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Prime Report

Lending from Privatized Banks: More for government, less for private sector

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KEY MESSAGES

1. Post-privatization, banking sector's efficiency and profitability has improved reaching Rs. 244 billion in 2020 as against Rs. 7 billion in 2000.
2. Episodes of higher private sector lending and lesser exposure to government securities notwithstanding, the long-term trend of private sector lending from commercial banks after privatization suggest a visible decline.
3. Declining role of Development Finance Institutions (DFIs), rising government footprint in credit market, high private credit risk, procedural complexities, low financial literacy, information asymmetries and muted demand for long-term investment have suppressed the private credit off-take.
4. Restructuring of financial sector has been detrimental from the inclusion standpoint as banks' disbursements are skewed towards blue-chip corporations, while SMEs remain financially deprived.
5. Pakistan continues to lag regional economies with respect to penetration of bank credit and private investment.
6. Practicing fiscal prudence, streamlining credit procedures, strengthening insolvency law & order, limiting self-selection bias in lending, utilizing credit bureaus to tackle information asymmetry and introducing financial literacy programs remain cardinal measures to create space for private credit.

INTRODUCTION

A well-established banking sector is a pre-requisite for efficient resource allocation and sustained economic growth as it allocates capital to its most productive use. In the last two decades, Pakistan's banking industry experienced noteworthy growth and structural reforms. Notwithstanding, it is debatable whether the post-reform banking sector has contributed meaningfully towards financing private-sector growth. In this backdrop, the report aims to

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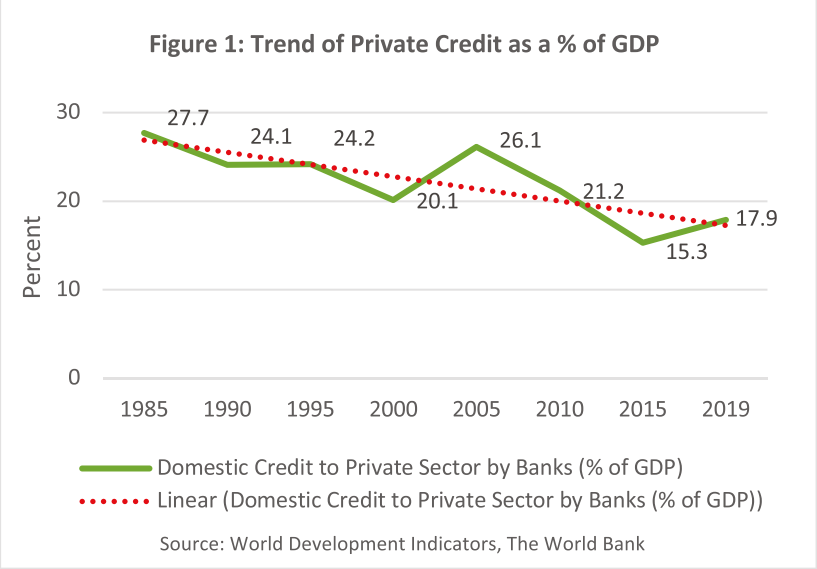
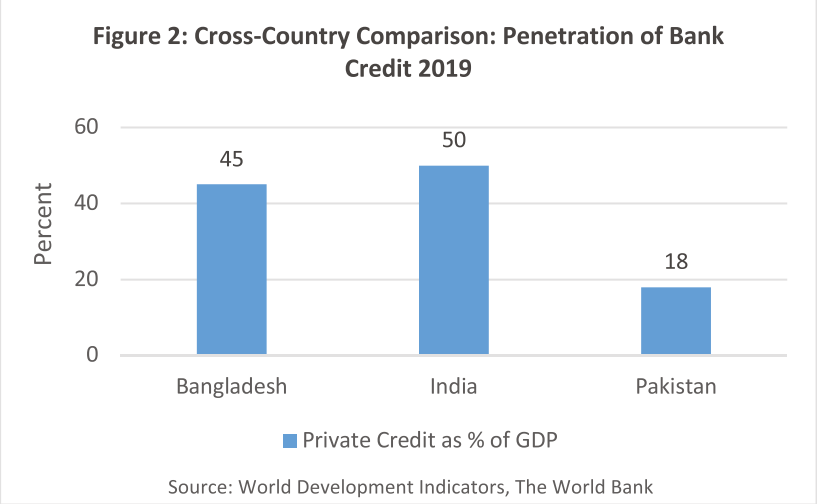
assess the trend in bank lending to government and the private sector post-reform. It also examines the factors underlying low credit disbursement to private sector and proposes policy measures for increasing bank credit to private sector.

