CHAPTER 6

ANALYSIS OF PRODUCT-MARKETS: BANK DEPOSITS

"Questions relating to competition, monopoly and oligopoly must be considered in terms of markets, whilst questions concerning labour, profits, technical progress, localization and so forth have to be considered in terms of industries."
Robinson, Joan, "The Industry and the Market", Economic Journal, 66, 1956, pp. 360-361

Despite the on-going consolidation in the banking sector, the efficiency that the State Bank had hoped for has remained elusive. The primary reason for it is the high cost of financial intermediation, reflected in the high banking spread. The State Bank's own

> "analysis indicates that factors such as the structure of bank deposits (with 25 percent of total deposits in non-remunerative accounts) and the liquidity preference of depositors have a significant bearing on the level of banking spreads. Concerted efforts by banks to increase the proportion of fixed deposits are likely to narrow these spreads. The process of a gradual shift towards fixed deposits has already started, in particular due to the incentive given by the central bank to zero rate fixed deposits in its reserve requirements."[78]

This chapter analyzes the changing structure of bank deposits during the past decade. It does not seek to gauge the performance, efficiency or cost-effectiveness of the banks ---financial analysts and the State Bank routinely provide these assessments. The objective of the present analysis is different. It is meant to identify and delineate product-markets in which competition has been (or has not been) taking place.

Competition analysis is a two-fold process. It comprises a supply-side analysis of the "industry", including a structural analysis and an examination of entry and exit conditions ('contestability') as well as a demand-side analysis of product-markets and geographic markets. In the previous chapters, we have conducted a supply side analysis. We commence now with the demand side analysis of markets.[79]

Table 6.1: Deposit profile (all banks) Amount in Rs. million

Year	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
# of Accounts	29,772,355	29,710,720	28,409,347	28,043,813	28,606,883	28,524,844	27,383,337	26,405,832	26,595,585	24,354,737	25,091,369
Amount	1,070,305.2	1,091,611.2	1,189,014.2	1,309,265.0	1,500,471.0	1,842,144.2	2,201,811.1	2,613,465.7	2,926,645.5	3,534,497.0	3,791,489.9

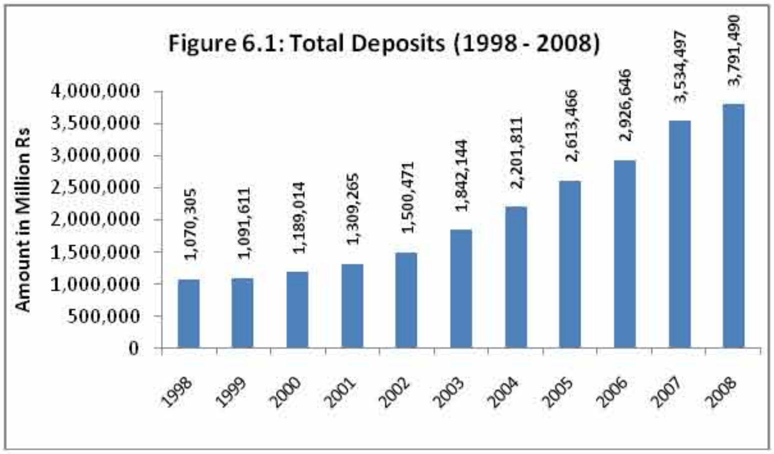
Source: State Bank of Pakistan

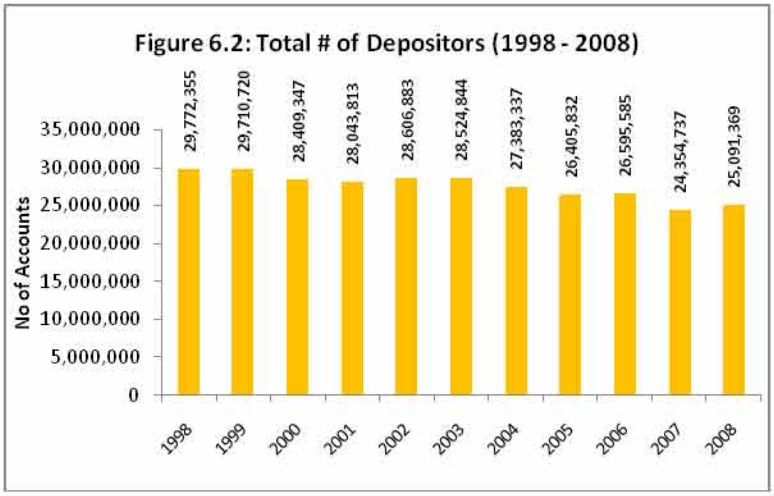
[78] *Financial Stability Review 2006,* State Bank of Pakistan, pp. 10-11

[79] Implicit in this analysis is the sharp distinction between the concept of the market and that of the industry that has been underscored by Joan Robinson (and others) but one which often gets blurred in economic analyses of competition.

I. EXPANSION OF DEPOSITS

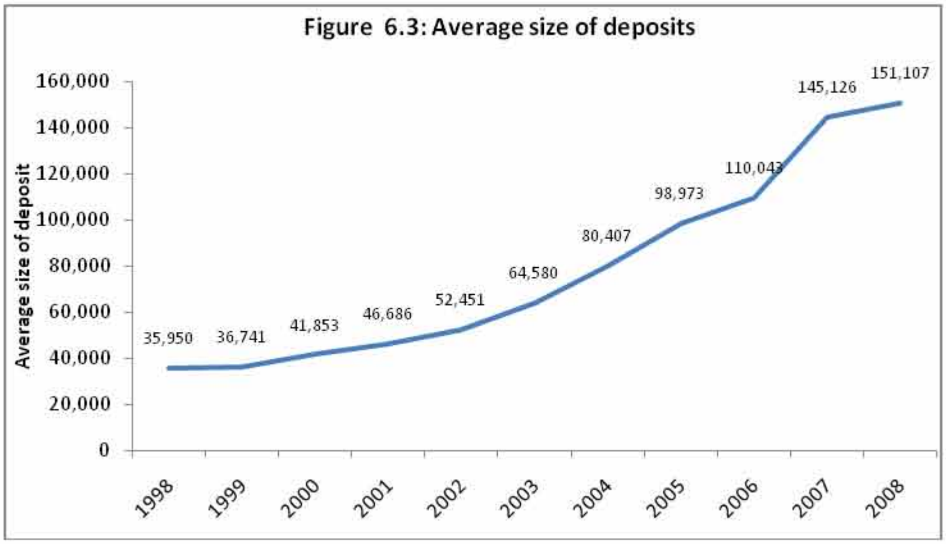
The aggregate deposits' market has expanded nearly four-fold in the last ten years, although the number of depositors has decreased from 29.77 million to 25 million in the same period. This becomes starkly apparent from Table 6.1. However, in real terms the expansion in deposits is of a somewhat smaller magnitude[80], but it is still no less than double of what it was 10 years back. For a visual representation of these trends, see Figures 6.1 and 6.2.



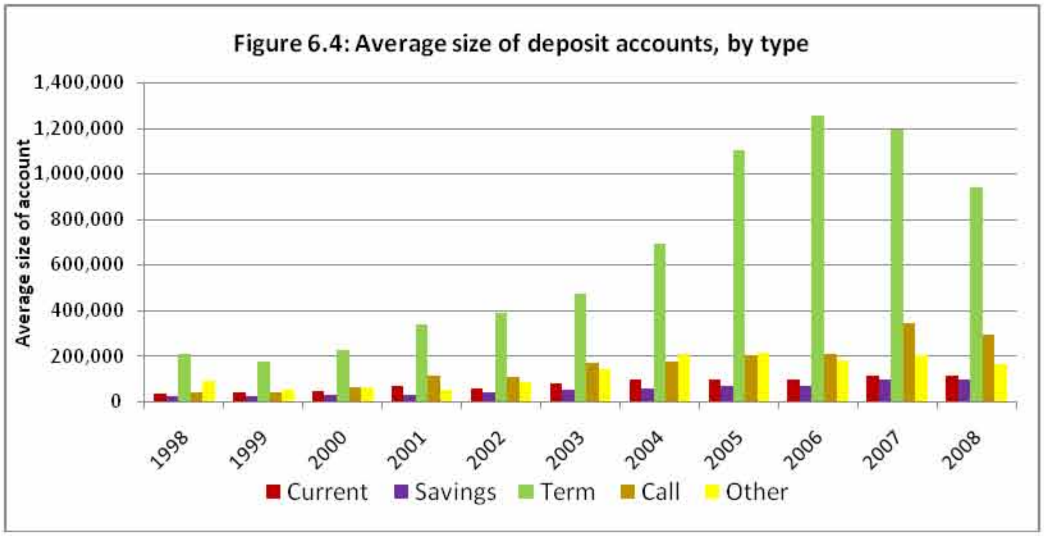


The decrease in the number of depositors, with a simultaneous increase (from Rs. 1 trillion to Rs. 3.79 trillion) in the deposit amount is indicative of an increase in the average size of bank deposits. In 1998 the average deposit- size was Rs 35,950. In 2008 it became Rs. 151,107. Figure 6.3 seems to show that this was a fairly smooth and moderately progressive increase.

[80] Deposits increased from Rs. 1 trillion in 1998 to Rs. 3.79 trillion in 2008 in *nominal* terms. Various inflationary indices based on 2000 price levels (CPI, SPI, WPI) have been compiled by the Federal Bureau of Statistics. None of them is designed specifically for the banking sector, and each one of them has its weaknesses. Yet, they provide good approximations and have the virtue of using 2000 as the base price level. A rough and ready guide, on the basis of these indices, suggests that, in terms of 2000 prices, the total deposits in 2008 were (in *real* terms) Rs. 2 trillion.

