stiglitz, J.Y. Lin, and E. Patel (2013). "Introduction: The Rejuvenation of Industrial Policy". In J.E. Stiglitz, J.Y. Lin, and E. Patel (Eds.). *The Industrial Policy Revolution I: The Role of Government Beyond Ideology*. Basingstoke: Palgrave Macmillan (pp. 1-15).

68 Gertz, G., and H. Kharas (2019). *Beyond Neoliberalism. Insights from Emerging Markets*. Washington, DC: Brookings Institute.