BANKING SECTOR'S LENDING: GOVERNMENT VS. PRIVATE SECTOR

1. **Credit to Private Sector:** Prior to the financial reforms of 1990s, the penetration of bank credit in Pakistan's economy, measured by private credit as a percentage of GDP was 27.7 percent (see Figure 1). Then the reforms began in early 1990s and continued in the 2000s with the aim to reduce government's footprint in the banking sector, increase private credit, minimize the ratio of non-performing loans, improve banks' efficiency and profitability.[2] Post-reform, the technical efficiency[3] and profitability of banks increased manifold. As of December 2020, the banking sector's net profit stood at Rs. 244 billion as against Rs. 7 billion in December 2000.[4] However, over the past two decades, the ratio of private credit to GDP has declined, indicating low bank credit penetration in the economy (see Figure 1). This may be noted that the long-term decline notwithstanding, there have been episodes of higher private sector credit in particular during 2000 and 2005. This ratio of 18% relative to regional economies (see Figure 2).





One of the reasons for the decline in private credit has been the shrinking footprint of Development Finance Institutions (DFIs). Prior to the reforms, DFIs used to complement the banking sector by bridging the gaps in the supply of financial products and services to the identified key industries/sectors. However post-reform, these institutions gradually faded[5]

2 Munir, K., & Naqvi, N. (2013). Pakistan's Post-Reforms Banking Sector: A Critical Evaluation. Economic and Political Weekly, 48(47), 38-42. Retrieved June 3, 2021, from http://www.jstor.org/stable/23528640

3 Ahmad, U. 2011, Financial Reforms and Banking Efficiency: Case of Pakistan. MPRA. Retrieved: https://mpra.ub.uni-muenchen.de/34220/1/Financial_Reforms_and_Banking_Efficiency_Case_of_Pakistan._06-02-2011.pdf

4 Quarterly Compendium: Banking Statistics, State Bank of Pakistan.

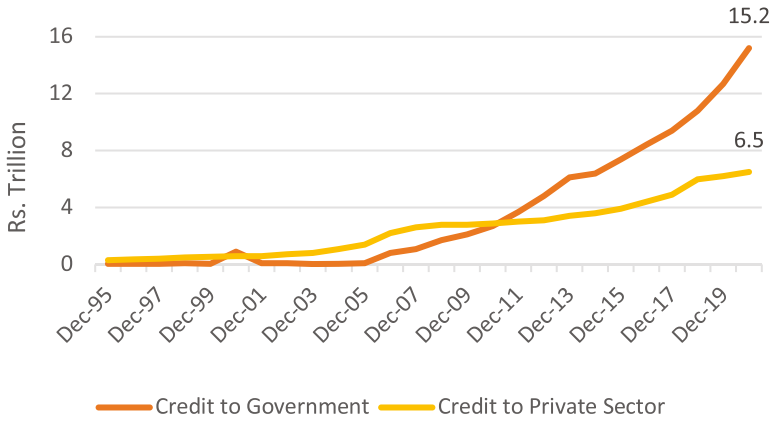
5 Within DFIs, Banker's Equity Limited was initially privatized in 1996 and subsequently liquidated in 1999. Meanwhile, the National Development Finance Corporation (whose equity had turned negative in 1999 after heavy losses in second half of 1990s) was merged with National Bank of Pakistan in 2001 (SBP, 2002). In addition, Regional Development Finance Corporation and Small Business Finance Corporation – which were both serving the SME sector – were merged to create SME Bank in 2002. Among the few DFIs which survived this period of broad restructuring was the Pakistan Industrial Credit and Investment Corporation Ltd (PICIC) – which was the first DFI to be formed in 1957 with the help of the World Bank – and some

due to the broad restructuring of the financial sector, leaving a void in terms of institutions that could provide long-term finance for the development of vital industries.[6]

Though with a lag, the global financial crisis also triggered a sense of uncertainty which coupled with growing security concerns and energy shortages, adversely affected domestic business prospects resulting in sluggish private credit demand between 2009 and 2015 (see Figure 3).

