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Impact of financial reforms on banking sector in Pakistan: A critical review

Ayesha Sarwat

The University of Lahore (School of Accountancy & Finance), Pakistan.

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ABSTRACT

Banking sector contributes 95% of the total financial sector in Pakistan economy and financial sector has a large share in overall growth of the country. For banking sector performance growth, State Bank of Pakistan has taken many significant steps. Banks involved in providing the financial needs of government and private businesses and neglecting the needs of small and medium enterprises, agriculture sector and consumer sector. Massive financial reforms as privatization, interest rate liberalization and banks restructuring and alike were introduced by Government of Pakistan in order to improve the performance of banking sector. The current study is designed to cater the need of financial reforms in banking sector, entailing the major financial reforms in banking sector by the Government of Pakistan and excogitate their impact on performance of banking sector in Pakistan. The outcome of the meta-analysis suggests that in this dynamic world of financial liberalization and global market integration the regulatory body must be vigilant and agile to cater the needs of every sector and introduce transformations on regular basis in order to create sound, healthy and competitive economy.

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Introduction

Financial sector is one of the most significant and great contributor to the economy of every country. The development of financial sector has a direct impact on the economic development. In Pakistan, banks contribute 95% of the financial sector and the sound performance of banks certainly fosters the economic growth of a country (Husain, 2004).

Banks, on one hand, fulfill the financial needs of government and private businesses, whereas on the other hand, they neglect the needs of small and medium enterprises, agriculture sector and consumer sector. Foreign banks are large in number than state-owned banks and they did not directly competed the state-owned banks till mid 1980s before the reforms in banking sector (Rehman, Fatime, & Ahmad, 2011). Patti and Hardy (2005) stated that state-owned banks were least efficient in the utilization of resources of banking sector.

For banking sector performance growth, State Bank of Pakistan has taken many significant steps. Massive financial reforms were introduced by Government of Pakistan in order to improve the performance of banking sector. The objective behind financial reforms was to restructure banking sector and to overcome the loss caused by non-performing loans as it was the major cause in poor performance of banking sector. The banking sector of Pakistan enjoyed very positive financial results after financial reforms (Rehman et al., 2011).

The objective of this study was to identify the need of financial reforms in banking sector, enlist the major financial reforms by the Government of Pakistan and excogitate their impact on performance of banking sector in Pakistan.

Need and Justification

Commercial banks, foreign banks, investment banks, leasing companies, development financial institutions, house financing companies and asset management companies are combined to develop the financial sector of Pakistan (Ahmad, 2011).

There was a question mark on the efficiency of this sector before 1990 because of couple of reasons. One of them was that most of the banking sector in Pakistan was under Government influence. Nationalized commercial banks were meeting the needs of government organizations and a few large corporations. They were overlooking the needs of small and medium enterprises, agriculture sector and consumer sector (Husain, 2005).

There were problems of overstaffing, poor customer services, unprofitable branches and a high ratio of non-performing loans (Haque, 1997). High bureaucratic approach was prevailing. Government influenced the credit decisions of banks and there was very low recovery rate of loans. Almost 25% of the total loans were jammed because they have been sanctioned on political considerations, not on merit basis (Husain, 2005).

Another reason of inefficiency and low profitability was the high tax rate of banking sector. Banks paid 58% as tax while the rest of corporate sector paid only 35% as tax (Husain, 2005). It drastically affected the profitability of banking sector and made this sector as unattractive to the new entrants.

Due to the aforementioned reasons, the performance of banking sector was not to the extent that it could contribute towards the economic development of the country. There is a need to restructure this sector so that it could be able to give results as expected.

Financial sector reforms were introduced during 1990s through a reform program aimed to reduce the market segmentation, inculcate competition and to have more efficient monetary and credit tools (*Financial Sector Assessment 1990-2000*, 2004).