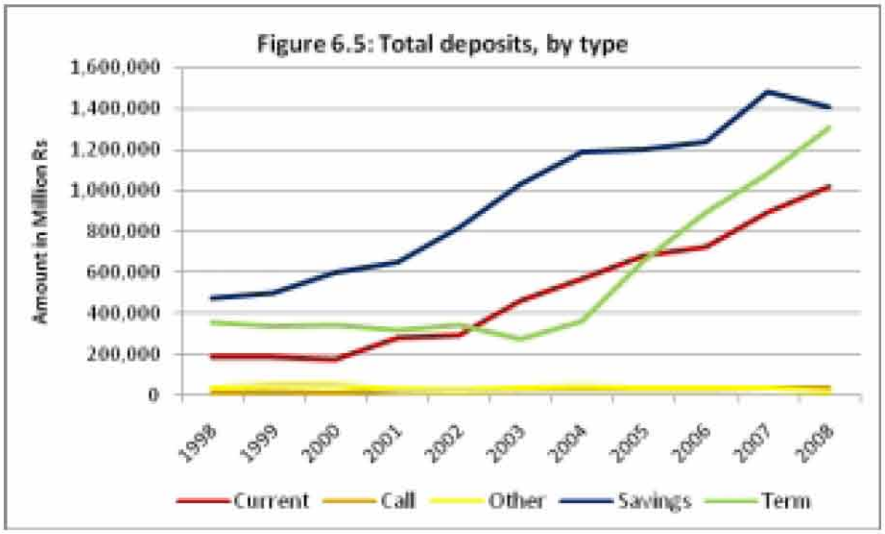


Actually, this increase in size of deposits was not uniform across different types of deposits. The aggregate figures hide substantial differences between types of deposits. A careful analysis shows that the rise in deposits was largely on account of a substantial increase in the average size of <u>term</u> deposits, as shown in <u>Figure 6.4.</u>

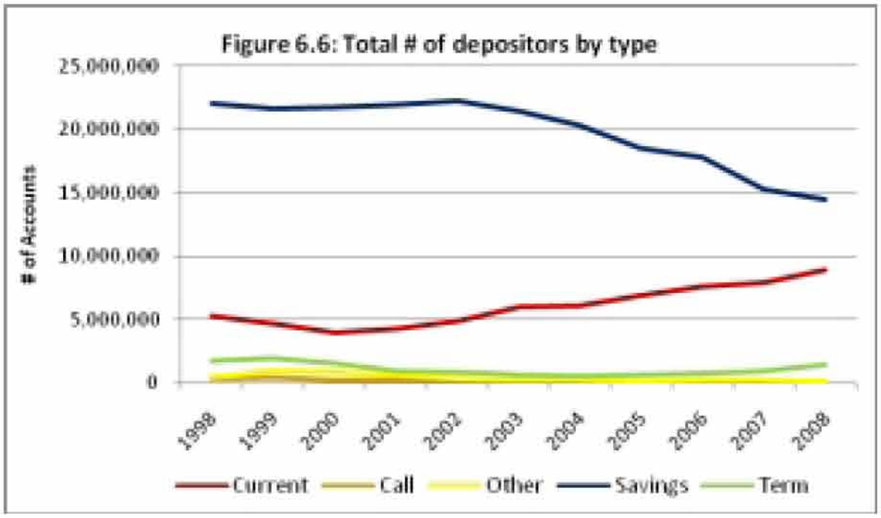


The highest contribution to deposits was, however, not that of term deposits but of savings accounts, as is obvious from <u>Figure 6.5</u>. The amount of savings deposits increased from Rs. 474 billion to Rs. 1.4 trillion, and that of term deposits from Rs. 357 billion to Rs. 1.3 trillion[81].

[81] This seems to be the basis of the shift towards fixed deposits, reported by the State Bank and cited at the beginning of this chapter.



However, it is also true that the number of savings accounts fell from 22 million in 1998 to 14.5 million in 2008, and the number of term deposit accounts also decreased from 1.7 million (1998) to 1.4 million (2008). See Figure 6.6



On the other hand, the number of current accounts increased from 5.29 million in 1998 to 8.9 million in 2008. The amount held as current deposits also increased from Rs.188 billion in 1998 to Rs. 1 trillion in 2008. This remarkable rise in current accounts seems to belie the claim of the State Bank regarding a shift towards fixed deposits. Current account deposits were the only deposits that witnessed an increase (and a significant one at that) both in terms of number of account holders and the amounts deposited (see Figures 6.5 and 6.6). This is a reflection of the growing liquidity preference in the economy.

II. THREE TYPES OF ACCOUNTS

Table 6.2 presents a time series (from 1998 to 2008) of the three types of accounts: current, savings and term deposits. Together they comprise more than 98% of the entire banking deposits.[82] They also constitute distinct markets with products ranging from a zero-rated 'withdrawal-on-demand' market of current accounts (at one end) to an 8.75% interest rate[83] on term deposits (at the other end), with Profit-&-Loss Sharing (PLS), other savings and call deposits with variable interest rates in between.

Table 6.2: Deposits by 3 major types amount in Rs million

Year	Current #	Current Amount	Savings #	Savings Amount	Term #	Term Amount
1998	5,293,143	188,845.4	22,021,172	473,519.1	1,707,675	357,404.5
1999	4,749,918	186,456.1	21,591,295	500,853.6	1,949,979	338,149.9
2000	4,027,794	174,693.0	21,763,283	601,488.8	1,536,200	345,797.1
2001	4,290,568	282,213.5	21897,851	647,393.8	956,344	321,945.8
2002	4,941,154	290,309.9	22,242,554	817,220.9	880,663	342,083.0
2003	6,076,487	462,392.0	21,415,945	1,035,895.6	587,196	275,918.9
2004	6,138,924	570,592.6	20,327,237	1,190,802.6	527,099	365,105.0
2005	6,960,155	681,323.0	18,517,167	1,203,183.7	598,767	659,906.4
2006	7,689,055	722,052.7	17,844,700	1,240,838.6	716,206	897,510.2
2007	7,903,659	893,189.8	15,262,657	1,485,578.3	907,162	1,083,172.6
2008	8,943,013	1,018,241.4	14,507,663	1,408,136.4	1,396,108	1,308,226.2

This segregation of markets is in accordance with published data and takes into account the very wide range of reported statistics[84] on rates of return (interest rates) offered on different types of deposits (of different sizes) obtained from different categories of depositors.

[82] For instance, out of the total deposits of Rs 3812.1609 billion on 30-06-08, current deposits were Rs 965.4311 billion (25.3%), savings deposits were Rs 1572.6622 billion (41.25%), term deposits were Rs 1211.5193billion (31.78%), collectively contributing 98.4% of all bank deposits. Call deposits were only Rs 32.9912 billion (0.865%) and others were Rs 29.5569 billion (0.775%).

[83] 8.75% (and above) interest rate are given on term deposits for five years (and above).

[84] The State Bank's Statistics on Scheduled Banks in Pakistan report biannually on deposits categorized according to five types (current, call, other, saving and 'fixed'-- which are further broken down according to the time for which deposits are held, ranging from less than 6 months to more than 5 years) and 36 rates of return ranging from zero to 8.75% and above (see Statistics, June 2008). The same bulletin also reports on the amount of each type of deposit obtained from 7 different categories of depositors. The 7 categories have a vast number of sub-categories. Deposits are also broken in terms of size and classified into 31 intervals.

There is also a more fundamental economic reason for focusing on these products to the exclusion of others. They are imperfect substitutes of one another. In theory, the difference in interest rates, offered for different durations for which deposits are held, would determine their demand, depending upon price-elasticity. However, as Cruickshank maintained in the UK review, current accounts have no substitute. They fulfill a specific need and serve a function that cannot be replicated by other types of accounts[85]. Since they are 'on-demand' deposits, they have a zero rate of return (interest rate). That is why he excluded all 'savings accounts' from his product-market analysis, on the basis of the argument that savings accounts were no substitute for current accounts, on the one hand, but (on the other hand) they were imperfect substitutes for long-term investments (e.g. fixed / term deposits). Since 'investments' and investment banking were outside the scope of his inquiry, neither savings nor fixed (term) deposits were even looked at in the U.K. review. South African and Irish Reports took a similar position.

Adjacent product markets

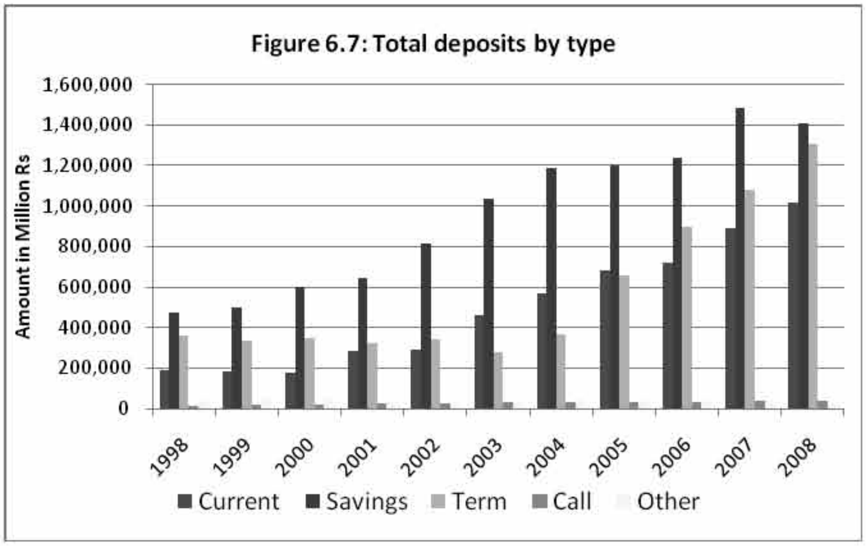
The present analysis does take into account savings and fixed (term) deposits. There are important reasons for this inclusion. First, even though in theory the products may not be substitutes of one another, they lie in adjacent markets along a continuum of interest rates starting from zero. Second, in Pakistan the banks offer a floating interest rate[86] through the Profit & Loss (PLS) account that straddles all types of deposits (excluding the zero- rated current account). This makes it difficult to separate out products on the basis of price (interest) elasticity. Third, there has been a parallel growth in all three markets. Figure 6.7 appears to confirm this. It shows the increase in the quantum of different deposits.

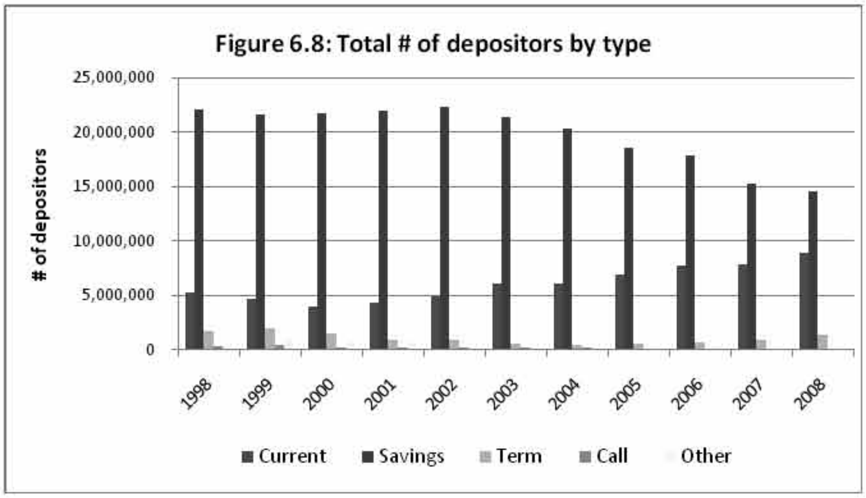
By covering all three markets we are able to observe strategic differences. For instance, the simultaneous decline in the number of savings and term accounts might suggest that some (or all) banks may be following a strategy of going after richer customers only and pursuing only large sized deposits(see Figure 6.8). This has implications for competition.