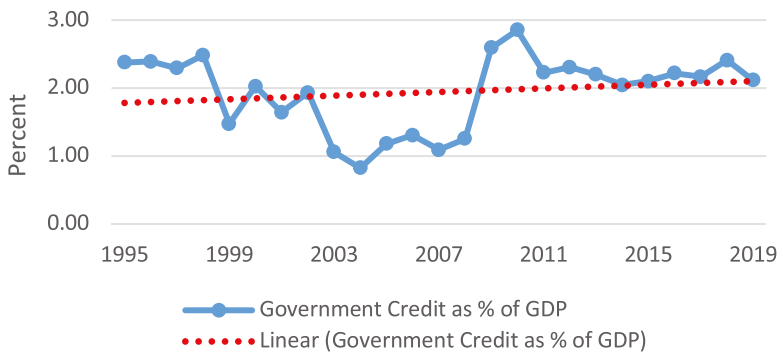
Another factor underlying the slow down in private credit growth has been the rising government footprint in the form of increased borrowings from commercial banks (elaborated further in the subsequent section). As of December 2020, government bank borrowings amount to Rs. 15.2 trillion as against private sector borrowings of Rs. 6.5 trillion. Disaggregation of private credit further reveals that banks' credit disbursements are skewed towards big businesses and industries. Over the last two years, credit for manufacturing industry and non-SMEs has increased by 6.2 percent and 8.5 percent respectively while loans to SMEs have decreased by 6.6 percent.[7]

Figure 3: Bank Credit: Government vs. Private Sector



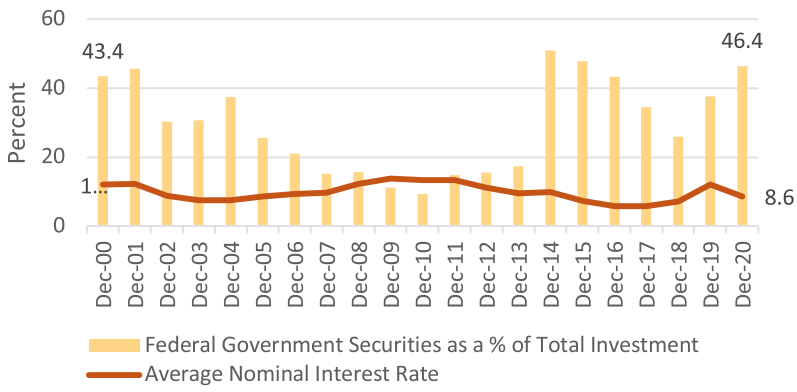
Source: State Bank of Pakistan

Figure 4: Trend of Government Credit as a % of GDP



Author's calculation based on data from State Bank of Pakistan

Figure 5: Share of Government Securities in Scheduled Banks' Total Investment



Source: Author's calculation based on SBP dataset

2. **Credit to Government:** Between 1995 and 2010, banks' lending to private sector was higher than its lending to the government. However, the lending portfolio changed course after 2011, with banks' credit to government dominating its credit to private sector (see Figure 3). One of the reasons for this reversal has been the suspension

foreign sponsored DFIs, which had generally performed better on the back of "strong support of their sponsors, sound capital structure and consistent profitability" (SBP, 2004). However, PICIC was also privatized in 2007.

6 Khalid, A. and Nadeem, T. (2017). Bank Credit to Private Sector: A Critical Review in the Context of Financial Sector Reforms. SBP Staff Notes.

7 Author's calculation based on dataset 'Loans to private sector business by type of finance' from State Bank of Pakistan. Retrieved: https://www.sbp.org.pk/ecodata/By-type-of-finance.pdf

of SBA agreement with the IMF in 2011[8], causing the government to increasingly rely on local banks to meet its budgetary requirements which in turn crowded out the private sector from credit market. Not only in absolute terms but also in relative terms, government's credit footprint has increased though in recent years it has somewhat stabilized (see Figure 4, Page 3). The surge in government credit as a percentage of GDP between 2008 and 2010 has largely been on account of higher average nominal interest rates[9] (see Figure 5, Page 3).