Patti and Hardy (2005) classified the period from 1981 to 1992 as the pre-reform period, from 1993 to 1997 as first reform period and from 1998 to 2002 as the second reform period. The objectives of financial sector reforms were:

- To strengthen certain stronger banks through mergers, acquisition and liquidation.
- To reduce the political and government influence on banking sector through privatization of nationalized commercial banks.
- To empower State Bank of Pakistan and Security and Exchange Commission of Pakistan as an effective regulator and controller of financial sector (*Financial Sector Assessment 2001-2002, 2003*).

According to Husain (2005), Government played a dynamic role in this regard. Initially in 1997, during the Nawaz Sharif Government, certain CEOs and board of directors were appointed on non-political basis for the very first time. To strengthen the capital of nationalized commercial banks, fresh equity was introduced. Pakistan Banking Council was abolished; interference of labor union in decision making process was reduced along with the autonomies the State Bank of Pakistan.

Then in the Musharraf Government, it was decided that banks will be privatized and no ownership and control of Government will be there. From private sector, chief executives and board of directors were appointed. The Government recapitalizes these nationalized commercial banks by providing Rs.30.7 billion (Husain, 2005).

Financial Reforms in Pakistan

The salient features of financial reforms that are directly related to the banking sector from 1990-2000 are as follows:

Privatization of Public Sector Financial Institutions

The process of privatization started with amendments in Banks Act, 1974. It was amended that Federal Government will sell all or any part of Nationalized Commercial Banks to the private sector (*Financial Sector Assessment 2001-2002, 2003*).

Two state-owned banks, Muslim Commercial Bank (MCB) and Allied Bank Limited (ABL), were privatized by selling 26% shares of MCB to the private sector in 1991 and 26% share of ABL to Employee Management Group under the Employee Stock Ownership Plan in 1991 (*Financial Sector Assessment 2001-2002, 2003; Patti & Hardy, 2005*).

In 1993, further 49% shares of MCB were transferred to the buyer to handover the management and control to the buyer and 25% shares of ABL were sold to the private sector. Also in 1993, 26% shares of United Bank Limited (UBL) were transferred to the private sector. In addition to the privatization of existing banks, it was also allowed to the private sector to open new banks according to the amendment in Banks Act 1974 in 1991. In 1995, it was also imposed that no new branch of private bank will be allowed to open. In contrast, nationalized commercial banks were asked to close their unprofitable and un-efficient branches in 1997 (*Financial Sector Assessment 2001-2002, 2003*).

Corporate Governance

In order to put best corporate governance in the system, there was a fit and proper criteria for appointment of chief executives and board of directors. It was required to establish an independent audit committee of the board of directors. External auditors would be selected through transparent procedures and rated according to their performance (*Financial Sector Assessment 2001-2002, 2003; Husain, 2004*).

Restructuring of Banks

The efficiency of banking sector was declining due to over-sizing of workforce and over costing. Also the non-performing loans were rapidly growing. These all were severely causing damage to the performance of the banking sector. Profitability

of the banking sector was under stress and to overcome this issue proper restructuring of banking sector was required. Keeping the above factors in view, banks were required to prepare restructuring plans. In 1997, banks introduced separation schemes for employees as golden handshake. It resulted in 8% reduction of the bank force till 1999 (*Financial Sector Assessment 2001-2002, 2003*).

Strengthening of Prudential Measures

To protect the interest of depositor, creditors and potential investors, it was required to strengthen the prudential measures in terms of capital adequacy, provisioning and legal procedures. By the end of 1998, banks were required to achieve minimum Rs.500 million as paid-up capital and in 2000; it was doubled to Rs.1000 million. Moreover banks had to rate themselves from approved credit rating agencies. Banks had to meet liquidity requirement of 15% in 1996 and in 1997 banks were allowed to offer fund management services by establishing subsidiary companies (*Financial Sector Assessment 2001-2002, 2003*).

Strengthening of Loan Recovery Process

It was required from State Bank of Pakistan (SBP) to introduce guidelines for recovery of non-performing loans and advances in 1992. Quarterly recovery targets for banks were announced by SBP in 1993 and they were required to submit their progress report and set new strategies to improve the process of loan recovery. The State Bank of Pakistan introduced three programs to improve the process of loan recovery in 1997. That included amnesty scheme for the defaulters, new banking court and strengthen the asset recovery department (Patti & Hardy, 2005).