Secondly, the three markets may be behaving very differently. If so, it would provide further confirmation of the fact that these three are in fact distinct markets, warranting independent consideration that must not be subsumed in aggregate data analysis. Whether or not there are behavioural, (or trend) differences is, of course, an empirical question.

[85] Similarly call deposits perform a specific economic function and therefore form a distinct product (without substitutes), albeit with a limited demand.

[86] It is "floating" because the PLS rate that is notified in advance is only a tentative one can be revised by the bank.





Thirdly, there may be significant differences in the approach of various banks towards each of the product markets. For instances, the three different kinds of banks, on which we have statistical data (namely, Pakistani commercial banks, specialized banks and foreign banks), might well have different clientele in each product market. This would require further segmentation of product markets.

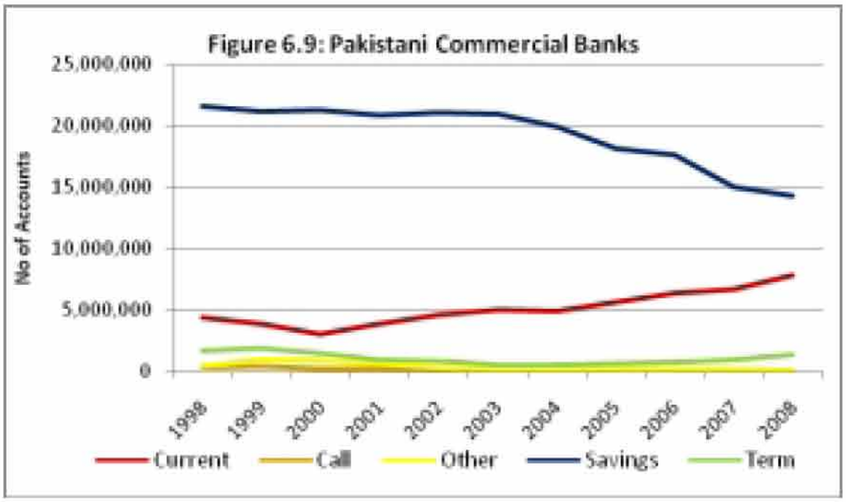
These three questions pose competition issues: what is the relevant market and how is it segmented and to what effect? We begin by differentiating between the three kinds of banks: Pakistani commercial banks, specialized banks (including DFIs) and foreign banks.[87]*. They form*

[87] The State Bank was asked by the author (and the Bank promptly obliged) to break up all aggregate data and provide all the statistics separately for Pakistani commercial banks, specialized banks and foreign banks. The results shown here are based on these disaggregated calculations.

three distinct strategic groups within the banking industry.[88] *Their performance has also been very different.*

Dominance of domestic banks

The historic dominance of Pakistani domestic banks was noted in previous chapters. Here we look at how they have stood out in the last 10 years.



[88] These three "strategic groups" as isolated in the present study would serve as an apt illustration of the concept, and of the existence of sub-industry mobility barriers. An informed case study on Pakistan, for which we now have all the relevant data, would provide even more interesting insights than those provided by the Polish, Austrian and European studies reviewed in the literature (see Chapter 3). However, since our present concern is only a demand-side product market analysis, we refrain from the supply-side analysis implicit in strategic groups. None the less, a case study on the lines of looking at intra-industry mobility barriers and isolating strategic differences (distance) between banks in Pakistan, is certainly recommended.

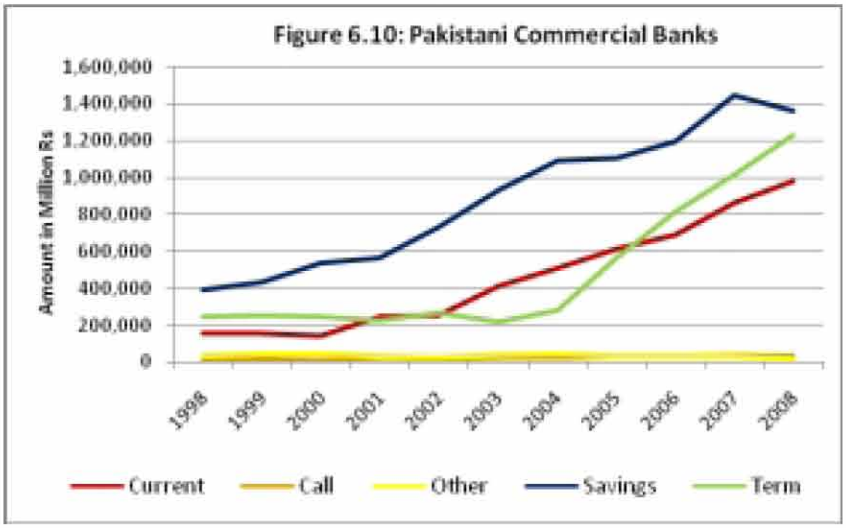


Figure 6.9 shows the trend of the number of deposits of savings, term deposit and current accounts of Pakistani commercial banks, while Figure 6.10 shows the trend for the amounts involved in each type of account. These trends are almost identical to the trends for all banks shown in Figure 6.6 and Figure 6.5. In fact they appear to replicate them. The obvious explanation for this is that Pakistani domestic banks, having a lion's share of all markets, have so completely dominated them that neither foreign banks nor specialized banks have made any dent in their deposit bases. This is certainly true in aggregate terms, and suggests that domestic commercial banking as a whole has not had to face significant competition from outside; otherwise the distribution pattern would have experienced some change. However, in order to confirm that we must look first at other groups of banks. We begin with the specialized banks.

III. SPECIALIZED BANKS

There are four specialized banks still operating in Pakistan: Zarai Taraqiati Bank Ltd (Agriculture Development bank), Industrial Development Bank, Punjab Provincial Cooperative Bank, and SME Bank[89].

Zarai Taraqiati Bank Ltd (ZTBL) is the largest of the specialized banks, having 345 nation-wide branches, followed by Punjab Provincial Cooperative Bank (PPCB) with 159 branches. IDBP has 20 and SME Bank 15 branches. A profile of these banks, as on 31.12.2007, is shown in Table 6.3[90].

[89] SME Bank came into being in 2001 as an amalgam of the small Business Finance Corporation and the Regional Development Finance Corporation, originally a subsidiary of NDFC that was itself merged into the National Bank of Pakistan in 2001.

[90] IDBP had the highest amount of deposits. Yet it was the worst performer with no capital and no profits. With a negative capital adequacy ratio and 95% of its loan portfolio comprising non-performing loans, it clearly awaits its extinction. The other three can survive as instruments of government's credit policy for agriculture, rural development and SME promotion. Their role as competitors to commercial banks is non-existent.

Table 6.3: Indicators of specialized banks

Rs. million

	ZTBL	IDBP	PPCB	SME
Deposits	4,323	6,111	2,008	1,880
Advances/loans	61,313	1,200	8,010	2,118
Assets	93,386	9,425	17,657	6,584
Capital	14,955	(-) 28,120	3,424	2,809
Profit before tax	1,784	(-) 396	130	152
Profit after tax	1,033	(-) 398	130	110
CAR (%)	24.5	(-) 1688.9	12.5	100.9
NPLs to loans (%)	23.7	95.2	34.4	73.5
ROA (after tax) (%)	1.2	(-) 9.1	1.6	1.4

Source: State Bank of Pakistan

Specialized banks have had a long history of providing concessionary credit to industry and agriculture. They have served as instruments of State policy before, during and after nationalization of commercial banks, and have promoted and channelized public and private investment and capital formation, through project finance. They may not be intrinsically profitable. Nor can they compete for profitability with commercial banks. Not surprisingly, therefore, mobilization of deposits, as a source of income, is not likely to figure prominently on their agenda. Even so, they have had deposits of all 5 types (current, call, savings, term and others).

Three types of specialized bank accounts

Table 6.4 provides an overview of the total deposits of specialized banks from 1998 to 2008. Table 6.5 distinguishes between the three types of bank accounts of the specialized banks for the same time period. The three types of accounts (current, savings and term) constitute 98% - 99% of deposits of specialized banks.[91] We therefore define the product market only in terms of these three types, excluding call and other deposits.

Table 6.4: Deposits of specialized banks

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
# of Accounts	941,420	1,013,593	1,072,095	1,106,245	1,122,661	1,152,413	1,202,215	1,291,627	1,287,371	1,297,347	1,283,378
Amount (Rs million)	11,474.8	14,507.5	18,674.1	16,309.8	17,191.4	17,189.2	16,630.9	13,749.4	13,522.5	13,366.6	13,218.3

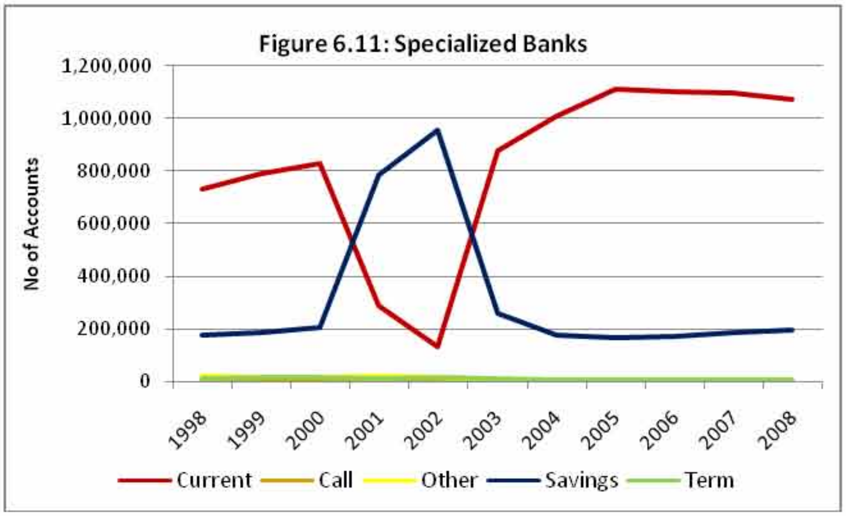
Source: State Bank of Pakistan

[91] In 1998 the three types represented 98% of depositors and 92.3% of the amounts deposited, while a decade later (2008) the three types of depositors represented 99.5% of the number of accounts and 99% of the deposit amounts.

