earnings from corporate lending. The South African Task Group noted that in the UK the loan business tended to subsidize the money transmission business, but the reverse was the case in South Africa. Consequently, the low- income households and SME's were bearing the burden of the more prosperous clients.[17]

Low- income SME's were found to be under-served and paying higher fees than was warranted. As in the UK, SME lending was highly concentrated. The business was controlled entirely by the top four banks.[18] The Task Force found prima facie evidence that a complex monopoly condition existed in the national payment system as well as in the SME lending sector. Accordingly, it recommended the setting up of another independent inquiry commission to investigate bank-lending to SMEs as well as the entire payment system.[19]

The problem of access is quite significant in South Africa. Conventional competition analysis does not quite address the problem. Nor does advocacy of greater contestability ensure that the lowest income group would get banking services. Cruickshank had recommended a government stipulation of a minimum requirement of a universal banking service[20]. South Africa considered an initiative for a National Bank Account for all. However, since it entailed a subsidy to the big banks and would have led to price fixing and collusion, the Task Group argued against the proposal. Yet, it supported the principle and the concept behind the proposal. At the same time it recommended explicit deposit insurance of all bank accounts.

The South African Task Group was more concerned with "effective competition" than with contestability or conventional competition indicators. For competition to be effective, it held that consumers needed to make rational choices between alternatives. Hence, relevant information on products was a pre-requisite. Switching costs had to be minimal for the exercise of consumer choice. Therefore, the Task Group placed much emphasis on full disclosure requirements, on the one hand, and on enlarging the accessibility of low- income households and SMEs, on the other. It noted that those who had been denied access faced barriers that were more than simply economic barriers. The behaviour of the banks also deterred certain categories of clients from opening bank accounts and gaining access to the banking system.

The South African Task Group's Report (2004) is important because it serves as a bridge between the analysis of competition in advanced industrialized countries (UK being the prime example that provided the inspiration for the South African study) and statistical analyses in the

[17] This was an important and disturbing finding. Yet, South Africa's case is not an unusual one. There is sufficient evidence of this happening elsewhere – in Pakistan, for instance.

[18] This too is reminiscent not only for the UK. It appears to be a well-nigh universal problem in the less developed countries. There appears to be a nexus between an uncompetitive payment system and denial of access to low income groups and SMEs

[19] A commission was indeed set up, 4 August 2006 -- The National Payment System and Competition in the Banking Sector.

[20] As noted earlier, this included access to ATMs and retail cash back for all, cash deposit and chequeing facility for all and a universal facility for receiving credit electronically and making payments electronically.

developing countries, such as Brazil, India and Pakistan. The similarities of issues and problems, on both sides of the divide, are so striking that it almost suggests that, insofar as competition in banking sector is concerned, the problems are of a universal nature. Whether it be the existence of complex monopolies in the payment system or in lending to the SMEs, whether it be the denial of access to low-income groups, whether it be cross-subsidization across product markets, or it be excessive profitability in retailing, banks appear to be behaving in an uncompetitive fashion world-wide. This uncompetitive behaviour is strengthened by the regulators' excessive concern with stability and less regard for competition. This too appears to be a universal phenomenon. The testament of South Africa's Task Group applies thus to all countries:

> " The South African economy is sound and poised for further growth. At the same time, the banking system is stable, profitable and functions well for high-net-worth individuals and corporations. Since banks supply a crucial service for society at large and because bank failure may impose high direct and indirect costs on a nation, the Task Group is mindful that banks need protection against systemic failures in the financial system. However, there is no economic justification to exempt banks from competition policy in general. In countries such as the US, UK and Australia, where there is emphasis on the importance of effective competition in the banking sector, experience indicates that increases in competition and efficiency can be achieved without introducing instability in the banking system.
>
> It is for this reason that the Task Group considers South Africa's sound and profitable banking system to be an excellent foundation upon which to encourage conduct conducive to effective competition. Competition is important in all industries as it is a spur to efficiency, innovation, consumer choice, quality of goods and services, and low prices. If competition is weak these advantages may be lost and there is likely to be a transfer of wealth from consumers to both the producers of goods and services and the share holders in these firms. Because of the central role of the banking system in the economy, the role of competition (and the costs of its impairment) are particularly important in banking. Disclosure to consumers should perform two functions: to enable them to evaluate the appropriateness of financial services for their needs and to enable them to compare appropriate financial services offered by different suppliers. Disclosure of this sort will enhance effective competition in the industry, so that fairness to all market participants and the efficient allocation of resources are achieved." [21]

IV. IRELAND

While the Report on South Africa is important for the expanse of its recommendations and the relevance of its findings for almost all baking sector environments, the report on Ireland is important for its methodological clarity. The Competition Authority initiated a study on competition in the Irish Republic in September 2002; and commissioned LECG as external consultants. The study was done in several phases, with the Final Report coming out on 29 November 2004.

The findings of the Report were not dissimilar to those in the U.K. and in South Africa, as discussed already. Competition was found not to be working well. The banking industry was characterized by high barriers to entry. SMEs were not getting working capital. Customers faced

[21] Excerpt from Competition in South African Banking: (2004) The Way Forward: Conclusions and Recommendations. p.156

high switching costs. As in the U.K., personal current accounts provided the banks with a gateway to sell a bundle of other products. There was competition for school-leavers and university-leavers who were wooed to current accounts so that they could be locked in. The personal current accounts market was highly concentrated: top two banks controlling 70%. An unusual feature of the Irish market (Kenya being the only other place where this was found) was that the State controlled bank charges on current accounts and also imposed stamp duty on plastic cards. The SME market was highly concentrated and characterized by switching difficulties: SME lending was linked by Irish banks to business current accounts.

The Irish Report is significant in that it focused squarely on competition rather than on profitability. This sharp focus was the result of the way LECG went about their work agenda. In Phase I they cleared the decks and not only defined the scope of future work but also provided definitions of all concepts relevant for conducting competition analysis.

Phase 1 of the report, published 21 August 2003, provided the Competition Authority with a comprehensive compendium on competition terminology as well as citation of relevant case law on each aspect, derived from different jurisdictions world-wide. It outlined the steps to be taken in any analysis, including the analysis of Ireland done subsequently by the consultants. The first step is the definition of relevant markets. It is surprising that this first necessary step is not taken in most studies. The vast number of studies already discussed in the literature review (Chapter 1 of this Report on Pakistan) and in Chapter 2, failed to define the relevant market.

The next step, according to LECG, is the identification of players in those specific markets, to be followed by an analysis of market concentration. Herein lies another methodological problem. Studies of Industrial Organization, adopting the SCP approach, do calculate concentration indices but not for relevant markets. The implicit assumption in this SCP approach is that all banking firms are alike (except for size difference), that they operate uniformly in all product markets, and that they have identical business portfolios. The EU's annual review of banking structures makes the same erroneous assumption. It was to address this deficiency that Cruickshank surveyed 2,000 respondents in order to isolate the unequal presence of different players in different markets.

Once the presence, howsoever unequal, of the incumbents in the different markets has been established, competition analysis proceeds to determine the extent of competitive rivalry or collusion prevalent in each market. This is determined largely by barriers to entry. In the traditional Industrial Organization model, entry barriers are industry-wide and protect all incumbent firms alike. Yet, this is not the case. Although the Irish Report does not advance this argument, it has been noticed that firms do not face identical entry barriers. The impact differs according to how the market is carved out. There is a strategic dimension involved. Mobility barriers, rather than entry barriers (as discussed earlier) are congruous with "strategic groups" in the industry. The Irish report does not consider this aspect. However, it does identify another important aspect – whether or not the potential gains in public welfare obtained from entry restrictions are comparable to the opportunity cost (benefits foregone) of competition. This is, of course, an empirical question, one that cannot be measured with any degree of accuracy and falls

in the domain of public policy. It is also in this context that the trade-off between stability and competition, so central in the banking industry, comes to the force.

Phase I of the Irish Report spelt out the methodology for competitor analysis in detail. Simultaneously (on 21 August 2003) it provided an accompanying Consultation Document for analyzing competition in specific markets. This Consultation Document also followed Cruickshank and sharpened the focus of subsequent analysis to three products: personal current accounts, SME loan financing, and payment clearing system. What the Irish methodology seems to be saying is that by focusing on these three product markets, analysts can bring out and address all the important issues pertaining to competition in the banking sector. It is probably no coincidence that the South African study also devotes maximum attention to these three markets. It is logical, makes eminent sense and is methodologically correct.