As evident from the Figure 5, post-reform banking sector has experienced different episodes in terms of share of government securities. It has witnessed a decline during 2004 and 2013, during which the share of government securities has remained less than 20%. From 2013 onwards, this share has increased tremendously to reach, and in fact exceed the level of 2000 when it was 43.4%. In Dec 2020, the share of government securities was recorded at 46.4%. Between 2004 and 2011, share of government securities in banks' total investment decreased on account of absence of PIBs auction coupled with PIBs and MTBs reaching their respective maturities.[10] In 2014 however, the ratio surged due to heavy government borrowing from commercial banks owing to a ceiling on SBP borrowing under Extended Fund Facility (EFF) program of IMF.[11] Between 2015 and 2018, focus of government borrowing shifted from scheduled banks to SBP resulting in decelerated pace of scheduled banks' investment in government securities.[12] Over the last two years, banks' investment in government papers has resurfaced on account of IMF conditions that restricted the government borrowing from SBP, increasing its reliance on commercial banks. As of December 2020, share of government securities in banking sector's total investment stands at 46 percent, indicating a moderately large federal footprint.

FACTORS UNDERLYING LOW CREDIT DISBURSEMENT TO PRIVATE SECTOR

Several factors are responsible for the low credit disbursement to the private sector in Pakistan. These can be categorized into supply- and demand-side factors.

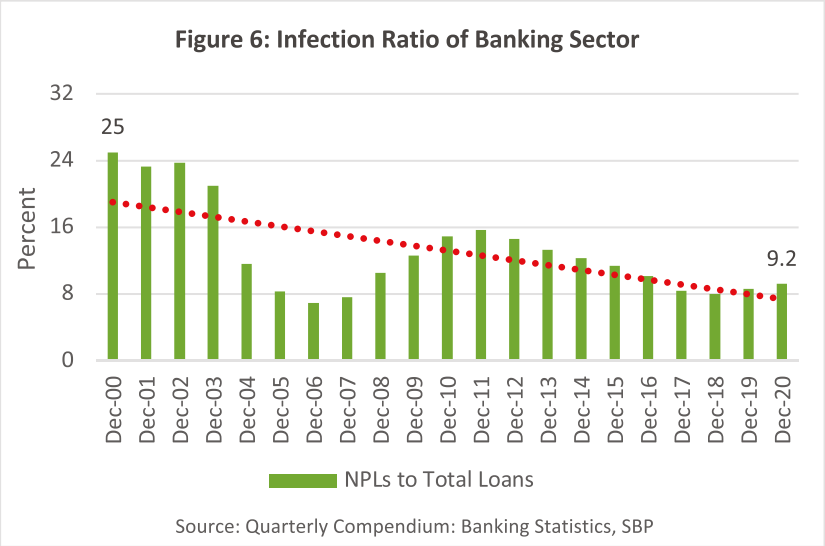
Supply-Side Factors

1. **Large Federal Footprint:** As mentioned previously, government borrowing from banks has not decreased post-reform. Instead, the increased budgetary requirements have kept the government as a major borrower from the banking sector. High fiscal deficits (which have been the norm) have been financed through commercial borrowing, which in turn has crowded out the private sector from the credit market. The increasing government guarantees covering outstanding state-owned enterprises' debt liabilities provide an impetus to banks to issue loans to SOEs rather than private businesses, depriving the private sector of the financing that it needs to grow. Following SBP's autonomy and the subsequent surrendering of government's right to borrow from the central bank, government borrowing from private commercial banks is likely to further increase at the back of an expected surge in budget deficit amid higher spending to achieve growth targets which will have serious implications for the private sector credit.

2. **Greater Credit Risk:** Loans and advances made to the private sector generally entail risk of

8 Pakistan: Debt spiral under PPP Govt. CADTM. Retrieved: http://www.cadtm.org/Pakistan-Debt-spiral-under-PPP
9 Findings by Ahmed Jamal Pirzada. Retrieved: https://twitter.com/ajpirzada/status/1323437993881907200
10 Quarterly Performance Review of the Banking System September 2004. State Bank of Pakistan. Retrieved: https://www.sbp.org.pk/publications/q_reviews/q_review_sept_04.pdf
11 Quarterly Performance Review of the Banking Sector December 2014. State Bank of Pakistan. Retrieved: https://www.sbp.org.pk/publications/q_reviews/q_review_Oct-Dec_14.pdf
12 Quarterly Performance Review of the Banking Sector December 2016. State Bank of Pakistan. Retrieved: https://www.sbp.org.pk/publications/q_reviews/2016/Oct-Dec.pdf