Table 6.5: Specialized bank deposits – by types of accounts

Year	Current		Savings		Term	
	#	Rs. million	#	Rs. million	#	Rs. million
1998	732,401	2,384.1	175,894	1,176.3	11,509	7,031.1
1999	788,970	5,254.0	189,353	1,290.5	16,286	7,124.4
2000	828,292	4,546.9	206,468	2,034.2	18,727	11,038.6
2001	288,648	3,066.3	784,956	2,969.0	13,397	10,027.6
2002	133,713	1,416.4	954,214	5,511.8	15,857	9,416.4
2003	877,109	2,270.4	260,440	7,706.1	8,659	6,890.5
2004	1,009,113	3,634.0	180,017	5,439.1	6,796	7,286.4
2005	1,110,938	2,851.3	168,105	4,805.3	4,934	5,880.0
2006	1,102,509	3,737.6	174,452	3,979.7	4,648	5,658.0
2007	1,098,687	4,332.2	187,759	3,828.6	4,648	4,954.8
2008	1,072,145	5,296.2	199,437	3,418.5	5,800	4,319.5

It would be seen that the number of depositors in specialized banks has actually increased from 941,420 in 1998 to 1,283,378 (a 3.6% increase). Their proportion among the total country-wide number of depositors has also increased from 3% in 1998 to 5% in 2008, suggesting that the specialized banks are still capable of attracting depositors. However, the amount of their deposits, which were not spectacular to begin with, has increased only 15% in ten years, from Rs 11,475 million (1998) to Rs.13,218 million (2008). In real terms this growth is negative. Nor are specialized bank deposits a significant part of overall banking deposits. In 1998 they constituted 1% of the total deposit amount in commercial banks. In 2008 this proportion came down to the negligible level of 0.3%.



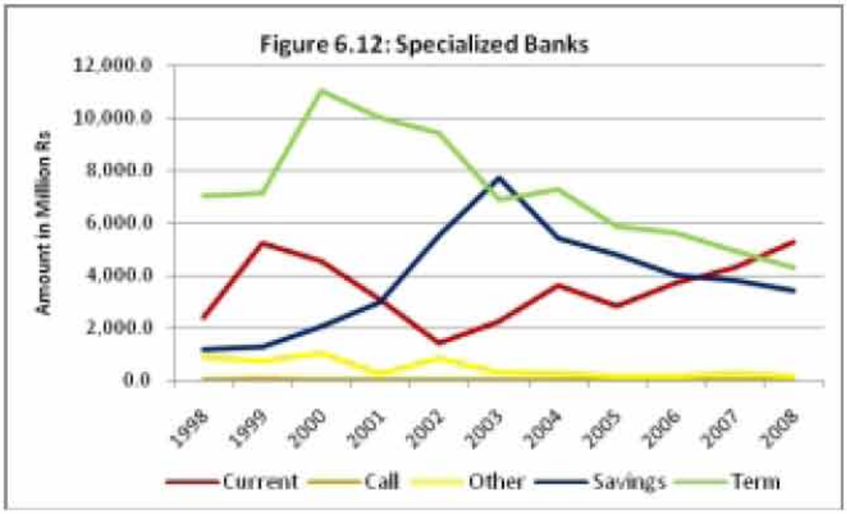


Figure 6.11 shows that the numbers of current and savings depositors of specialized banks have oscillated contrapuntally. The amounts of these deposit accounts have also been cyclical, as can be seen from Figure 6.12.

Figure 6.13 looks at the same depositors from a different angle – that of the category to which they belong. Private sector businesses have the largest number of accounts.

However, Figure 6.14 shows that, in terms of the amount of deposits, personal deposits have been equally important.

Figure 6.13: Specialized bank depositors, by category

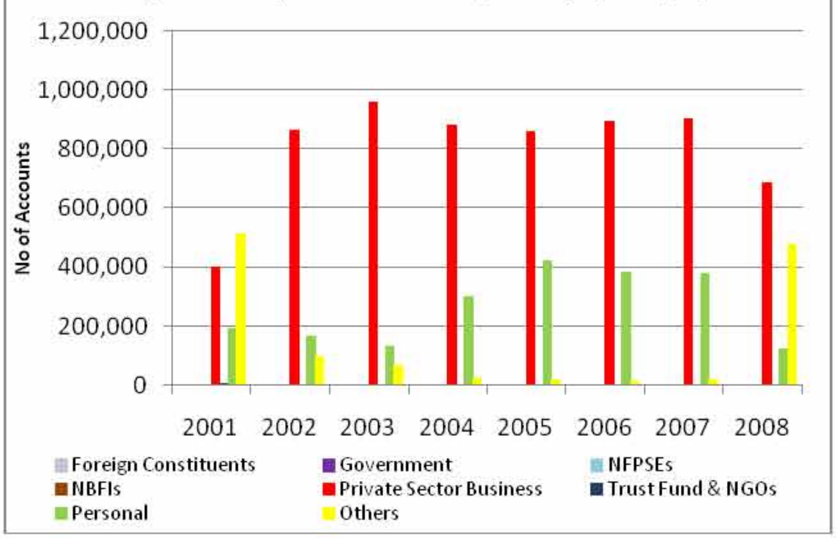
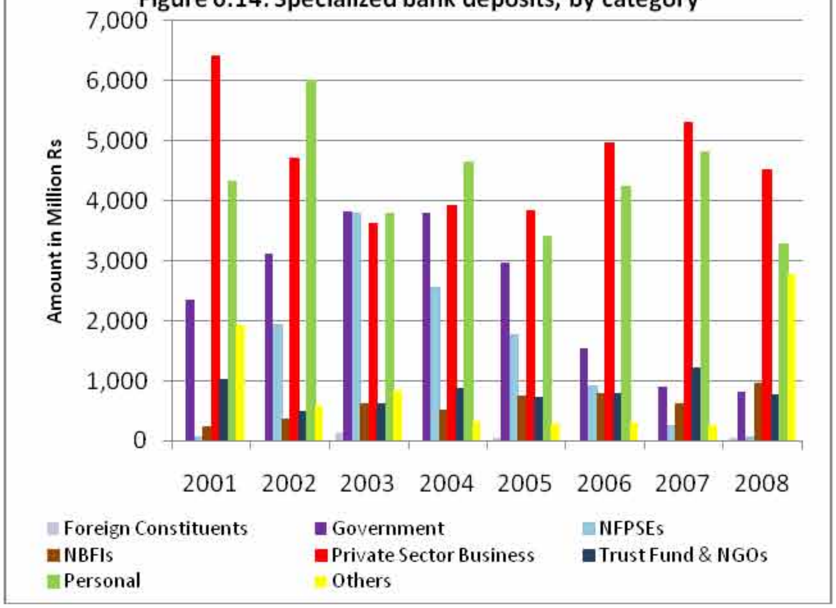


Figure 6.14: Specialized bank deposits, by category



Distribution of accounts

Specialized banks do not provide any significant opportunity to depositors. A very large number of their deposit accounts are of small sizes, and probably continue to be maintained to qualify for credit allocations. Accounts with deposits under Rs 20,000 constitute more than 95% of depositors (their proportion has been as high as 97%)[92]. The next account-size (between Rs. 20,000 and Rs 100,000) constitutes 1% - 3% of the number of depositors. Account sizes above Rs 100,000 represent less than 1% of the number of depositors. Thus, the overwhelming number of deposit accounts in specialized banks has always been of very small amounts. However, in value terms, these deposits are not so significant. In 2001, 97% of deposit accounts (numbering 1,074,662) represented only 13% of the value of deposits (Rs 2,153.6 million out of the total deposits of Rs 16,309.8 million in 2001). In 2008, 1,226,174 depositors (95.5%) held 35% (Rs 4,655.5 million) of the deposits worth Rs 13,218.3 million.

The distribution appears to have become less skewed because of larger sized deposits becoming available to specialized banks from government, non-financial public sector enterprises (NFPSE) and non-banking financial institutions (NBFI). Government deposits increased for 3 years from 2001 until 2004, and then went down. Likewise, NFPSE deposits increased till 2003 and then went down. However, deposits of NBFI consistently increased, from Rs 226 million in 2001 to Rs 961 million in 2008. These institutional deposits were naturally in larger denominations (above Rs 1 million, more often Rs 10 million and above) and helped shore up the specialized banks, but only up to a point.

The two most important categories of deposit accounts, which are also the cause of distress to specialized banks, are private sector businesses and household (personal) accounts. Private sector business accounts in fact increased from 396,829 in (2001) to 901,984 in 2007 but there was a net decrease in their amount of deposits. This anomaly can be explained again by the skewed nature of the account distribution and subsidy losses.

Moribund specialized banks

Specialized banks have been subjected to extreme stress in the 2000s, and are in dire straits. In the past they had served a useful purpose as the concessionary lending arm of the government for project finance and agricultural loans. With subsidized credit having become unfashionable, they appear to have lost their *raison d'être* although there might well be a revival of interest in their operations at some future date. Meanwhile, in competitive terms, these banks have lost their utility and have been allowed to decline. Their deposit base is not strong enough to sustain them. They have an infected portfolio of loans and advances. Some of them have needed a safe exit and others might have to follow.

Specialized banks have also suffered because of their presence in shrinking markets and an inability to diversify out of them. The lower end of the deposit market (especially of accounts under the value of Rs 20,000) has shrunk to the point of near-extinction. Public sector deposits would no longer be available in sufficient quantity to sustain operations. Private sector

[92] In 2001, out of the total 1,106,245 accounts of specialized banks, 1,074,662 (97%) were accounts with deposits less than Rs 20,000, while another 19,361 accounts (1.75%) were those with deposits under Rs 100,000. Only 1.25% of depositors maintained accounts larger than Rs 100,000. Similarly, in 2008, out of the total number of 1,283,378 deposit accounts, 1,226,174(95.5%) were those under Rs 20,000, while another 50,067 (3.9%) were under Rs 100,000. Thus, accounts larger than Rs 100,000 were held by less than one-half per cent of the depositors.

businesses are difficult to entice in an economic downturn. So, apparently, are household accounts. Under these circumstances, the ability of specialized banks to compete in the marketplace is seriously jeopardized. Consequently, we must take them out of the data set for further competition analysis, and turn to the supposed rivals of Pakistani commercial banks --- the foreign banks.

IV. FOREIGN BANK COMPETITION

There were 17 foreign banks operating in Pakistan at the time of nationalization (1 January 1974). They were allowed to continue unhindered and their number remained the same for the next two decades. During 1991-1994 when divesture of the 7 State-owned banks started, and 19 new private banks were allowed to commence operations (two of them did not, despite sanctions to do so), the number of foreign banks increased by two. Consequently, by 2000 there were 19 foreign banks[93], as against 14 private domestic banks and 6 State-owned (plus 4 specialized banks). This number went down to 16 in 2002 when the number of domestic private banks was also 16 and the number of government banks had fallen to 5. Over the next 6 years the number of foreign banks was to progressively decrease to 6, with a corresponding rise in the number of domestic private banks, as indicated in Table 6.6.