CHAPTER 4

ANTECEDENTS OF BANKING COMPETITION IN PAKISTAN

Stability of the banking system has been of paramount concern to the State Bank of Pakistan. There are cogent historical reasons for this, which will be discussed presently.

At the outset it must be noted, however, that the debate regarding the conventionally-argued trade-off between stability and competition has never entered any public (perhaps not even private) discourse in Pakistan. Nevertheless, the need for public confidence in stability of the financial system has, in the past, made the State Bank nervous about "unfettered competition"[22], and it is only recently that the opportunity cost of competition has entered the calculus[23]. To be fair to the State Bank, promotion of competition was never any part of the central bank's mandate. Even the word "competition" does not figure anywhere in the State Bank Order (1948) or the State Bank Act (1956) setting up the central bank as the sole regulator of the banking system. Nor does competition get any mention in subsequent legislation (Banking Companies Ordinance, 1962, S.B.P. Banking Services Corporation, 2001), or even its present Strategic Plan 2005 – 2010, or the 19 "Objectives of the Draft Banking Act" that has been submitted recently by the State Bank to the Government for enactment[24]. Ironically, the only brief mention it gets is in the phrase "without eliminating healthy competition" that qualifies the stated objectives and reasons for the promulgation of the Banks (Nationalization) Ordinance of 1-1-1974 through which all banks were nationalized[25].

I. GENESIS OF STABILITY CONCERN

The banking system of Pakistan was still-born in 1947. Before Partition banking was a monopoly of the Hindu community, which was forced to leave the provinces comprising Pakistan. Their migration to India left behind a complete vacuum. It was an utter breakdown, made much worse by the unhelpful attitude of the new Indian government over the settlement of assets between the two Dominions, and further aggravated by an incipient conflict that was to escalate soon to a full-fledged conflagration. 62 years later, it is difficult to visualize the financial peril in which

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[22] This is apparent even from a reading of the official history of the State Bank. See Chapter 4 of Volume II of Husain, S.A. (1994) *History of the State Bank of Pakistan 1961 – 77,* which dilates upon the perceived threats, resulting from "the intensification of competitive forces in the banking system" (p. 60) and the fear "that unbridled and unrestricted competition or a sudden upsurge of competitive forces would bring in its wake harmful consequences that would have threatened the very stability of the banking system and shaken the confidence of the public which had been built up over the years" (p. 79).

[23] Pakistan - 10 Years Strategy Paper for the Banking Sector Reforms, placed on the State Bank's website this year (2009), is a recent step in the direction of internalizing the benefits of competition.

[24] See Annex-C of 10 Year Strategy Paper for Banking Sector Reforms, SBP.

[25] Subsequently legislated as the Banks (Nationalization) Act of 1974.

Pakistan found itself[26]. Yet, even the barest of statistics can give an idea of why the prognosis at the time was so bleak and the future outlook so gloomy.

Undivided India had 99 scheduled banks[27]. Only one of these, Australasia Bank, had its head office in what was to constitute Pakistan[28]. One other bank, Habib Bank, which had been launched in 1941 in Bombay and which was handling the Muslim League Fund, shifted its Head Office to Karachi at the time of Partition. Of the 99 Indian scheduled banks, 13 had their head offices in what was to become Pakistan. 12 of them shifted their head offices to India and immediately got classified as 'foreign banks' in Pakistan and, in the conflict that ensued, they were to be regarded as enemy banks. The solitary Muslim-owned bank, the Australasia Bank located in Lahore, was too small to cope with the volume of business entrusted to it. Habib Bank came to the rescue in Karachi. East Pakistan did not have any indigenous bank until the Muslim Commercial Bank that had been set up in July 1947 as a small bank in Calcutta (India) shifted its head office (1948) to Dacca (subsequently to Karachi) and opened 5 branches. For the first 18 months the country, therefore, had only 3 banks of its own: Habib, Muslim Commercial and Australasia.

This rump of Pakistani banking faced myriad problems. By 15 August 1947, the migrating Hindu community had moved its assets, estimated to be Rs. 3 billion, out of the 631 branches of the Indian banks operating in Pakistani territory. Most of these branches were closed without the Indian bank owners honouring their liabilities to the local depositors (the predominantly Muslim community still resident in Pakistan). The incoming Muslim immigrants also faced problems in getting their accounts, previously held in India, transferred to Pakistan through the Imperial Bank[29].

The nascent Government of Pakistan had far more serious problem of its own vis-à-vis the Reserve Bank of India and the Indian Government. It did not have currency, for a start. Indian currency notes were therefore used until 30 September 1948, and the Reserve Bank of India also acted as Pakistan's banker – a very uneasy relationship considering the animosity between the two countries. Pakistan Government was apportioned a limited amount of securities to be held with the Reserve Bank (Rs 400 million). Cash balances of Rs. 4 billion had to be divided. Pakistan was given Rs 750 million, but the amount was not disbursed because of the start of the

[26] Recollection of that time, and of the financial hazard implicit in the vexatious distribution of assets and the paucity of funds on the Pakistan side, has been helped by the first volume (Vol. I) of the *History of the State Bank of Pakistan 1948 – 1960*, by S. Aijaz Husain, and the present narrative has relied upon it.

[27] Listed as such in the Second Schedule of the Reserve Bank of India Act 1935

[28] Started in 1942 in a motor garage in Lahore as a rent collection agency for a family estate, it became a realtor that moved its premises in 1944. When it applied for inclusion in the Second Schedule,, the Government of India reluctantly incorporated it in 1946 – 1947. After Partition the Pakistan Government extended Treasury functions to it.

[29] Imperial Bank, which continued to operate in Pakistan, was the agent of the Reserve Bank of India (until 30/9/1948) for this purpose, but was unable to discharge its responsibility to the immigrant influx. It could not even handle government revenues, simply because it no longer had the necessary staff to do so.

Kashmir dispute[30]. In these circumstances, Pakistan came to the conclusion that its need for a central bank of its own could brook no delay, and notified (February 1948) the Government of India that it was advancing the date of its establishment to 1st April 1948, instead of 1st October 1948. The Indian Government was averse to this advancement but agreed to the date of 1st July 1948, when the State Bank was actually set up[31].

The circumstances in which the State Bank was hastily set up left a mark upon the institution. Given the enormity of the challenge and the dedicated manner in which it was overcome in a short span of time, those that were involved in its inception and development felt justifiably proud of the achievement deserving public adulation. This esteem has been strengthened by the fact that, despite the country's subsequently fractured polity, the truncation of its eastern part and endemic financial crises (such as near-defaults on external debt), the State Bank has been a sheet-anchor. Also – and more importantly in the context of competition analysis – the Bank's shaky start amid peril has shaped a psyche of rigid control over financial institutions, in which stability is all-important. The State Bank is too nervous to countenance any banking fragility and will tend to over-regulate rather than risk bank failure as a consequence of unfettered competition. This also explains excessive government control over financial intermediation.

A national commercial bank

The Imperial Bank that performed the Treasury functions for both India and Pakistan was unable to discharge its fiduciary duties, owing either to shortages of residual staff or possibly to conflict of interest. It was unable to transfer the deposits of Muslim immigrants. The dispersal of these deposits was another problem. Even almost a year after Partition (in July 1948) Rs 740 million out of the total deposits worth Rs 1080 million were held by foreign banks. The problem was compounded by the fast-diminishing number of bank branches in the wake of Partition and its social-political aftermath, including communal blood-baths. From 631 bank branches in Pakistan prior to partition the number went down drastically in 1947 to 213. By July 1948 their number went down further to 195. In West Pakistan there were only 69 bank branches.

Strong policy measures had to be introduced by the State Bank. Some of them thwarted competition and were discriminatory. For instance, Pakistani banks were encouraged to open new branches, while foreign banks were discouraged. Foreign banks that had previously enjoyed

[30] Out of this Rs 750 million allocation, working capital of Rs 200 million was allowed. The remaining Rs 550 was withheld, as a result of which Pakistan had to resort to obtaining an interest bearing loan of Rs 50 million against the surety of the amount of Rs 550 million.

[31] The travail of establishing the State Bank is another story. The wisdom of having a regulatory agency in the absence of a banking system was questioned. John Turner, the British Financial Advisor, recommended a Currency Board of the Reserve Bank of India to be set up in Karachi instead of a central bank, especially when there was no staff available for it. There were only 8 officers, 13 superintendents and 129 clerks available for the task. Nevertheless, the Government pressed ahead.

equal opportunity, and in fact had a favoured status owing to their links to the City of London, were prohibited from re-opening any branch that had been shut.