default. This risk however, is more pronounced in case of Pakistan due to non-existence of bankruptcy law and information asymmetry[13]. Resultantly, the infection ratio remains volatile due to the problem of adverse selection and moral hazard (see Figure 6). Though the infection ratio has significantly fallen post-reform, it has increased over the last two years, clocking at 9.2 percent as of December 2020. It may be interesting to witness an increase in the infection ratio alongside the rise in the private sector credit (Figure 3) during 2006 and 2011. Recently, the pandemic has affected the borrowers' capacity to service their loans on time. Given that there is an alternative of risk-free investment available (i.e. government securities) and the credit demand from government continues to increase at the back of rising budgetary requirements, the banking sector holds little incentive to extend credit to risky private sector, especially the SMEs who are often subjected to credit rationing.[14]



3. **Procedural Complexity:** It is pertinent to mention that the red-tape or cumbersome procedures to access finance through formal channels discourages many businesses from borrowing. Banks have devised the procedures and systems keeping in mind the blue-chip corporations. The higher collateral requirements and legal costs in case of default increases the compliance cost and puts the SMEs at a significant disadvantage. It is pertinent to mention that many SMEs operate under the ambit of informal economy which makes it difficult for them to access finance through formal channels as their movable assets cannot be used as collateral.

4. **Skewed Credit Distribution:** An assessment of loan distribution reveals that the banks' credit disbursements to private sector are heavily skewed towards large enterprises. Access to credit becomes progressively more constrained as the size of the enterprise becomes smaller. The imperfect information provided by smaller firms impose a cost (credit risk) due to which banks are reluctant to provide loans to them and therefore favor large businesses. In this regard, the share of large sized borrowers in total loans of the banking sector reveals a more skewed credit distribution in Pakistan relative to regional counterpart. In Bangladesh, this ratio stands at 72.5 percent while in Pakistan it measures at 87 percent, while such borrowers account for only 1.6 percent of the total borrowers (see Table 1).

Table 1: Distribution of Loans to Private Sector by Size as of 2019

	Bangladesh		Pakistan	
	No. of accounts	Amount	No. of accounts	Amount
Less than LCU 10 million	99.1	27.5	98.4	13
More than LCU 10 million	0.9	72.5	1.6	87

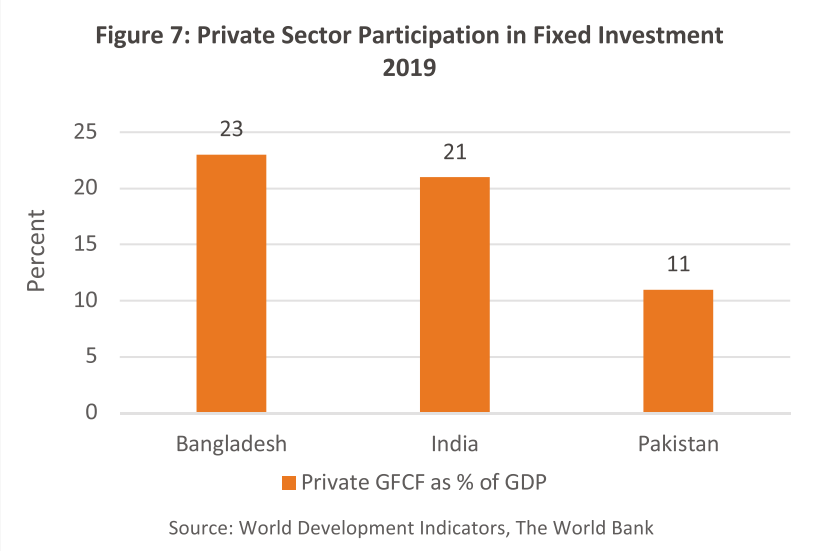
Source: Author's calculation based on data from Bangladesh Bank and State Bank of Pakistan