Table 6.6: Number of foreign and domestic banks

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008
Foreign (#)	19	19	16	14	11	11	7	6	6
Domestic Private (#)	14	14	16	18	20	20	24	26	25
State-owned (#)	6	6	5	5	4	4	4	4	4

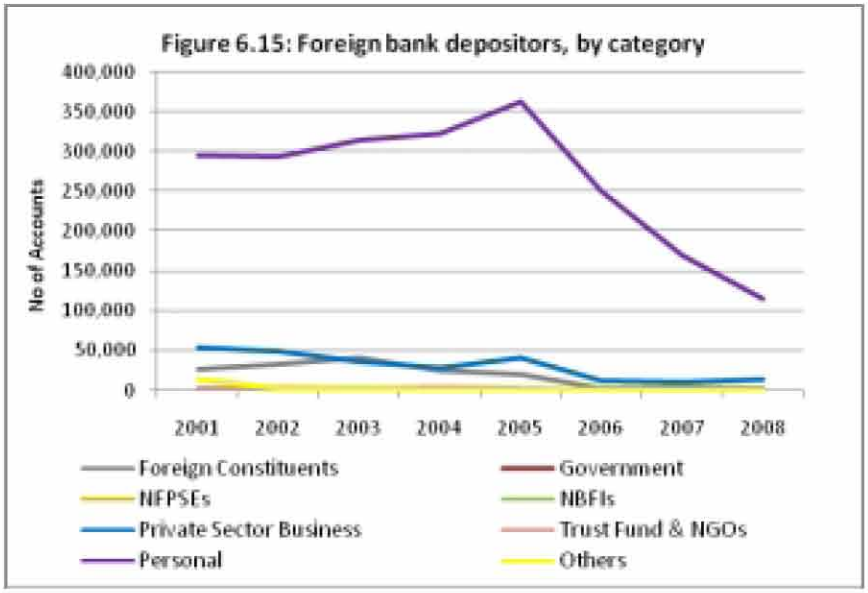
Source: State Bank of Pakistan

The progressive decline in foreign banking in Pakistan during the decade of 2000s runs counter to common perceptions about the increase in visible foreign presence. This perception may be based on the opening up of foreign bank branches, the rise in foreign currency deposits that had been frozen in May 1998, or on fanfare and publicity accorded by the government to foreign investment. Some other statistical data may also have contributed to this common perception. For instance, in the middle of the decade, the banking sector became the highest recipient of direct foreign investment (DFI). It would, therefore, be natural to expect a multiplier effect of this investment. However, the facts are to the contrary.

Not only did the number of foreign banks actually decrease, but whatever new bank entry occurred, was unable to cause any disturbance in the market. The number of foreign bank deposits did rise for a few years, but then dwindled.

This section analyses the data pertaining to different segments of the market, to understand what effect foreign banks might have had upon competition.

[93] The State Bank's *Financial Stability Review 2006* gives this number of 19, but another State Bank publication, *Financial Assessment 2005* lists only 15 foreign banks. This discrepancy cannot be explained.



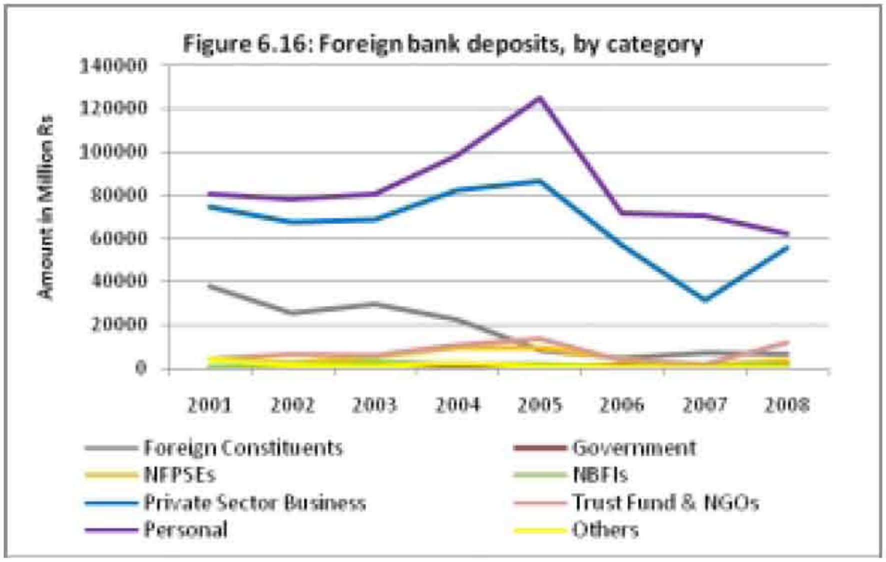


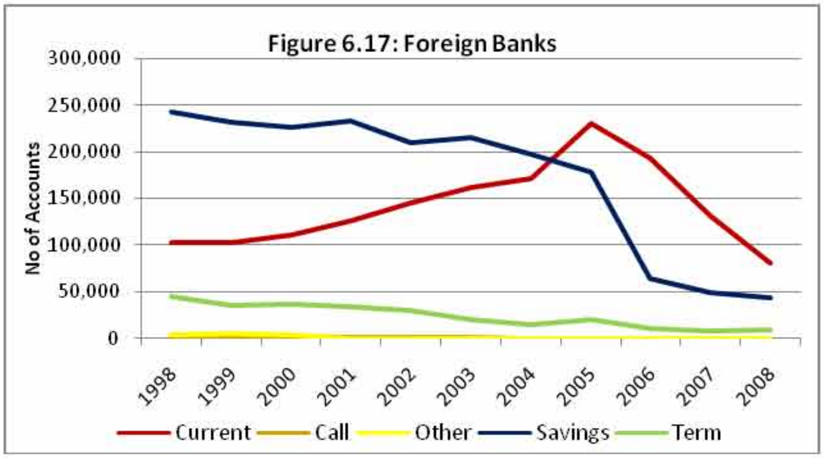
Figure 6.15 shows a decrease in every category of deposit account holders: private sector businesses, personal funds, NFPSEs, NBFIs and government. The downward trend was most sharply noticeable after 2005 in the number as well as amount of personal deposits, which constitute the main category (see Figure 6.16).

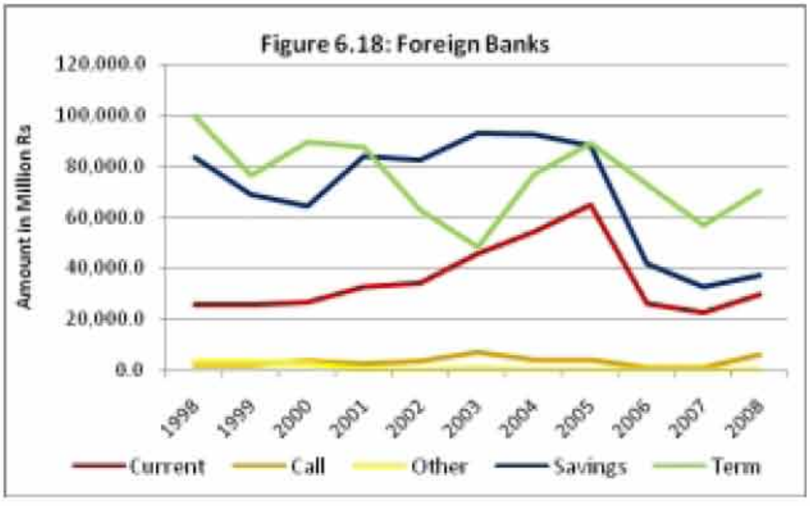
The downward trend in the smaller categories may, however, have been arrested for a while. Government deposits in foreign banks increased[94]. They rose steadily from Rs. 299 million in 2001 to Rs 1,137 million in 2006 and to Rs 2,028 million in 2008. This was accompanied by a

[94] This may have been the result of some policy decision to be even handed between domestic and foreign banks. Otherwise, it is difficult to imagine how foreign banks would, through some competitive process, influence the government's discretion in keeping its deposits with its own banks.

similar increase in the deposits of NFPSEs. They rose from Rs 4,183 million (2001) to Rs 9,235 million (in 2005), but came down subsequently. Likewise, deposits of NBFIs rose from Rs. 474 million (2001) to Rs 1,136 million (2008) albeit with some dips in between. This suggests that foreign banks enjoyed some government policy support that was at variance with the market trend, as displayed by the diminishing deposits by the private sector and households. Alternatively, the foreign banks were offering the public sector some incentive that was being denied to the private sector.

Just as there was a decrease in the main category of accounts, there was a decrease in all types of deposits. Figure 6.17 shows the declining number of current, savings and term accounts after 2005. There was a corresponding decline in the amount of the three types of accounts after 2005, but it may have been arrested in 2007 (as noted earlier). See Figure 6.18.





As shown in Table 6.7, the largest number of accounts in foreign banks was that of savings deposits (243,038 in 1998). This number went down drastically to 44,052 (2008), accompanied by a fall in the amount of deposits from Rs. 83,119 million (1998) to Rs. 37,283 million (2008). The two other type of accounts, current and term deposits, witnessed a similar decrease.

Table 6.7 : Foreign bank deposits, by type

Year	Current		Savings		Term	
	#	Amount (million Rs)	#	Amount (million Rs)	#	Amount (million Rs)
1998	102,645	25,527.1	243,038	83,119.0	44,611	99,656.3
1999	103,089	25,422.8	232,485	68,705.8	35,055	76,441.2
2000	110,886	26,467.7	226,375	64,416.9	36,340	89,846.2
2001	125,893	32,442.3	233,143	83,791.7	34,365	87,735.9
2002	145,181	34,110.1	209,654	82,043.9	29,840	63,217.3
2003	162,081	45,598.3	215,206	92,717.2	21,142	48,398.8
2004	171,791	54,168.5	197,172	92,324.7	15,270	76,903.8
2005	230,610	64,957.6	178,717	87,718.8	20,974	89,267.7
2006	193,236	26,244.4	64,456	41,879.5	11,397	73,053.3
2007	130,997	22,478.1	48,982	32,893.6	8,466	56,802.3
2008	80,752	29,383.3	44,052	37,283.0	9,928	70,474.3

One of the distinguishing features of foreign banks in Pakistan is that they cater to the upper end of the market, and focus on larger sized deposits rather than smaller accounts. Deposits (and depositors) under Rs 20,000 (even those under Rs 100,000) constitute a very small portion of their portfolio. The greater concentration is on accounts exceeding Rs. 100,000, preferably those exceeding Rs. 1 million.

Figure 6.19 shows that the largest number of 'personal' foreign-bank accounts were (until 2004) those with deposits ranging from Rs.100,000 to Rs. to 1 million (the middle range). Subsequently, the number of relatively smaller account-holder (up to Rs. 100,000) also caught up, but not in terms of the amounts involved. Figure 6.20 shows that, insofar as the deposit-amounts were concerned, the class that outstripped the middle range was not the one below it, but the one above it (i.e., ranging from Rs. 1 million to Rs. 10 million).