Immediately upon its inception the State Bank allowed the opening of 38 new branches (10 in East Pakistan, 28 in West Pakistan). To protect depositors, the State Bank mandated that banking firms hold assets equal to 75% of their liabilities. Yet, the three indigenous Pakistani banks (Habib, Muslim Commercial and Australasia) were not strong enough to compete with foreign banks or the exchange banks, which not only financed commodity exports but also negotiated all letters of credit.

The economic power of foreign banks became manifest in 1948-1949. As agent of the State Bank performing Treasury functions, the Imperial Bank of India not only disbursed Government salaries, but it was also expected to purchase its securities. It refused to do so, pleading that it could not market Government securities. This compelled to government to re-think its options. It decided to directly enter commercial banking by floating its own national bank and drive out foreign competition.

The decision was precipitated by events in the wake of the devaluation of the sterling (September 1949). India followed suit but Pakistan desisted, provoking a trade suspension (of jute) by India. Confronted with the prospect of foreign banks not extending credit to Pakistani exporters, the Government of Pakistan advanced the date of launching its own commercial bank (The National Bank of Pakistan), just as it had advanced the date of setting up its central bank. National Bank commenced operation at the end of 1949. Eventually it not only replaced the Imperial Bank, but emerged as the foremost Pakistani commercial bank, with full government patronage[32]. This was against norms of providing a level playing field to all commercial banks. Yet, the State Bank and the Government felt that national exigencies over-rode all other considerations. It was a manifestation of the evolving psyche of regulatory government control to ensure stability. In time it would result in government appropriation of all banking assets.

II. RAPID EXPANSION

Pakistan had started off with a rump of 3 banks. Two years later (1949) the domestic structure was still the same (see Table 4.1). However, the newly-established State Bank was determined to alter it and reduce the power of foreign banks.

The next five years (1949 – 1954) represented "a challenging situation, perhaps unparalleled in the history of banking in any other country." (Husain, Vol. I, p.141). Responding to complaints of Muslim depositors, delayed payments and other irregularities, the State Bank launched a

[32] The Governor of the State Bank (Mr Zahid Husain) was concurrently appointed as the first President of National Bank through a special dispensation, creating an anomaly and a conflict of interest. Nevertheless, the arrangement lasted 3 year until in 1952 Mr Zahid Husain pointed out how untenable this dual charge had become, and asked to be relieved of his duties as President of National Bank.

systematic inspection of all commercial banks with a view to weed out the unsound ones. As a result of these inspections 16 banks were liquidated by 1955; another 3 were to follow suit in the next 3 years. In each case the State Bank was the official liquidator.

Table 4.1: Scheduled banks* in Pakistan

	# of banks	Branches in West Pakistan	East Pakistan	Total
Pakistani scheduled banks	4	52	7	59
Indian scheduled banks	23	40	68	108
Exchange banks	8	17	8	25
Total	35	109	83	192

*as of December 31, 1949, National Bank of Pakistan excluded.
Source: Husain, S.A. History of the State Bank of Pakistan 1948 -1960 Vol. I, p. 137

Despite these forced closures the number of bank branches was increasing, even though the number of banks had declined[33]. A shift was taking place in the financing of trade and commerce. Hitherto this had been the preserve of exchange banks or the foreign banks[34]. But, according to a survey done in 1952, Pakistani banks had already captured 38.3% of the loan market. 22.2% lending was by Indian banks, while 39.5% (still the largest share) was by other foreign banks. This profile was to change by 1955, when advances by Pakistani banks had increased from 38.3% to 59%. Advances by Indian banks fell from 22.2% to 15% while the share of foreign banks fell from 39.5% to 26%.

Table 4.2 : DEPOSITS & ADVANCES

Year	1950	1951	1952	1954	1955	1956	1959	1960	1970	1971
Deposits (Rs. m)	1,135	1,472	1,360	1,715		1,995	2,623	2,943	14,131	15,593
Advances (Rs. m)			632		723			1,445		11,447

The expansion in the 1960s was even more rapid. In 1960 there were 29 banks (19 foreign, 10 Pakistani) with 430 branches. In the next three years there was a proliferation of new branches. Their number increased to 957 (in 1963), and continued to rise. By 1970, when the number of banks had risen to 36, the number of branches had gone up to 3,344.

Before the break-up of the country in 1971, there were 35 banks, with 3,381 branches (2188 in West Pakistan, 1193 in East Pakistan). 17 banks were Pakistani, 18 were foreign. The Pakistani banks, however, held a lion's share of deposits: Rs 12,721 million out of the total deposits of Rs 14,131 million[35].

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[33] The number of branches went up from 192 in 1949 to 246 in 1954. Pakistani banks were encouraged to expand their networks.

[34] Their mainstay was to finance wholesale and retail trade that constituted 48% of lending (1952).

[35] A slightly different estimate is that deposits were Rs 15,593 million, while advances were Rs 11,447 million.

Although in terms of numbers their strength did not exceed that of foreign banks, by 1970 (actually much earlier) the domestic Pakistani banks had competed the foreign ones out of the market, largely through Government support exercised through the State Bank. By the end of the 1950s there were only 8 Pakistani banks[36]. The number doubled to 16 in three years, but remained static after that[37]. It seemed that an oligopoly consensus had emerged and optimal structure was perceived to have been attained. Henceforth the State Bank concerned itself with encouraging existing banks to increase their coverage. The upsurge in the number of branches, from 430 (1960) to 957 (1963), was to continue until 1971, when the country had 3,418 (2,396 were in West Pakistan) branches. The per capita coverage provided by these branches was impressive in numbers. In 1960, there was an average of 176,000 persons served by one branch. By 1970 this number had fallen to 29,000. It was to go down further to 11,300 by 1977.[38]

The proliferation of bank branches led to a massive mobilization of deposits. See Table 4.2. The deposit base increased from Rs 2,943 million (1960) to Rs 14,131 million (1970)[39]. This nearly five-fold increase in the amount of deposits was accompanied by an eleven-fold increase in the number of depositors, suggesting that smaller depositors were coming into the net. The number of deposit accounts increased from 573,440 in 1960 to 6,380,959 in 1970. It was to rise further to 11,970,966 by 1977[40].

III. CONCENTRATION

The numbers, impressive though they might be, and suggestive of heightened competitive activity, actually camouflaged a high degree of concentration. This concentration was of three kinds. The first concentration was that of bank branches in large cities. This had serious adverse implication for agriculture and the rural economy that remained starved of credit. This aspect will be taken up later in this Report.

The second concentration was in terms of deposits. Not only were the deposits concentrated in West Pakistan (to the deprivation of East Pakistan), they were also concentrated in the top 4 banks (National Bank, Habib Bank, United Bank and Muslim Commercial Bank) with regard to which the State Bank had a different (and more favourable) policy than the one towards other banks[41].

The third (and possibly the most significant of all) concentration was that of loan accounts. The number of loan accounts registered a sharp increase after 1959 with the advent of greater perceived political stability, following the first military takeover. Bank lending increased: the number of loan accounts went up from 50,000 (1959) to 120,000 (by 1963) and was to continue

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[36] A recent entrant, in 1959, had been United Bank which caught up very quickly to become one of the top 4.

[37] When the country broke up in 1971 there were 17 domestic banks, 18 foreign ones.

[38] History of the State Bank (*Ibid*, p. 50)

[39] of which 90% (Rs 12,721) was mobilized by the Pakistani banks, as noted earlier.

[40] There was a corresponding increase in lending by Pakistani banks, as indicated in Table 4.2.

[41] This dual policy, according to which these four banks were categorized as Category I, whilst the rest comprised Category II, differentiated between their requirements for obtaining new licenses, especially for opening new branches

rising throughout the Decade of Development as it was called. The supply of bank credit was, however, heavily concentrated in West Pakistan. Out of the advances of Rs 11,734 million in 1960, Rs. 10,463 (or 89%) had been made in West Pakistan, even though this part of the country comprised less than half its population.
The recipients of these credits were none other than those rich industrial corporations that also controlled the banking system[42].Characterized as the 22 families they have had a significant influence on the rise and fall of socio-economic developments in Pakistan. Insofar as banking competition is concerned, two things are worth noting here. Firstly, the 22 families controlled the banking business and used it to finance their own industrial wealth. This is not empty political rhetoric[43]. Statistical evidence is available on it. The increasing volume of bank lending was highly skewed, with obvious implications for competition. Secondly, the skew was not simply an outcome of the Decade of Development, as often maintained. It may have been accentuated by the policies of the Decade but actually pre-dated it.