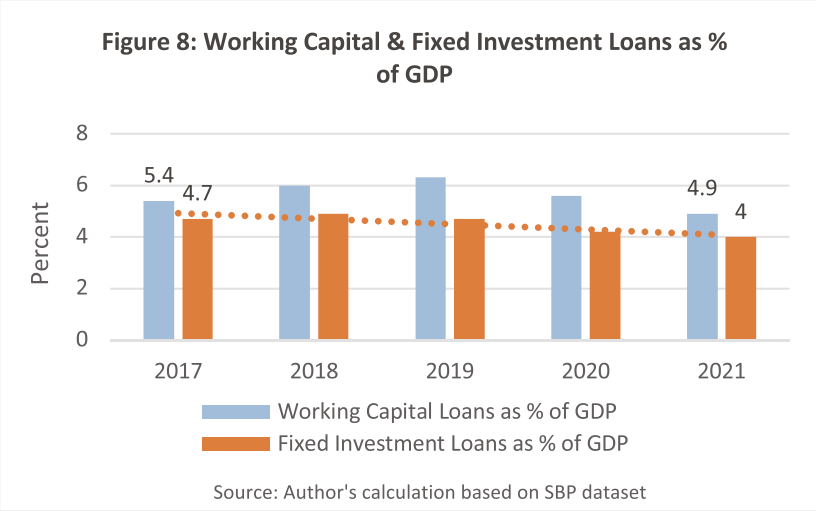
13 Information asymmetry leads to problem of adverse selection when banks cannot rightly differentiate among good and bad borrowers. In addition, it also leads to moral hazard which occurs when an entity has an incentive to increase its exposure to risk because it does not bear the full costs of that risk

14 Credit rationing is a measure undertaken by the banks to limit or deny the supply of credit based on the investor's creditworthiness and an increased loan demand.

DEMAND-SIDE FACTORS

1. **Poor Financial Awareness & Attitude towards Formal Finance:** Most of the private sector in Pakistan, in particular the Micro-Small and Medium Enterprises (MSMEs) lack adequate knowledge about accessing formal channels of finance. This lack of awareness coupled with minimal credit history, high borrowing cost, decision to remain in the informal sector, religious beliefs and banks' selection bias has caused these businesses to increasingly rely on informal channels of finance.





2. **Sluggish Demand for Long-Term Investment:** Private sector has low participation in country's gross fixed capital formation (GFCF) due to various factors[15], one of them being the high markup on long-term loans for fixed investment[16] which makes them costlier to avail and reduces the profit margins of investors. As per World Bank report[17], the low levels of return on investment in Pakistan[18] has weakened the financial incentives, resulting in weaker demand for long-term investment.[19] As of 2019, private sector's share in gross fixed capital formation stands at 11 percent which is lower than some of the regional economies such as Bangladesh and India (see Figure 7). Most borrowings by the private sector are for working capital. The share of fixed investment loans in GDP is lower than the share of working capital loans, however both depict a declining trend indicating shrinking footprint of private investment in the economy (see Figure 8).

3. **Structural Constraints:** The country faces structural challenges such as energy-related issues including higher electricity tariffs, transmission and distribution issues and political

15 Other factors include large government footprint in the banking sector, economic growth, business and investment policies, low savings, shallow financial market and presence of large informal economy.

16 Where does SME financing stand in Pakistan? Here are the numbers. Dawn. Retrieved: https://www.dawn.com/news/1624501

17 Pakistan@100: Growth and Investment. World Bank. Retrieved: https://openknowledge.worldbank.org/bitstream/handle/10986/31411/135325.pdf?sequence=4&isAllowed=y

18 For this approach, the required rate of return for investors is constructed using Pakistan's credit 'B3' credit rating by Moody's, CDS (Credit Default Swap) spread and following Damodaran (2016) and DuPont Formula. Given the average leverage ratio of 7.28 percent among our sample of firms, the ROAs are estimated to be 13.85 percent. Broadly, this implies that the current ROA of 8.8 percent offered by listed firms in the Pakistan Stock Exchange is 36 percent short of the required rate of ROI into these firms. In this case, low private sector investment translates into a low demand for capital in the local economy.

19 Pakistan@100: Growth and Investment. World Bank. Retrieved: https://openknowledge.worldbank.org/bitstream/handle/10986/31411/135325.pdf?sequence=4&isAllowed=y

instability, which although improved in recent years, has caused the businesses to operate below their optimal threshold. These factors in addition to the above-mentioned constraints add to the current and future uncertainties due to which the credit demand remains suppressed as businesses prefer to invest less. On the other hand, the regulatory, administrative, and legal bottlenecks impede the development and functioning of existing credit bureaus[20] due to which, the issue of asymmetric information continues to prevail in the credit market[21].