A similar trend can be noticed in the profile of private sector business accounts maintained by depositors in foreign banks. Again, the number of depositors in the middle range (Rs. 100,000 to Rs 1 million) was the largest, but their number began to decrease until (in 2005) the number of smaller depositors caught up with them. See Figure 6.21.

However, the contribution to the amount of deposits showed an opposite trend. It becomes starkly apparent from Figure 6.22 that, by 2001, the middle range had already been outstripped by the higher ranges. The deposits under Rs 100,00 had become so insignificant that they did not even show up in the profile of private sector business deposits. Instead, a larger contribution came from bigger accounts of up to Rs. 10 million. The biggest contribution came, however, from the very large-sized accounts exceeding Rs. 10 million.

The inescapable conclusion drawn from these data is that the size distribution of foreign bank customers is highly skewed. An extremely small number of depositors who hold large-sized deposits (above Rs 10 million each) provide a disproportionately large number of deposit amounts. This is true of the private sector business accounts as well as the personal accounts. Looking, for instance, at the "personal" category of accounts exceeding Rs 10 million, one finds that, in 2001, 40 account holders had deposits of Rs 1,262 million, implying an average deposit size of Rs 31.55 million.

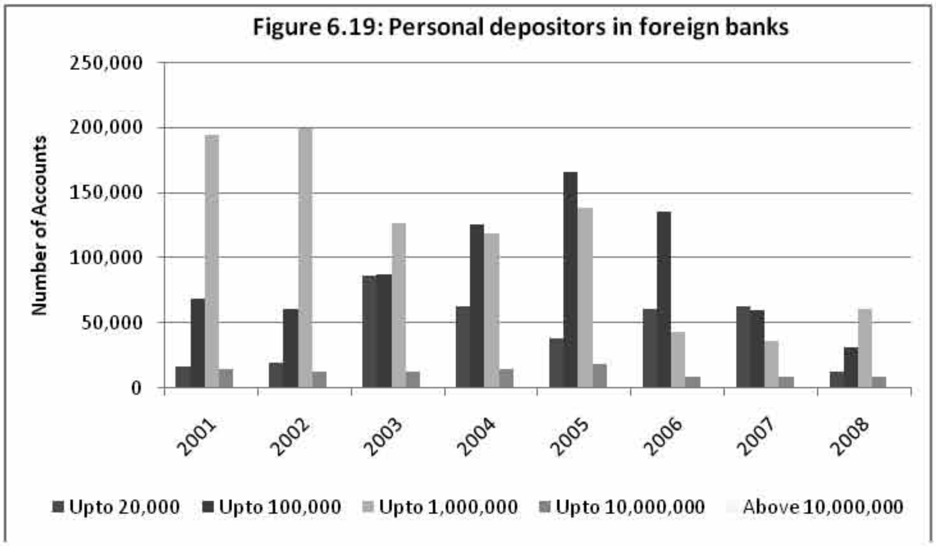


Figure 6.19: Personal depositors in foreign banks
250,000
200,000
150,000
100,000
50,000
0
Number of Accounts
2001
2002
2003
2004
2005
2006
2007
2008
Upto 20,000
Upto 100,000
Upto 1,000,000
Upto 10,000,000
Above 10,000,000

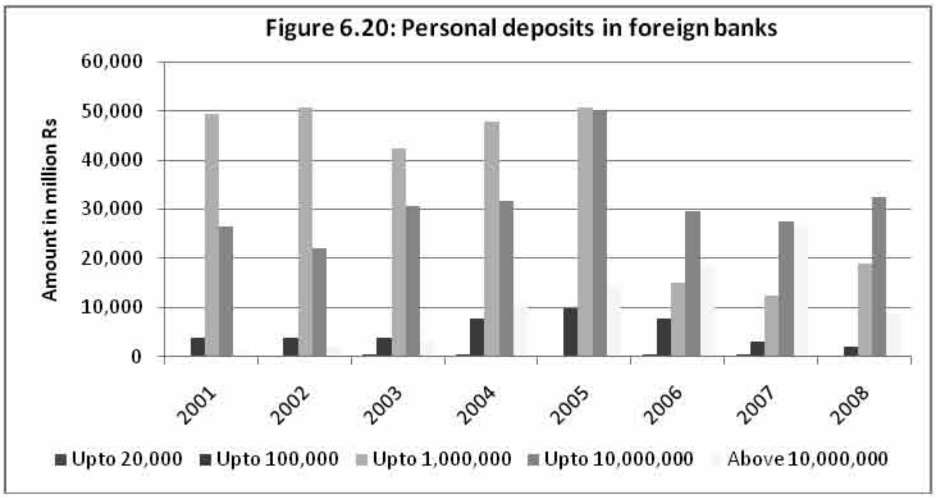


Figure 6.20: Personal deposits in foreign banks
60,000
50,000
40,000
30,000
20,000
10,000
0
Amount in million Rs
2001
2002
2003
2004
2005
2006
2007
2008
Upto 20,000
Upto 100,000
Upto 1,000,000
Upto 10,000,000
Above 10,000,000

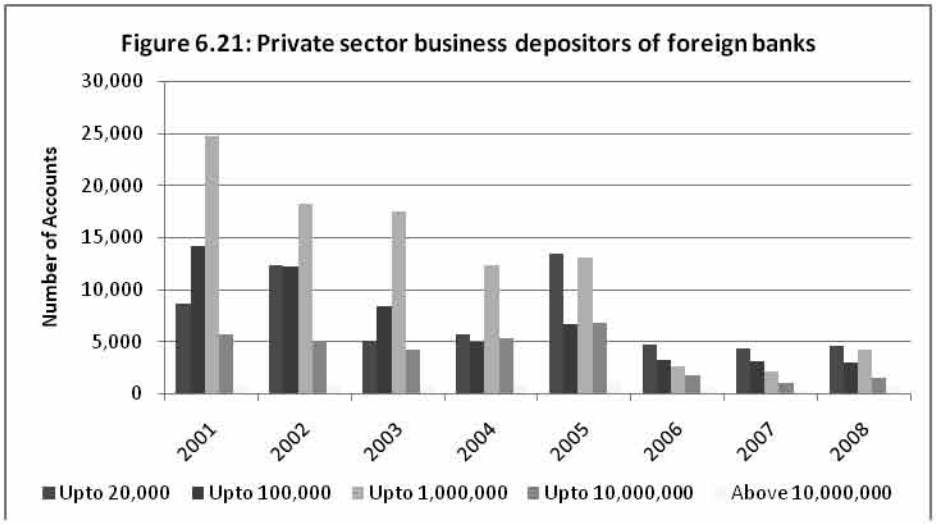
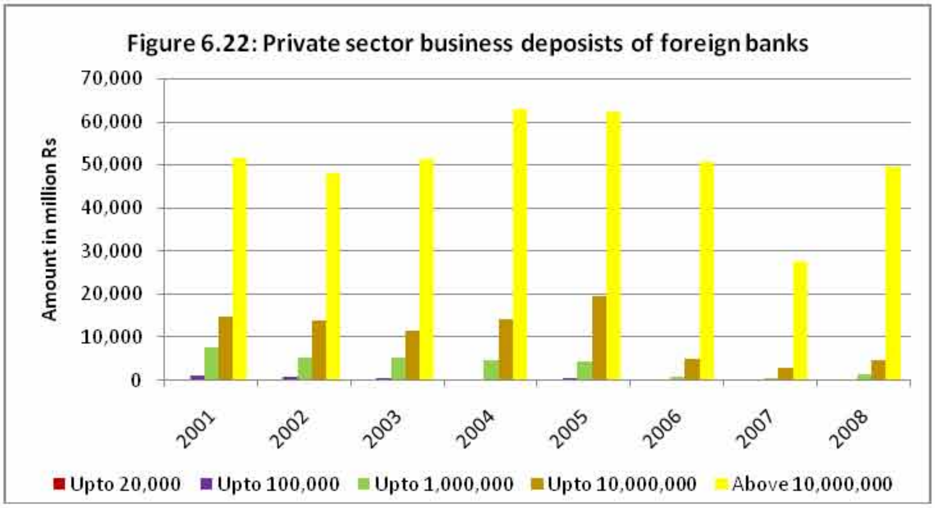


Figure 6.21: Private sector business depositors of foreign banks
30,000
25,000
20,000
15,000
10,000
5,000
0
Number of Accounts
2001
2002
2003
2004
2005
2006
2007
2008
Upto 20,000
Upto 100,000
Upto 1,000,000
Upto 10,000,000
Above 10,000,000



In 2007, this average personal deposit size was Rs. 54.2 million. However, in 2008 this went down to Rs. 20.15 million, with 439 depositors holding deposits of Rs 8,848 million. It is possible that a deceleration has already started in the accumulation (by foreign banks) of disproportionately large-sized personal accounts. The very rich clientele of foreign banks may not necessarily remain a captive market of theirs. Competition from Pakistani commercial banks might well erode this segment too.

Loss of identity

This part of the analysis was preceded by the posing of questions relevant to competition. The first set of questions related to the existence of differences within and across product markets. These differences could not have been explained without disaggregating the data obtained from the State Bank. That is why all available statistics were broken down in terms of type, size and category of accounts for different kinds of banks.

Analysis based on unbundled data now reveals definitive answers to questions whether some kinds of banks (foreign banks in this case) follow a distinctly different approach, segment the market differently, follow a niche strategy or have a unique and captive clientele? Detailed scrutiny shows that foreign banks are different mostly in their pursuit of the upper end of the market of rich depositors and business customers. However, this segment may no longer be secure from competition from domestic banks.

The second set of questions relates to the effect of foreign bank entry on domestic competition. The extensive literature review in Chapter 1 and the case studies in Chapter 2 seemed to suggest that foreign entry had a salutary effect on domestic competition and was therefore a very important indicator of contestability. None of this appears to be the case. Foreign banks in Pakistan have posed no threat to domestic banks.

Foreign banks have in fact declined in number and in their importance, and this decline has been progressive over the last 10 years. Their share in deposits has never exceeded 20% and is currently 3.78%. In terms of number of accounts they represent only one-half of one per cent (see Table 6.8). At best they have represent fringe competition. Even their baneful effects, cited in the literature, have gone unnoticed.