IV. COLLUSION

The State Bank was unable to distinguish between the need for market forces to determine price (especially interest rates) and restriction of competition. It did not disapprove of the 1959 Inter-Bank Agreement to fix the deposit rate. While it frowned on other so-called corrupt practices, it not only condoned but tacitly encouraged the leading banks to fix a ceiling on deposit rates. This cartelization was to have very serious consequences. It widened the interest rate spread, making all banks earn monopoly profits. See Table 4.3.

In January 1959, the State Bank raised the Bank Rate from 3% to 4%. Realizing that the lending rate would have to be raised as a consequence, the big banks exploited the opportunity to widen the spread through a "voluntary" agreement to depress the deposit rate. The smaller banks were not too keen to artificially depress the deposit rate; they wanted to offer higher deposit rates to partake of some of the liquidity that was coming into the market via aggressive deposit mobilization, higher interest rates offered by government's national savings scheme and a rise in time deposits. However, they were deterred from doing so by the big banks that enforced the ceiling (maximum permissible deposit rate to be offered by all banks) with State Bank connivance and also retained their valuable big depositors – local governments, semi-government agencies and provincial and federal government departments, whose officials were given kick-backs to lock in cheap deposits from them[44].

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[42] This high level of concentration of industrial and financial wealth, and of its implications on competition in Pakistan and on political developments has been discussed extensively elsewhere. See also the Competition Commission of Pakistan (2009), *State of Competition Report 2008*, p 29.

[43] although it was part of the rhetoric that led to the nationalization of industry (1973) and banking (1974).

[44] The Government and the State Bank were in full knowledge of this. The State Bank also set up an Inquiry Committee in 1963. But, neither the Government nor the Bank was able, or inclined, to do anything about it, as recorded in the Bank's history.

Table 4.3: Profitability of Top 3 banks (In million rupees)

	1957	1958	1959	1960	1961	1962
National Bank						
Income	26.4	30.2	35.5	41.8	59.0	71.2
Expenditure	17.2	20.8	25.3	29.8	41.5	50.2
Net Profit	9.2	9.4	10.2	11.9	17.4	20.9
Dividend %	5	5	6	9	10	10
Reserves	11.0	13.5	16.0	21.0	28.0	32.0
Habib Bank						
Income	21.9	25.9	28.0	31.5	34.1	47.5
Expenditure	14.3	22.5	16.8	24.1	24.1	39.1
Net Profit	7.5	3.4	11.1	7.4	10.0	8.3
Dividend %	17.5	14	15	17.5	20	20
Reserves	20.0	20.0	20.0	20.0	20.0	22.0
Muslim Commercial Bank						
Income	5.9	6.5	7.3	10.0	13.3	15.2
Expenditure	4.7	4.7	4.8	6.6	8.9	10.3
Net Profit	1.1	1.9	2.4	3.3	4.4	4.8
Dividend %	5	5	5	7	8	10
Reserves	1.5	1.7	2.0	3.2	4.2	6.0

Source: *History of the State Bank*, Vol. II, p.68

The State Bank should have remained aloof from the cartel. Instead, it tried to micro-manage the 1959 Inter-Bank Agreement by advising the banks that, instead of simply stipulating a maximum ceiling (which some of the smaller banks were reluctant to adhere to) the banks should segment and divide up the market according to a cascading differential. The formula proposed by the State Bank to the Bankers' Association for enforcement was as follows:

Banks with deposits up to Rs 50 million	1%
Banks with deposits from Rs 50 to Rs 100 million	¾%
Banks with deposits from Rs 100 to Rs 150 million	½ %
Banks with deposits above Rs 150 million	nil

What is even more astonishing is the justification given for this State-sponsored cartelization:

> "The idea of a Bankers' Agreement on deposit rates was highly commendable in order to avoid cut-throat competition and the frittering away of banks' rates arising out of temporary forces. Such agreements on deposit rates existed in many other countries, including India and the U.K. The need for it was all the greater in Pakistan where the banking system was comparatively young, whereas the demands in it were growing rapidly" (History of the State Bank, Vol. II, p.67)

The State Bank at that time was not averse to any increase in the deposit rate. In fact it wanted deposit rates to rise so that banks could compete with government saving schemes, and also to keep a check on the kick-backs that were being given to government departments to induce cheap deposits (with private incentives thrown in for large government depositors)[45]. What it objected to was not the collusion among the banks – on the contrary, it was very keen that they should cooperate further – nor the objectives for which the agreement was made. Its objection was that the banks had not succeeded in making the agreement watertight. It argued that "a still better arrangement would have been that the Agreement on deposit rates instead of laying down the maximum rates, should have prescribed the actual rates for various types of deposits." (*Ibid.* p.69).

V. IMPLICATIONS OF RESTRICTING COMPETITION

The rapid increase in bank deposits furnished an ideal opportunity for the government to increase its own bank borrowing and indulge in deficit financing. Often the Government obtained bank loans below the Bank Rate. This also provided encouragement to the banks to provide concessional lending (even without security) to the private sector. The distinction between public and private welfare got so blurred that bank managers usually obtained personal benefits from businesses to which they advanced highly concessionary unsecured credit[46]. It appears that concessionary lending was the *quid pro quo* for all manner of scams[47].
It is estimated that 30% of the total deposits of the banking system during the 1960s were *benami* or fictitious. These laundered assets were in reality not to be found in the vaults of the banks but in the private estates of the owners of the banks. What facilitated this enterprise was the fact that the ownership of the banks rested largely with the captains of industry. A large part of loan advances went in fact, by way of highly concessionary lending, to the families of Directors of the banks.

The State Bank was aware of this and made public pronouncements on it[48]. Yet, its proposed solution to the problem was in fact tantamount to an aggravation of it. The State Bank considered bank mergers to provide the right answer, because

> "it was one method through which the State Bank could seek to strengthen the banking system and reduce the chances of competition hitting the weak units unduly hard. It was an accepted practice in various countries of the world for the banks of different sizes and interests to pool their resources and to form one institution with a sound financial base. Such mergers provide financial stability to the integrated units reducing overhead costs and avoid unhealthy competition." (*Ibid*, p.82).

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[45] The State Bank also wanted to push up the Bank rate so that the cost of borrowing from the State Bank became higher for commercial banks. It was hoped that this might squeeze the interest rate spread. It turned out to be a fond hope.

[46] The history of the State Bank talks at length about such corrupt practices that became the norm.

[47] Every conceivable corrupt practice, ranging from money laundering to fraud, is recounted in the Bank's history (*Ibid*, pp. 55-124).

[48] See, *History of the State Bank* (*Ibid*, pp. 52 – 55 and pp. 105 – 108)

The State Bank therefore unabashedly promoted mergers, thereby increasing concentration. The philosophy appears to have been carried through to present times, as will be discussed later in this Report.

Meanwhile, the increase in concentration and the monopoly power of big businesses was not going unnoticed. A ground swell of public sentiment had risen against it. The 1967 manifesto of the Pakistan Peoples Party stated that: "Monopoly conditions were to be abolished so that private sector could function according to the rules of competition." With regard to the financial sector, the Manifesto was even more explicit:

> "The possession of financial institutions in the hands of private parties is a source of exploitation which use wealth and private deposits, to create money for financing of monopoly capitalism. All big industries have been set up on bank loans, i.e., on the funds of the depositors. Such loans can be said to have been misappropriations of public money by the bankers. To this sort of abuse which is inherent in any system where banks are in private hands, there has been added the control of banks by cartels belonging to industrial families. Unless the State takes hold of all the banks by making them national property it will not be able to check inflation. All banks and insurance companies must be forthwith nationalized."[49]

Accordingly, when the PPP government came to power it started with a wide range of reforms in 1972-73, but these were not considered to be sufficient. The imperative of the situation demanded complete nationalization of the banking system. With nationalization (1974) all pretence of a market economy, of which competition is the central pillar, was abandoned.

The existing 14 domestic banks were nationalized on 1st January, 1974. Industrial enterprises which had been funded by their bank loans had also been nationalized earlier. The 14 banks were consolidated, through notifications by the Ministry of Finance, into five banks: National Bank, Habib Bank, United Bank, Muslim Commercial Bank and Allied Bank[50].

The Ministry of Finance took command, exercising its authority through a new institution, the Pakistan Banking Council, much to the chagrin of the State Bank. This dispensation was observed for the next eighteen years. The Monopolies and Restrictive Trade Practices Ordinance did not apply to nationalized banks. The jurisdiction of the Monopoly Control Authority had been ousted; MCA was barred from looking into any aspect of banking.