CONCLUSION

The general inference from the trends presented above is that while the privatization has improved the efficiency and profitability of the banking sector, the state of private sector credit remains unsatisfactory. Post-reform banking sector is not effectively performing its core function of channeling depositors' savings into loans for private businesses. While there have been episodes of higher private sector lending, these commercial funds are being increasingly geared towards government debt instruments to earn secure profits. Consequently, a large proportion of private businesses particularly SMEs remain financially excluded and face difficulty in accessing finance. This in turn has repercussions for private sector investment, causing the country to lag its regional competitors in terms of penetration of bank credit and private fixed investment. The large federal government footprint in the credit market is suppressing private credit off-take by reducing the funds available for private sector credit. Even within the private sector credit, the banks' disbursements are heavily skewed towards blue-chip corporations who get priority in lending decisions, possibly, at the cost of SMEs. During these unprecedented times, increasing banks' credit to private sector and ensuring financial inclusion is necessary for restoring the business confidence and propelling private sector activity forward that has been suppressed with the onset of Covid-19. As the incumbent government sits down to think about rekindling economic growth post-pandemic, sustainable measures to enhance banks' credit to private sector should not be discounted.

RECOMMENDATIONS

In order to make banking sector conducive to private sector growth, there are certain policy measures that the public and private stakeholders should consider in order to facilitate banks' credit to private sector:

- **Rationalize & Diversify Government Borrowing:** It is high time that the government practices fiscal prudence and diversifies its borrowing sources so that the commercial banks can increasingly divert their funds to the private sector.
- **Strengthen Insolvency Law and Order:** In Pakistan, the bankruptcy law is almost non-existent due to which the credit-risk is high and so is the ratio of non-performing loans. To minimize the credit-risk associated with private sector, there is need to strengthen the implementation of Insolvency law and streamline the judicial procedures so that the courts can settle the financial cases in a timely manner. On the other hand, the banks should revamp their credit approval procedures and strengthen their systems so that they can assess the creditworthiness of the borrowers more efficiently.
- **Streamline Financial Services & Procedures:** Banks need to revamp and streamline their financial procedures to reduce red-tape and encourage private sector especially the SMEs to borrow.

20 Currently, Tasdeeq and DataCheck are the only two licensed private bureaus in Pakistan that offer services such as credit reports, portfolio scrubbing, daily alerts, microfinance credit report, recovery agency and benchmark comparison to member banks. However, these bureaus have information on only 8.6 million individuals or 6.7 percent of adult population in the country, which is marginal. Source: https://www.sbp.org.pk/reports/quarterly/fy21/Third/Special-Section.pdf

21 Special Edition: Private Credit Bureaus in Pakistan - Enhancing Credit Penetration by Addressing Information Asymmetries. State Bank of Pakistan. Retrieved: https://www.sbp.org.pk/reports/quarterly/fy21/Third/Special-Section.pdf

- **Limit Self-Selection Behavior in Lending:** When it comes to lending, the banking sector needs to cease discriminating among the borrowers and ensure simple, transparent, and evenhanded treatment of all businesses irrespective of their size. However, this would only be possible when banks have adequate information regarding the borrower, which leads to the next point of mitigating information asymmetry.
- **Develop Credit Bureau Market to Tackle Information Asymmetry:** In order to minimize information asymmetries in credit market, it is imperative to utilize and build on the existing private credit bureaus. Currently, few banks are registered as members of the existing two bureaus. Therefore, there is need to encourage banks to become member of the bureaus. Moreover, the scope of bureaus' credit information coverage; which is currently limited to only consumer loans or loans for sole proprietorship[22], needs to be extended to SMEs and corporations in order to holistically tackle information asymmetry.
- **Awareness of Formal Credit:** Financial literacy programs are imperative to tackle the demand-side constraints and raise awareness among the private sector regarding formal financing opportunities. These programs can be a product of public-private partnership.
- **Improve Business Environment:** Increasing demand for private credit ultimately depends on improvement in business environment. These improvements should focus on addressing regulatory, administrative, and legal issues so that the credit bureaus and private sector can develop and operate smoothly.

22 The coverage has been limited to only consumer loans and sole proprietorship loans by the bureaus as they are deemed riskier than loans to corporates and SMEs.