Table 6.8: Percentage of foreign banks' deposits in total banking deposits

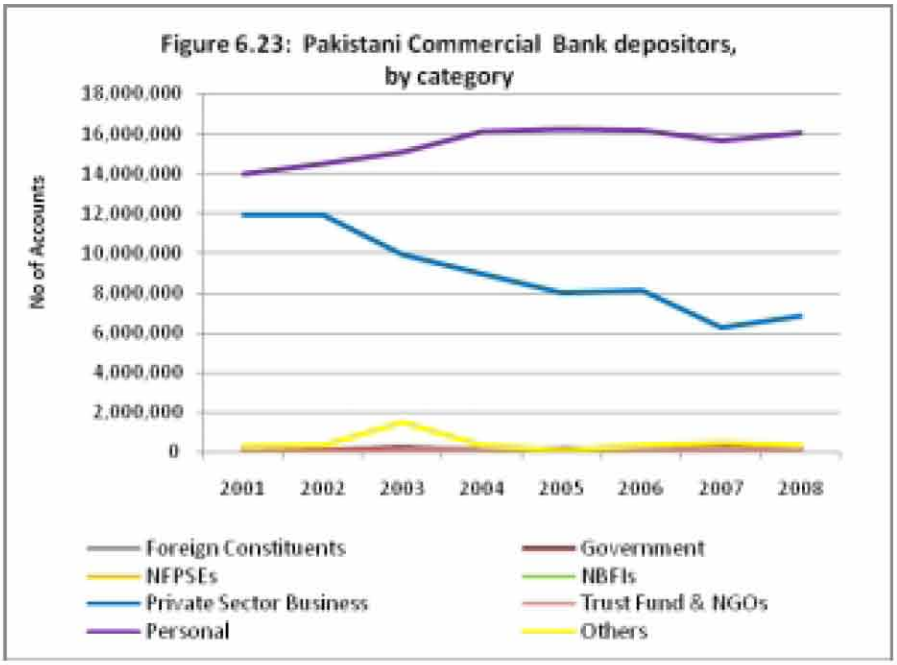
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
# of Accounts	1.33	1.27	1.34	1.41	1.35	1.40	1.41	1.63	1.01	0.77	0.54
Amount (Rs million)	19.94	16.08	15.69	15.82	12.22	10.55	10.33	9.41	4.86	3.20	3.78

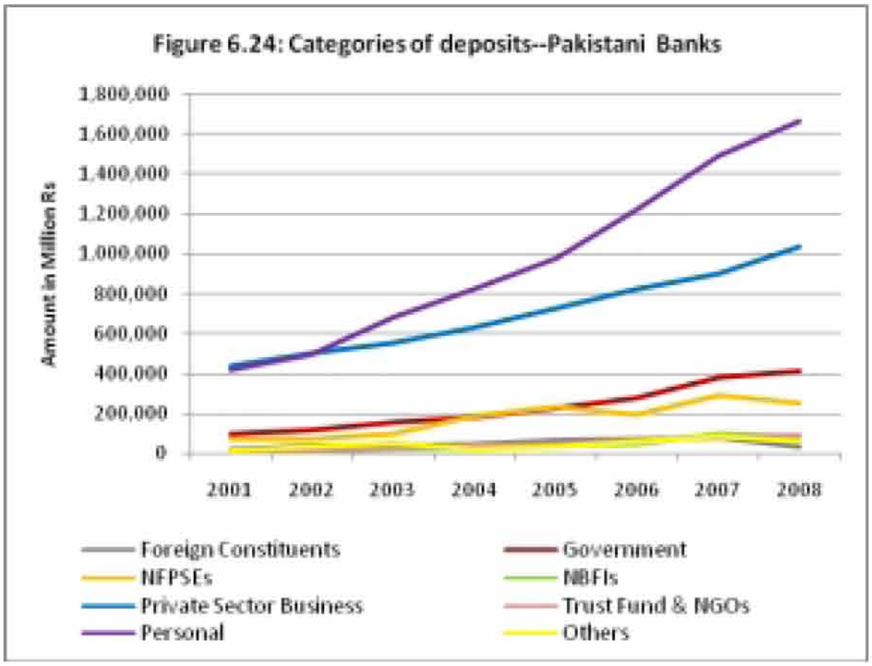
There is quite a simple explanation for the demise of foreign banks. As a part of the on-going process of consolidation (discussed in Chapter 5) they have been indigenized. The declining market shares, shown in Table 6.8, can say nothing about contestability, or any effect of heightened competition, resulting from any price-war or competitive re-positioning or loss of advantage. The foreign banks have simply lost their identity as a result of their assimilation in domestic banking and have gotten re-classified in the State Bank database. Any inferences drawn from statistics will depend upon the compatibility of the data. For the present, if we are to understand competition in the banking sector more comprehensibly, we must look more closely into the product markets of domestic commercial banks.

V. PAKISTANI COMMERCIAL BANKS

Categories of deposits

The most important category of deposits for Pakistani commercial banks is 'personal' (household) accounts, followed by private sector businesses. The number of personal accounts increased over the decade from 14 million to 16 million (see Figure 6.23), while their amount increased four-fold, from Rs 420,133 million in 2001 to Rs 1,663,438 million in 2008 (see Figure 6.24).





The number of private sector business accounts actually went down from about 12 million (2001) to 6.8 million (2008), but the amount involved more than doubled, rising from Rs. 438 billion to Rs 1,038 billion. This suggests that there was a significant jump in the average size of the private business account. In 2001 the (average) size of the private-business deposit was Rs. 37,801, but in 2008 it had risen to Rs. 152,666. This four-fold increase (in nominal terms) in deposit-size made the most significant contribution to mobilization of bank deposits in 2000s.

These two categories of deposits have clearly been the most important ones for commercial banks. In 2001, 'personal' deposits accounted for 38.6% of the Pakistani bank deposits (totaling Rs 1,085,894 million) while private sector business deposits were 40.3% of the total. In 2008, 'personal' deposits became 45.8% of total deposits (Rs 3,635,066 million), while private sector business deposits became 28.6% of the total. In terms of numbers, personal accounts occupied a central place. In 2001, the 14 million personal accounts constituted 53% of the total of 26.5 million accounts. Their importance increased further: in 2008, 16 million personal accounts formed 68% of 23.67 million depositors. On the other hand, 12 million private business accounts were 45% of the total number of 26.5 million depositors in 2001. Their number declined to 6.8 million in 2008 and became 29% of the total number of 23.67 million depositors.

The Government also has a fairly large number of deposit accounts in commercial banks. In the middle of the decade, when it increased its deposits in foreign banks (as mentioned already), the government deposits in Pakistani banks also increased. From Rs 98 billion in 2001 they rose steadily to Rs 411 billion in 2008. There was a similar, and parallel, increase in the deposits of non-financial public sector enterprises, whose deposits rose from Rs 74 billion (2001) to Rs 251 billion (2008). Accompanying this increase was that of deposits of non-bank financial institutions from Rs 17 billion to Rs 88 billion.

Thus, it can be seen that the vast majority of the country's deposits have been accumulating in Pakistani commercial banks; the role of foreign or specialized banks has been marginal.

Types of deposits --- current accounts of different sizes

The increasing number of current accounts, and the significance of this, has already been noted. A profile of this increase in current account holders would be helpful in identifying the market segment from where banks are augmenting their deposit base. This profiling is done in Figure 6.25, which shows that the most significant segment is that of deposits below Rs 1 million.

Figure 6.25: Current deposits of Pakistani banks

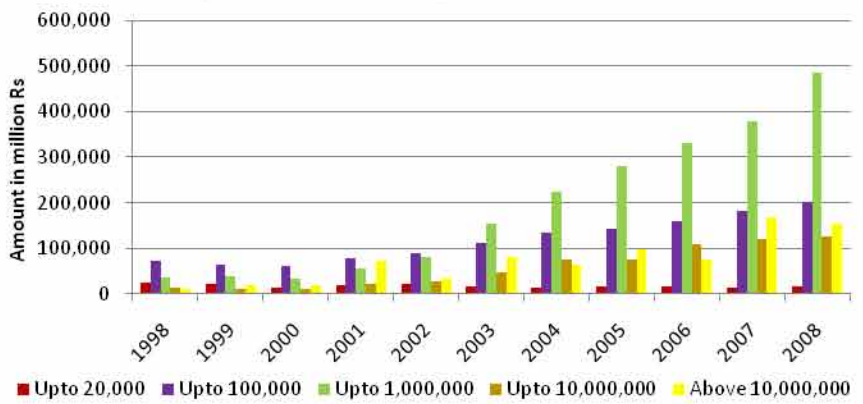
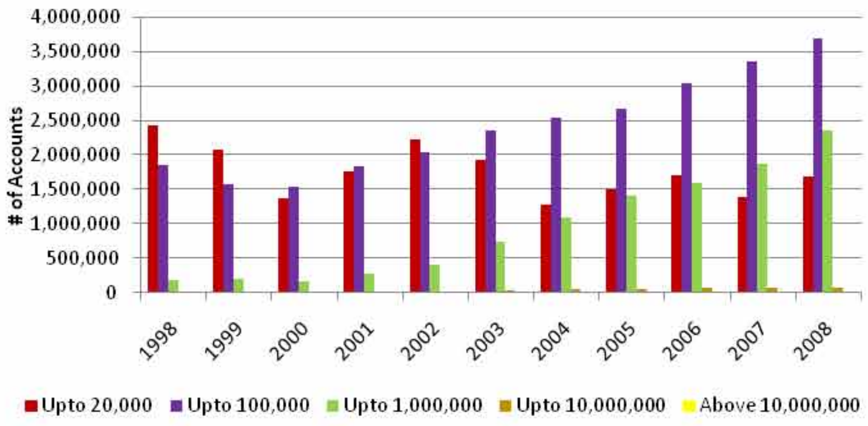


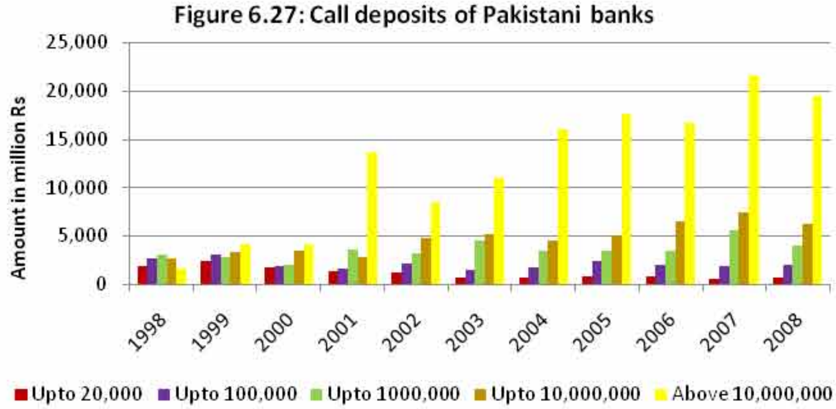
Figure 6.26: Current account depositors of Pakistani banks



The largest number of current accounts used to be that of those with accounts up to Rs 20,000, but these depositors are diminishing, having been replaced by the next size – of up to Rs 100,000 (see Figure 6.26). Although the number of accounts ranging from Rs 20,000 to Rs 100,000 appears to have grown rapidly in the process of displacing the size immediately below it, even this size of account is not likely to sustain itself and make a significant contribution. The time series show a very rapid rate of growth in accounts ranging from Rs 100,000 to Rs 1 million, both in terms of numbers as well as amounts. This can be seen clearly from both Figure 6.25 and Figure 6.26. Consequently, this size of account has emerged as the most dynamic market segment.