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[49] PPP Manifesto, 1967

[50] The Bank of Bahawalpur was taken over by the National Bank. Habib (Overseas) and Standard Bank were merged with Habib Bank. Commerce Bank Limited was incorporated into United Bank. Premier Bank was merged with Muslim Commercial. Australasia Bank, Pak Bank, Lahore Commercial and Sarhad Bank were merged to form Allied Bank.

CHAPTER 5

BANKING SINCE NATIONALIZATION

I. SRUCTURE OF BANKING (1974 – 1999) AND ERSATZ COMPETITION

The case for nationalization of banks rested on fairly strong premises. Commercial banks had contributed towards the highly skewed distribution of national income. Their liberal credit policies had been directed towards providing finance for industry and commerce both of which were owned by the very people who controlled the banking system[51]. An inevitable concentration of economic power, financial and industrial, made the case for nationalization even stronger[52]. Despite best efforts by the Government and the State Bank, banking stability had not been achieved. Mass political demonstrations of 1971, accompanied by massive looting of banks, worsened the situation. In addition, the commercial banks were riddled with corruption and malpractices that the State Bank, as regulator, did not tire of pointing out. It wrongly attributed them to "intense competition" in commercial banking[53]. However, whilst this attribution was faulty, the objective reality of malpractices, market distortion and concentration was undeniable.

This false attribution by the State Bank historian, and possibly by a large number of policy-makers and bankers themselves, results from a conceptual difficulty. They always use the word "competition" in a pejorative sense and equate it with a malpractice. No other inference can be drawn from the statements of the State Bank's official historian on the state of competition prevailing before and after nationalization:

> "The private sector was basically competitive in contrast to the monopolistic nature of the public sector. The element of competition should in consequence have been contained in the nationalized sector of the banking profession. On the contrary, it was preserved and encouraged as an essential ingredient of progress. Not only it was manifested in the frantic race for expansion but also in the rush for publicity on which millions were spent every year by every nationalized bank,. The increase in expenditure on all heads was phenomenal; salaries, rents, stationary, publicity, travelling, entertainment, had all moved up quite out of proportion to the business of the banks".[54]

The fundamental problem here is that competition, either as a concept or as a positive societal requirement, has never been taken seriously in Pakistan – and certainly not in the banking industry. Consequently, there is ample confusion regarding cause and effect. In order to dispel

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[51] Both imports and exports were licensed, and there was a strong nexus between the license-holders and controllers of bank credits.

[52] See White, Lawrence J., *Industrial Concentration and Economic Power*, 1974, Princeton University Press, New Jersey, and "Review: Socialism for 22 Families", 1975, Economic and Political Weekly, Vol. 10, No. 23 (June 7, 1975) pp. 889 – 892.

[53] The official history of the State Bank (see Husain, S.A., *op cit*) is a jeremiad of the baneful effects of competition.

[54] *History of the State Bank, op cit*, p. 149

this confusion it is necessary here to reiterate (once again) that in the present analysis, as indeed in all analyses of competition by the Competition Commission of Pakistan, the view[55] that has consistently been taken is that competition is a public good that the State is obliged to provide to its citizens, but which it has failed to do – and most certainly in the case of the banking industry. What the State has provided instead is another public good – prudential regulation – that was equally necessary but could not be substituted for competition. In the process, genuine competition got driven out, if it existed in the first place. Whatever residual manifestation was noticed by industrial analysts was that of ersatz competition: distorted, often fake, deceptive shadow-boxing perhaps.

What follows in this chapter is an identification of ersatz competition through a structural analysis of three time periods. The first is that of nationalized banking, starting from 1974 and tapering off in 1991-1993. The next phase of State-divestiture and the advent of banking reforms and prudential regulations started in 1991 and proceeded through 1999. The new millennium witnessed the third phase (still continuing) of quicker divestiture, privatization, private sector growth and opening up of the entire financial system. The structural analysis provides the facts upon which conclusions can be based and from which the state of competition can be deduced.

Nationalized banking

The State Bank lost its primacy with the nationalization (1 January 1974) of all domestic[56] banks. The Nationalization Ordinance, the preamble of which included a reference to the promotion of healthy competition as being one of its objectives, simultaneously set up a Pakistan Banking Council with jurisdiction over 21 functions that had previously been the State Bank's domain. In actual fact a troika of control came into being: the Ministry of Finance, the Banking Council and the State Bank, all with overlapping jurisdictions. The greater control over the 5 public sector banks and development finance institutions was exercised by the Pakistan Banking Council. Non-bank financial institutions (NBFI) were regulated not by the State Bank but by the Corporate Law Authority, with the Monopoly Control Authority having some jurisdiction over the private sector NBFIs, but none over public-sector concerns.

Despite claims to the contrary, competition could not be a determinant of any economic activity when all its parameters were fixed by the Government. The Bank Rate (at which the State Bank buys or rediscounts bills of exchange) was fixed at 9% (on 3rd September 1974), increased to 10% (on 7th June 1977) and kept at that level. All other rates were also fixed for each of the banks. There was a floor on the deposit rate and a ceiling on lending rates as well as a credit ceiling fixed separately for each bank. Squeezed between these two thresholds, banks were further pressed by the requirement of keeping 5% of demand deposits with the State Bank and 30% liabilities in government securities. The National Credit Consultative Council, which had been established in 1972 in the State Bank[57], set the rates at which subsidized credit was to be

[55] This view of competition is clearly spelt out in the State of Competition 2008 Report (see p. 10; pp 17-20; p.52)

[56] Foreign banks were exempted from the purview of the nationalization decree

[57] Reminiscent of the Credit Council set up in Germany (described in Chapter 3) with a similar mandate

provided by commercial banks to different sectors for different purposes: 3% for export refinance, 3.0% - 4.5% for industry, 0.5% for agriculture, though ADBP could lend at 6% rate. Industrial credit was also channeled through National Development Finance Corporation (NDFC), set up in 1973.

A floor was set by the Pakistan Banking Council on the rate of return on bank deposits. According to the State Bank, this policy discouraged savings and led to disintermediation. It resulted in the real rate of return on deposits becoming negative throughout the period (except for 3 years 1985 – 1988). The problem was compounded by the fact that the government's excessive need for deficit financing impelled it towards extensive borrowing, not only from the banking system but also from a parallel non-banking financial institution, the Central Directorate of National Savings (CDNS) that was a part of the Federal Government's Ministry of Finance[58]. The Central Directorate (CDNS) offered higher rates for term deposits--- also set by the Government. Arbitrage was, of course, strictly prohibited. Commercial banks could not invest in national savings to obtain a higher return themselves.

With insufficient deposit mobilization, and a ceiling on interest-income, it is not surprising that profitability of the 7 government-owned banks as well as intra-industry competition were both constrained. The only competition that was allowed to the 7 State-owned banks was with the 17 foreign banks that had not been nationalized and whose scope of operation was limited to financing foreign trade. No private sector domestic banking was allowed until 1991. For 10 years the same monopoly prevailed in the non-banking financial sector, until the mid-1980s, when that sector was opened to private enterprise, resulting in the emergence (by 1990) of 23 private NBFIs in addition to the 13 State-owned ones.

Divesture

The Nationalization Act of 1974 was amended in 1990 to allow dilution of State control. With a minimum stake of 26% of shares, private shareholders could buy management control from the government. The first divesture was that of Muslim Commercial Bank (MCB)[59] in April 1991, to be followed in September 1991 by the employees of Allied Bank buying out management control with 26% shares[60]. UBL's share sell-out (26%) was next on the agenda but it could not materialize until much later even though due diligence had been done.

It is significant to note that new entry was also allowed alongside divesture. In August 1991, 10 new private domestic banks were allowed[61].They were to be joined later by 11 others.[62] In

[58] It remains so to this day

[59] 26% shares were bought by the Mansha Group in 1991, to be followed by 49% share purchase in 1993

[60] This was followed in 1993 by an additional sale of 25% shares to other private investors.

[61] Al-Habib, Soneri, Union, Mehran, Indus, Prime, Askari, Bolan, Capital, and Republic were given licenses. The last two did not, however, commence operations.

[62] Metropolitan, Habib Credit, Schon, Faysal, Platinum, Prudential, Gulf, Alfalah, Bank of Ceylon, Oman Int'l and Trust Bank.

addition, two provincial government banks (Bank of Khyber and Bank of Punjab) were scheduled in 1994.

Next, the Government applied a sudden brake. In 1995 it placed a moratorium on new bank entry. Simultaneously it encouraged those who had already entered the market to expand through opening of new branches. To facilitate them it restrained the government-owned banks from any retaliatory competitive move to recoup market share: in 1996 State-owned banks were prohibited from opening any new branch. This prohibition was reinforced next year (1997) when they were directed to shut all unprofitable branches. As a result, 718 branches were closed: their number fell from 8,673 in 1997 to 7,955 in 2000.