Debt Management Reforms

To improve the system of debt management in the banks, State Bank of Pakistan established a security department that worked as secondary market for government securities and to launch auction system of public debt in December 1990 (*Financial Sector Assessment 2001-2002, 2003*).

Computerization

A computer service department was established in 1994 and the process of computerization was started. In 1999, the process of computerization was enhanced through establishment of "Information System Strategy Plan". The banks had upgraded their technology and expand their ATM networks and online banking system. The State Bank of Pakistan also developed its website with valuable information and updated it regularly. The banks were given the target till 2005 that all branches of banks must be on-line in the allocated time period (Husain, 2005).

Monetary Management Measures

As per *Financial Sector Assessment 2001-2002 2003*) banks were empowered to set their lending rate on the basis of demand and supply in the market. Floors on minimum lending rates were eliminated in 1997. To meet the cash reserve requirement, banks were required to maintain 5% of their demand in government securities on weekly basis. The statutory liquidity requirement was 45% that was reduced to 15% till 1998 as the result of these reforms.

There was a significant impact of financial reform on the performance of banking sector. In the first round of financial reforms (1991-1992), the profitability was slightly improved in banking sector (Patti & Hardy, 2005). Cost efficiency of private banks was higher than foreign and state-owned banks (Burki & Ahmad, 2009).

What have been the impacts of above reforms? Let's explore.

Impact of Reforms on Performance

In a country where the ratio of foreign banks is more and few activity restrictions has more competitive banking system (Claessens & Laeven, 2004). The transitional cost of banks i.e. the spread between lending and deposit rates has increased over time. As in financial year 1990 the banking spread was 2.4 percentage points and in financial year 2000 it raised to 8.1 percentage points. The increased spread was due to overstaffing, high administrative cost, increased bad debts and high risk of default (*Financial Sector Assessment 1990-2000*, 2004).

According to (Patti & Hardy, 2005), business conditions remained negative for all the periods i.e. pre-reform period, first reform period and second reform period. Profits decreased in the second reform period (1998-2002) due to the provisioning of non-performing loans. Costs had also increased due to administrative expenses that were required to increased productivity. They also proposed that in 1991-1992 a moderate increase in profits was there due to the increased profit productivity. Foreign banks were much productive than state-owned and private banks. The private banks increased their efficiency after privatization. In 1993-1997 banks proved to be highly efficient in their performance.

The policy of bank privatization led a positive impact on the whole economy. After reforms many banks were merged or acquired by other banks that resulted in enhanced technical efficiency. Private Banks were the higher gainers as compare to state-owned and foreign banks and also they were much cost efficient (Burki & Ahmad, 2009). In pre-reform period, foreign banks were highly efficient but in 1998, the efficiency of foreign banks falls due to the freezing of foreign currency accounts. The efficiency index of banks falls from 6% to 12% with every 10% increase in the share of nonperforming to total loans (Burki & Niazi, 2010).

The banking sector played a very dynamic role in developing economic growth. The deposits, lending and savings in banking sector increased that directly enhanced the economic growth of the country. More investments were the result of high interest rate and more lending, that eventually lead to economic growth (Rehman et al., 2011).

Conclusion and Recommendations

From the above discussion, it can be concluded that financial sector reforms led very positive influence on the performance of banking sector. In order to be competitive in this dynamic world banks need to be vigilant and agile as it is the age of financial liberalization and global market integration.

For the betterment and growth of any sector in an economy certain changes are always required and need to be adapted. The regulatory body must introduce transformations on regular basis in order to create a sound, healthy and competitive economy. For banking sector growth, it is strongly recommended that banks should introduce separate instrument for every sector according to the requirements of those sector. If these reforms will continue in future on regular basis, vital achievements in Pakistani economy through banking sector can be foreseen.

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