This policy constituted a U-turn because it was diametrically the opposite of providing an advantage (through government patronage) to the 5 government banks. Throughout the 1950's and 1960 this patronage had been extended in order to minimize foreign competition. However, the tables were now turned on the government banks, which were expected to wind down their operations – through a series of golden handshakes. Another salutary step towards the withdrawal of the previous patronage regime was the abolition (1997) of the Pakistan Banking Council.

None the less, the new policy moved ahead in fits and starts. It is not the intention of this Report to downgrade the importance of this encouragement (1991 onwards) to the private sector at the expense of the public sector. It was a conscious policy pursued with some vigour and consistency. It was not restricted to the banking sector but applied also to other sectors, such as the energy sector, where private power investment was keenly sought (through Independent Power Producers) in 1994-1996, with a corresponding embargo being placed on public sector investment (WAPDA being prohibited from setting up thermal power plants). The point worth noting, however, is that the U-turn was not accompanied by a conscious, continual and universal encouragement of competition. The contestability of the market must surely have improved with the entry of 19 private banking firms --- a large number by any reckoning --- to break a State-controlled (through 7 banks) oligopoly. Yet, having admitted 19 private banks, the Government seemed to have second thoughts when it imposed fresh entry barriers (stoppage of further entry, through the 1995 moratorium) —this time to protect the new entrants (now incumbents) not only against retaliation from the previously dominant firms, but also possibly from any future influx of potential competitors.

Structural Change, 1990 – 2000

In 1990 there were 7 State-owned banks, 17 foreign banks, but no private domestic bank operating in Pakistan. There were 13 State-owned non-bank financial institutions. In the mid-1980s, 23 private NBFI's that had also come into being. In addition, the Ministry of Finance operated the Central Directorate of National Savings (CDNS).

The State-owned banks completely dominated the financial sector. Through 7,043 branches (compared to a total of 45 branches of all 17 foreign banks put together) they held 92.2% of all

banking assets – half of them being in the form of deposits[63]. They provided 92.1% of advances and 93.5% of investments. See Table 5.1.

Table 5.1: Public/ private sector banks' shares

	Assets (%age)		Advances(%age)		Investment(%age)		Deposits(%age)		Capital(%age)		NPLs(%age)	
Year	Public	Private	Public	Private	Public	Private	Public	Private	Public	Private	Public	Private
1990	92.2	-	92.1	-	93.5	-	93.0	-	85.4	-	95.0	-
1991	89.1	-	90.0	-	87.9	-	89.8	-	80.4	-	95.8	-
1992	83.7	3.8	84.1	3.2	82.6	4.6	85.4	3.0	65.5	10.0	92.6	3.5
1993	80.1	5.2	83.4	4.2	77.2	5.6	82.1	4.1	60.6	10.5	94.4	2.1
1994	78.4	6.3	79.3	6.1	78.8	5.7	80.2	5.2	57.8	12.4	95.8	2.0
1995	76.7	8.5	76.1	8.8	80.9	6.3	78.8	6.9	52.6	18.4	94.1	2.5
1996	72.3	9.7	73.0	9.9	73.0	8.0	74.1	8.2	41.7	22.0	92.5	2.9
1997	68.7	11.3	67.0	12.3	67.4	13.2	69.9	10.3	20.8	28.3	91.7	3.6
1998	70.5	11.4	67.6	12.8	71.7	12.2	71.7	10.6	56.6	14.8	90.9	4.2
1999	71.8	11.9	69.2	12.8	78.9	12.2	74.6	10.6	50.6	17.8	88.9	7.2
2000	70.6	13.6	68.1	15.1	72.3	13.2	73.7	12.2	55.6	16.5	88.1	7.8
2000*	54.0	-	50.2	-	54.8	-	56.2	-	47.1	-	72.1	-

* excluding two privatized banks (MCB and ABL)

this ratio is low because of Rs. 35 billion losses shown by two large banks in 1997

Source: *Pakistan: Financial Sector Assessment 1999-2000* Chapter 3

Table 5.2: Public/ private sector banks' earnings and profitability

	Net Profit to Asset ratio (%age)		Net Profit to Equity Ratio(%age)		Net Interest Margin(%age)		Total Income to Total Assets(%age)	
Year	Public	Private	Public	Private	Public	Private	Public	Private
1990	0.4	-	10.5	-	3.2	-	9.6	-
1991	0.5	-	13.4	-	3.2	-	9.1	-
1992	0.5	0.7	15.3	6.3	3.3	2.3	8.9	4.3
1993	0.7	1.9	19.2	20.3	3.7	5.2	10.0	10.3
1994	0.2	1.5	7.5	17.2	3.4	4.7	9.6	10.5
1995	0.2	1.4	5.9	14.5	3.9	4.0	10.2	11.7
1996	-0.3	1.5	-14.8	16.6	1.9	3.4	9.6	12.3
1997	-2.3	1.0	-243.9	13.3	3.2	3.9	10.7	12.7
1998	0.5	0.6	11.5	8.0	3.5	3.5	10.6	13.1
1999	-0.7	0.6	-19.8	8.4	3.8	2.6	10.0	11.5
2000	0.1	0.3	2.8	4.6	4.1	2.8	9.5	10.2

Source: *Pakistan: Financial Sector Assessment 1999-2000* Chapter 3

[63] By contrast, the CDNS had only 363 branches.

This share of assets, advances, investments and deposits of the public - sector banks was to decline drastically over the decade. Table 5.1 shows this decline and the corresponding rise in the shares of private banks. Simultaneously, the earnings of the State-owned banks declined, whilst those of private banks increased. See Table 5.2.

According to the State Bank, the assets, capital endowment and management of the foreign banks were all superior to those of domestic banks. That is why their profitability was also higher. However, these banks were unable to retain their relative performance[64]. This trend is not without significance. It may be recalled (from Chapter 2) that the study of Indian banking for the same period had noted exactly the same trend in India, where the domestic banks had retaliated to foreign entry, as a result of which competition had increased. In both India and Pakistan, this observation regarding the impetus provided by foreign entry is controversial. One would not expect otherwise. The world-wide debate on this subject has been inconclusive, as discussed in Chapter 1.

There came a break in 1997. After an average annual growth of 17.8% for the previous 6 years, the banking sector growth fell to 7.0% and was to slow down further over the next three years. An aggravating condition occurred with the freezing of all foreign currency deposits in May 1998 upon a government decree. It reversed the gains that had been made four years earlier with foreign exchange liberalization (in July 1994 the rupee was made convertible on current account), and struck a serious blow to the establishment of an open and competitive environment. Other restrictions contributed to the slow-down. For instance, the capital adequacy ratio was increased (1997) from 3% to 8%. Possibly the most significant reason, for the shrinking of commercial bank deposits, was competition from the National Savings Schemes of CDNS.

The development finance institutions (e.g., National Development Finance Corporations) and the Central Directorate of National Savings were rivals of the commercial banks – one on the lending side, the other on the side of deposit mobilization. Their interest rates were directly under government control. Both were instruments of government policy. The DFIs channeled credit to promote industry – a strategic objective of the government going back to the 1950s (see Chapter 4). Project finance was supposed to be their mainstay. Yet, their performance throughout the post-nationalization phase, through the 1990s was lackluster. The State Bank found their asset quality and non-performing loans to be a mirror image and came to a considered conclusion:

> "Inadequate level of capital, poor asset quality, weak management performance, low earnings and profitability profile along with a deteriorating liquidity position are suffice to conclude overall weak financial health of DFIs. Current distressed state of DFIs is an upshot of the high level of non-performing loans, political interference in their management and business, and overall weak economic situation in 1990s. In addition, increased competition in mobilizing deposits,

[64] See *Pakistan: Financial Sector Assessment 1990 – 2000,* pp.52-53

discontinuation of credit lines from international finance institutions along with overall limited ability to generate resources intensified the problem. Freezing of foreign currency accounts in FY98 also aggravated the problems."[65]

The CDNS was the *bête noir* of the State Bank and completely outside its control. Its performance in deposit mobilization was the reverse of that of commercial banks, primarily because it offered higher rates on term deposits and fulfilled an investment function, in addition to its utility as a debt financier of the federal government. Until 2000 it enjoyed a privileged status vis-à-vis the commercial banks. Table 5.3 compares the commercial interest rates

(weighted average) offered on deposits (and also on bank lending) – both in nominal and real terms – with the profit (interest) rates on CDNS products such as Defence Savings Certificates (DSC), Special Savings Certificates (SSC) and *mahana amdani* (monthly income) accounts. It is not difficult to see the attractiveness of National Savings Schemes for investments and savings and why they posed a threat to bank deposits. The importance of the NSS to the government (Ministry of Finance, in particular) should become obvious from Table 5.4. They were a significant component of domestic debt, of national savings and GDP, and the Ministry of Finance relied on them to finance its budget deficit.

Table 5.3: Bank interest rates vs. CDNS rates

	Bank deposit rates (%)		Bank lending rates (%)		DSC (%) CDNS Profits		SSC-R (%) CDNS Profits		Mahana amdani accounts (%) CDNS Profits	
Year	Nominal	Real	Nominal	Real	Nominal	Real	Nominal	Real	Nominal	Real
1990	8.2	2.2	10.6	4.6	15.6	9.6	-	-	14.9	8.9
1991	6.0	-6.7	10.8	-1.9	15.6	2.9	-	-	14.9	2.2
1992	6.4	-4.2	13.2	2.6	15.6	5.0	13.6	3.0	14.9	4.3
1993	4.1	-3.7	13.3	3.5	15.6	5.8	13.6	3.8	14.9	5.1
1994	6.2	-5.1	13.7	2.4	16.0	4.7	13.7	2.4	14.9	3.6
1995	6.3	-6.8	13.7	0.7	16.0	3.0	14.9	1.9	14.9	1.9
1996	6.4	-4.4	14.4	3.6	16.0	5.2	15.8	5.0	14.9	4.1
1997	6.8	-5.0	14.6	2.8	18.0	6.2	16.9	5.1	14.9	3.1
1998	6.8	-1.0	15.6	7.8	18.0	10.2	16.9	9.1	14.9	7.1
1999	6.5	0.8	14.8	9.1	16.0	10.3	14.7	9.0	14.9	9.2
2000	5.5	1.9	14.5	10.9	15.0	11.4	12.6	9.0	14.9	11.3

Source: *Pakistan: Financial Sector Assessment 1999-2000* Chapter 4

It is tempting to examine, from a competition perspective, the pros and cons of a high-profit yielding, government-sponsored instrument that puts commercial banking into a competitive bind and evokes consistent protest from the central bank. However, since investment activity is

[65] *Pakistan: Financial Sector Assessment 1990 – 2000,* Chapter 4, pp.63 -64

outside the scope of this Report[66], further analysis of the competition offered by CDNS to the banking system is precluded.

Table 5.4: NSS (CDNS) share of finances

				As percent of
Year	Domestic Debt	Budget deficit	National savings	GDP
1990	37.5	31.8	14.6	15.4
1991	4.0	3.1	1.9	13.2
1992	5.3	4.7	2.1	11.5
1993	6.4	5.0	2.9	10.8
1994	34.1	35.1	13.2	11.2
1995	35.1	32.4	12.6	11.2
1996	37.8	30.5	16.8	11.8
1997	43.8	37.6	20.6	12.7
1998	74.0	49.4	25.8	15.4
1999	51.7	72.3	39.9	18.5
2000	48.6	44.8	21.9	19.9

Source: *Pakistan: Financial Sector Assessment 1999-2000* Chapter 4

Overall, the view of the State Bank towards DFIs and CDNS was not favourable. Its view of prevailing competition at the end of the decade (1990s) and of the splintered industry was summed up in the *Financial Sector Assessment 1990-2000* (p. 133). As before, and 10 years later (discussed later in this Report), its answer (and the solution to the problem) was the same---consolidation through mergers:

> "Consolidation of smaller institutions into bigger units is also required to enhance efficiency and promote competition. Implementation of these reforms would result in self-sustained and commercially viable financial institutions."[67]

II. THE DECADE OF MERGERS, 2000s

In 2000, there were 6 government-owned banks, 14 domestic private banks, 19 foreign banks and 4 specialized banks (DFIs), making a total of 43[68]. Even though the number of banks had risen, the new entrants had not succeeded in competing headlong with the top five, in spite of the market shares of the government banks having fallen (as shown earlier). Some of the reasons for this have also been suggested.

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[66] It was also outside the purview of Cruickshank's Review (2000) and of other country studies cited in this Report.

[67] *Pakistan: Financial Sector Assessment 1990 – 2000,* Chapter 7, p. 133

[68] As noted in the previous section, this number had risen suddenly from 31 in 1990 to 41 in 1992, and then to 45 by 1995. The moratorium of 1995 had frozen this number.

This Section looks at the further evolution of the industry structure, taking note in particular of the spate of mergers and acquisition that have taken place in this decade.

Consolidation

Predatory acquisitions have not been the preferred route to gaining monopoly power, as was noted by the *State of Competition 2008* Report (see pp. 29 – 31). Most of the mergers that have taken place in Pakistan have either been attempts by SMEs to unite in order to obtain synergy or market efficiency or they have been diversifications across industries. In both cases they have been unexceptionable and the Competition Commission has allowed them. The same situation has prevailed in the banking industry, with two important differences. Firstly, neither the Competition Commission, nor the Monopoly Control Authority that preceded it, has exercised any jurisdiction over mergers in the banking sector[69]. Secondly, there have been a vast number of bank mergers, but a vast majority of them have been driven by regulatory requirements and circumstances, and less by volition.

The State Bank acknowledges that it is actively engaged in the business of promoting consolidation, through mergers and acquisitions (M&E). Indeed it emphasizes that its pursuit of this policy is a national imperative in the interest of stability. This doctrinaire view that the State Bank has maintained ever since its inception – as recounted in these two chapters (Chapters 4 & 5) of this Report – and which it continues to pursue with vigour, has relegated the requirement of competition to a tertiary (or even more subordinate) position. One may question the theory behind this view --- and the theory has indeed been questioned world-wide --- but that will not alter the fact that this doctrine of State necessity for M&A has been applied to the banking industry, and will continue to be applied in the foreseeable future. The approach of this Report is positivist, and not normative. It will therefore not enter into a theoretical rebuttal or cite empirical evidence that might controvert the basis of the rationale that "big" is more efficient and less likely to fail. What cannot be denied, in any case, is that the doctrine espoused by the State Bank of Pakistan is completely in line with a universally- held view in banking jurisdictions. The trend towards consolidation is not only universal, but it has also accelerated globally during this decade.

The State Bank has promoted these mergers through several instruments, ranging from the twelve- fold increase in MCR (from the start of the decade to its end) to amendments in the Banking Companies Ordinance (1962) to help M&A. Tax incentives and institutional facilitations have been part of the enabling process.

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[69] The Competition Commission welcomed the State Bank's policy of promoting M&A in the banking sector by further raising (September 2008) the MCR. The CCP said that it was also "supportive of the regulatory thrust to achieve stable and sound companies not only in the financial sector but all the sectors of the economy." (see Bangash, MM, "Mergers & acquisitions: a competition perspective", in The Business Recorder, Karachi, December 06, 2008).

There have been about 60 mergers in Pakistan in the banking industry during this decade. The State Bank has not only published details of these, but also explained the reasons for them[70]. These reasons, or the compelling circumstances leading to the merger or acquisition, are varied, and the State Bank distinguishes between them. By far the most important reason and the exclusive reason in at least a third of the cases, is the inability of the banks in question to meet the Minimum Capital Requirement that was raised progressively from Rs 500 million in 2000 to Rs 6 billion by December 2009.

Meeting the MCR may also have been a contributory factor in mergers that the State Bank classified as "safe exits"[71] to banks that would otherwise have failed. There were of course genuine synergy considerations in certain cases: for instance, Faysal Investment and Faysal Bank merger (2002), Trust Investment, Fidelity Investment and Doha Bank (2004), Atlas Investment with Atlas Bank (2006). Many mergers were based on the usual premise of obtaining economies of scale and diversification of risk, the latter being an important rationale for cross-industry acquisitions, rather than intra-industry mergers.

As a result of these mergers, the composition of banking has changed. However, this change is not as radical as one might expect. As Table 5.5 shows, the number of public-sector banks decreased by 2, that of specialized banks remained the same, while the increase in domestic banks was at the corresponding expense of foreign banks (more about this later), and the overall number reduced only from 43 to 41

Table 5.5: Number of Banks

	Public Sector	Domestic private	Foreign banks	Specialized banks	Total
2000	6	14	19	4	43
2001	6	14	19	4	43
2002	5	16	16	3	40
2003	5	18	14	3	40
2004	4	20	11	3	38
2005	4	20	11	4	39
2006	4	24	7	4	39
2007	4	26	7	4	41
2008	4	26	7	4	41

Source: State Bank of Pakistan

[70] For a year-wise listing, see *Financial Stability Review*, 2006, State Bank of Pakistan, p. 37

[71] Notable so-called "safe-exits" were provided to the NFDC, when it was acquired by the National Bank in 2001, to Prudential Commercial Bank when it was acquired in 2001 by Saudi Pak, and to Meezan Bank upon its acquisition in 2002 by Societe Generale. Crescent Investment and Bolan Bank got safe exits in 2003 and 2004

The significant change, of course, is the complete reversal of the dominance of the public sector. The private sector now holds 65% of the banking assets.

Foreign entry

Foreign entry is supposedly an important element in improving the contestability of the market. The academic literature reviewed in Chapter 1 highlights the importance of foreign banks in explaining levels of competition, in particular the existence (or otherwise) of entry barriers. A number of studies have also looked at the effect of foreign banks on domestic competition. For instance, it has been argued that they provide an impetus to better quality domestic lending and greater efficiency[72]. The Indian studies (Murthy and Deb, 2008 and Prasad and Ghosh, 2005, 2007) have underlined the competitive retaliation (on the part of domestic banks) provoked by foreign bank entry. The same view has been subscribed to in Pakistan.

There are two problems in subscribing to this view of beneficial effects of foreign entry. Quite apart from the counter arguments pertaining to their baneful effects, as pointed out by Mian (2003, 2006) and others[73], there are basic inconsistencies and contradictions floating on the surface of the data. If foreign banks are as efficient and successful, as they are claimed to be, and if their competitive benefit is indeed so positive, why has their number and market share declined so rapidly? (see Table 5.5 to see what has happened in Pakistan during this decade). The answer might well be found in an even more basic explanation.

The distinction between foreign and domestic banks, which has become central to competition analysis, as practiced by analysts the world over, is possibly a misleading one. In Pakistan at least, this dichotomy has become so blurred as to almost cease to exist. The State Bank's "NEWCO" policy of integrating foreign banks with domestic banks, resulting in a large number of cross-border mergers, has led to the re-classification of several foreign banks as domestic banks. These definitional changes can confound any analysis, making any conclusions drawn on yearly statistics quite tenuous.

M&A effects

Anti-trust concerns are most relevant in mergers between direct competitors, usually from the same industry. The question of undue economic power, resulting from a merger, is the central one posed in any monopoly investigation and competition analysis. The question has not, however, surfaced during the spate of M&A activity in the last 10 years in Pakistan. The explanation for this, which comes most readily to mind, is that the regulatory agency (State Bank) is not concerned with the question. Being outside its reform agenda, and running contrary to its avowed aim to ensure consolidation, the State Bank cannot be expected to consider the question of competition. The Monopoly Control Authority would have been the natural forum

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[72] See, for instance, Detragiache, Tressel and Gupta, 2006; Chopra, 2007, as discussed previously in Chapter 1. Chapter 2 also discussed the case in Pakistan, as looked at by Qayyum and Khan, 2007

[73] This has been discussed in Chapter 1

for such a consideration. Indeed, in other jurisdictions it has been suggested that banking mergers should automatically qualify for phase II hearings (in-depth scrutiny). In Pakistan, however, the Monopoly Control Authority has been wound up. Consequently, economic power or dominance *per se* is no longer a legitimate question for inquiry. MCA's successor, the Competition Commission, will not look into the acquisition of a dominant position unless it is accompanied by an abuse of it. An abuse of power is, however, an empirical issue that has not come to light.

It is highly likely that an abuse of economic power has not occurred at all as a result of the banking mergers. There may be several reasons for this. Possibly one of the most important ones is that there has not been a single merger involving any one of the market leaders. There has been no significant disturbance in the ranking order of the top 5 banks. Most of the mergers have taken place between the smaller enterprises. Hence the State Bank might well be right in assuming that M&A will have no anti-competitive effects.

The State Bank has undoubtedly looked very carefully at the market concentration indices, none of which have picked up any adverse effects of M&A. All the concentration ratios, Herfindahl indices, coefficients of variation, Gini coefficients have been examined. None of them controvert the State Bank's expectations that strong post-merger banks will deliver a diverse portfolio of improved, competitive products, and that competition will increase as a result. Of course, none of these indices can confirm this hope either, because there is simply no causal link (or even a correlation) between market structure and competition, as has been discussed in Chapter 1. The connection between the on-going consolidation operation and the expected increase in competition is neither obvious nor axiomatic. Yet, the evidence so far does not belie the State Bank claim or their future expectation either. In other words, it all depends –let us wait and see.

The State Bank has also analyzed the possible effect of M&A on bank efficiency[74]. This was also one of the topics of inquiry of the PIDE study (Qayyum and Khan, 2007) cited in Chapter 2, in which the researchers had claimed an increase in efficiency, resulting possibly from foreign bank entry. Interestingly enough, the State Bank's own analysis of the comparative cost and profit efficiency (pre-merger compared with post-merger) shows that there have been no efficiency gains. A Review of theirs[75] acknowledges that similar international studies done elsewhere had also failed to find efficiency gains results from M&A[76]. Terming the results "inconclusive" at best, the State Bank's Review (2006) draws comfort from the conjecture that there might be accounting data problems which stand in the way of showing a positive relationship. Nevertheless, the failure, in Pakistan and elsewhere, to show any efficiency gains resulting from M&A is an occasion for a pause to reflect upon the assumptions that are being made to compel banks into consolidation. If the merger activity is meant to help smaller banks become more

[74] In the theoretical literature, reviewed in Chapter 1, efficiency gains cannot necessarily be expected from consolidation. Demirguc-Kunt, Laeven and Levine (2004) have in fact furnished evidence to the contrary—that market concentration decreases efficiency.

[75] See Chapter 2- 'Consolidation of the Financial Sector', of *Financial Stability Review, 2006,* Part I, pp. 40-41

[76] See, for instance "Group of Ten: Report on Consolidation in the Financial sector", BIS, January 2001

efficient and reap economies of scale (as the theory goes) but no such benefit is accruing, is it wise to restrict competition through further consolidations?

Some of the mergers that have taken place have been between commercial banks and development finance institutions, the notable one being the merger of NFDC and National Bank (2001). Another non-bank merger was between ICP and IDBP (2006). None of these mergers were between small commercial banks and none of them was made on grounds of synergy, increase in efficiency, or economies of scale. None of them was voluntary. None of them promoted competition. None of them can be shown to have had any beneficial effect on the market. From the point of view of competition, providing a "safe exit" (the justification given for these mergers) to a failed bank does not promote public welfare and should not be a function of a State or competition regulator.

III. PRODUCT MARKET CHANGE

Diversification across industry boundaries and across product markets is of the essence in competition analysis. All cross-industry mergers and acquisitions pose interesting anti-trust problems, provided they involve substantial-sized acquisitions. But, they can also be a source of product innovation and refresh a stagnant market. That is why special note must be taken of the mergers between commercial banks and the institutions from adjacent sectors. In the past decade, several mergers have taken place between commercial banks on the one hand and investment banks, DFIs and institutions marketing Islamic products[77].

Traditional Industrial Organization analysis is based on the concept of an industry as a collection of firms selling homogenous products. The banking sector has traditionally been considered as one such industry and its boundaries have been assumed to be well known and fixed by regulatory requirements. Banks are banks; other financial institutions do not qualify as banks. There is no definitional problem. Indeed, in the Terms of Reference of this Report, as of all such Reports analyzing competition in other countries (UK, South Africa, Ireland, Brazil, India) the banking sector is defined precisely and narrowly to include financial intermediation, but exclude non-commercial development finance (industrial project financing, rural credit supply through cooperative banks etc.) as well as investment banking. Yet, in real life, over the long-run, the behaviour of economic agents cannot be confined to remain within the parameters of the industry to which they have been assigned by regulators and data collection agencies. They will cross industry boundaries with insouciance.

This is what has happened in Pakistan in the wake of mergers and acquisitions. Arguably, it is one of the most positive developments, since it cannot but enlarge the market, cannot but lead to greater product substitution, to more free entry and to reduction in product regulation. Thus, this effect of M&A is likely to lead to an intensification of competition, though not for the reasons cited by State Bank analysts and some in the academic community. It is not for supply- side structural reasons, such as changes in concentration ratios or consolidation of banks through

[77] For a listing see p.37 of Chapter 2 of *Financial Stability Review 2006. Op cit*

M&A, that competition might increase, but it is for changes in product-markets (demand-side re-definition of markets) that one might expect a more healthy and competitive outlook. The next chapter turns therefore to an analysis of product markets.