Size of call accounts

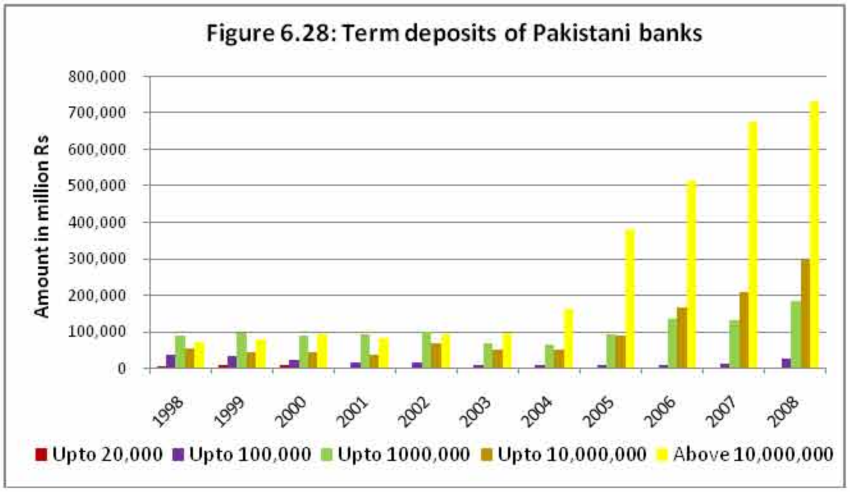
Figure 6.27: Call deposits of Pakistani banks

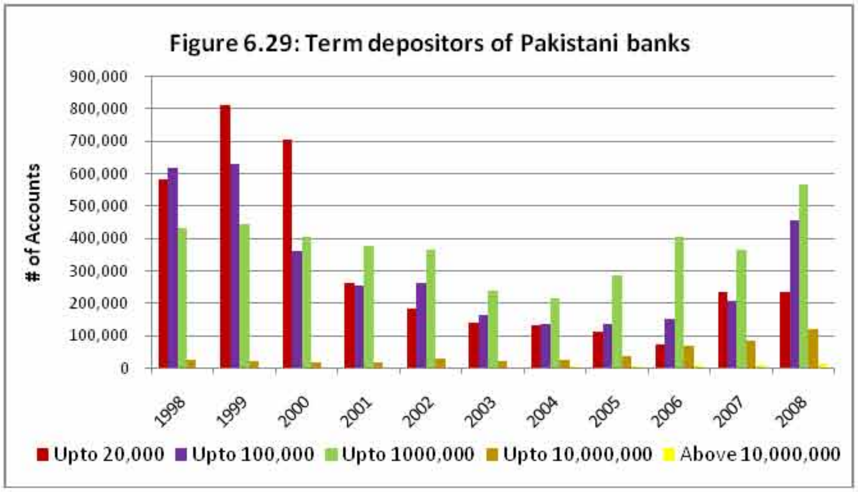


Call accounts can serve as an index of economic activity, even though the proportion of call accounts in total deposits is going to be small. Insofar as they reflect the growing demand for security deposits, especially for real estate transactions that witnessed a substantial growth in the economy during this decade, a profile of call accounts can be helpful. In terms of the amounts involved, the largest deposits, and also the ones that grew most of all, were those above Rs 10 million (i.e. the very large-sized deposits) – see Figure 6.27.

Size of term deposits

Again, the largest increase in deposits came from accounts above Rs 10 million (as can be seen from Figure 6.28), even though the number of term depositors was insignificant (see Figure 6.29).

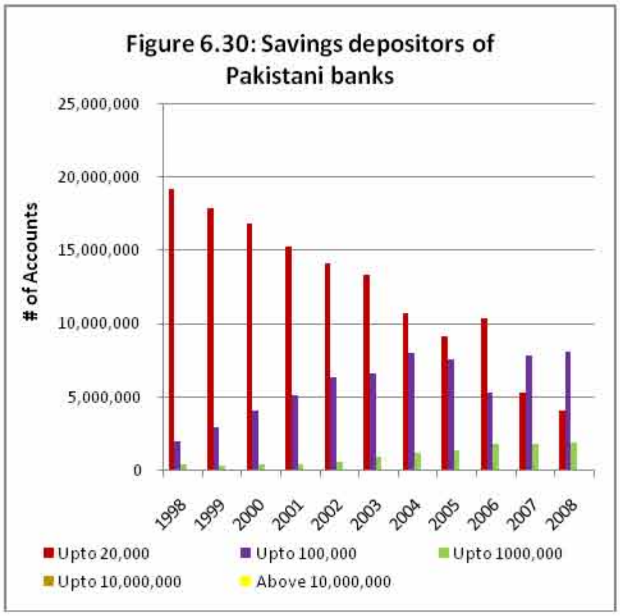


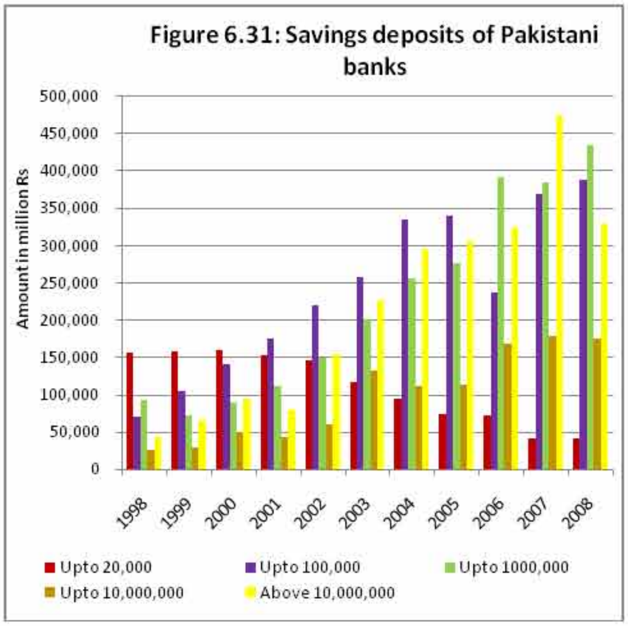


This was so because depositors holding accounts exceeding Rs 10 million in value are those of premium customers, much sought after by bankers.

Size of savings deposits

As expected, the number of small savings accounts (less than Rs 20,000) has declined (see Figure 6.30). Growth has occurred in all sizes of accounts (except under Rs 20,000), as shown in Figure 6.31.





VI. DYNAMICS OF DIFFERENT MARKET SEGMENTS

The Cruickshank report had provided the figure of £1,175 as the average size of a current account. Here, we have not attempted to calculate such an average because this citation does not really help in advancing our understanding of where competition is taking place and how the product markets are evolving. An average is merely an average. On the other hand, segregating the data in terms of categories of deposits (and depositors), size of deposits, and types of deposits, allows us to probe what is happening within product markets. No other Report on competition has made this attempt. In fact Cruickshank analyzed only one type of account (current account) to the exclusion of savings and term deposits. Nor did he look into categories and sizes. Here we try to understand the dynamics of each type of account (current, savings, term) and also record the changes that have taken place in each during the past ten years.

Each type of account is now further broken down further into five sizes: the smallest size (up to Rs 20,000), the small size (up to Rs 100,000), modest size (Rs 100,000 – Rs 1,000,000), the large size (Rs. 1 million to Rs. 10 million) and the largest size (above Rs 10 million). We then examine how each size of account of each type has stood up over time.

The savings account in the smallest segment (under Rs.20,000) declined sharply. From 19.2 million savings accounts in 1998, the number went down to 4.1 million in 2008, while the value of these deposits decreased from Rs 156,460 million (1998) to Rs 40,973 million (2008). The other accounts appear to be more static. See Figure 6.32 and 6.33.

It is important to mention here that it was in this declining market segment that the Pakistani commercial banks decided, with the connivance of the Pakistan Banking Association, to collectively fix rates of profit and other terms and conditions on these savings deposits. The Competition Commission of Pakistan took legal action against the banks for what it felt was collusive behaviour against the public interest. The case has been discussed in the State of Competition Report 2008 (pp. 48 – 49).

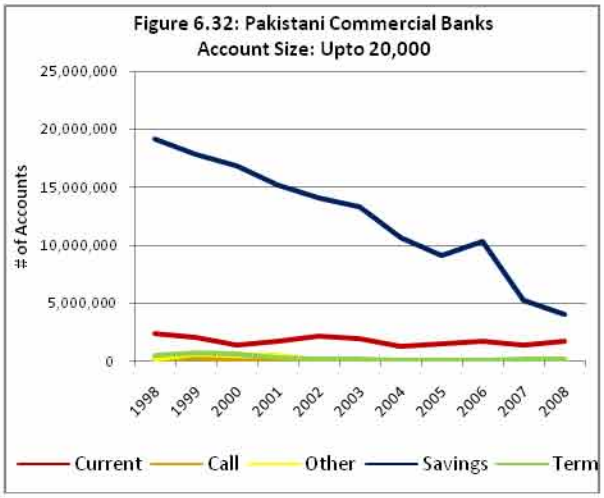


Figure 6.32: Pakistani Commercial Banks
Account Size: Upto 20,000

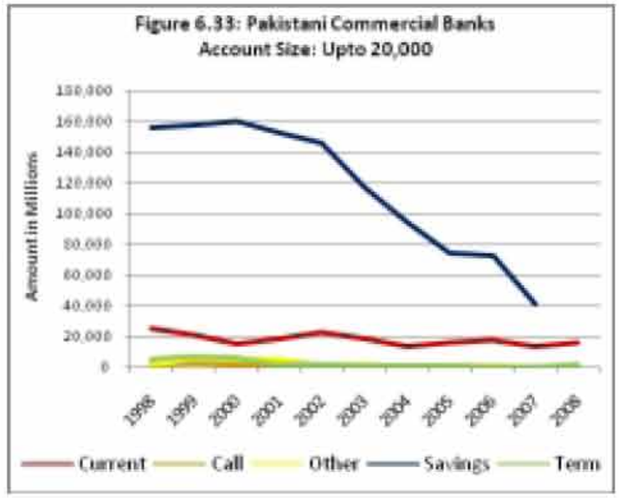


Figure 6.33: Pakistani Commercial Banks
Account Size: Upto 20,000

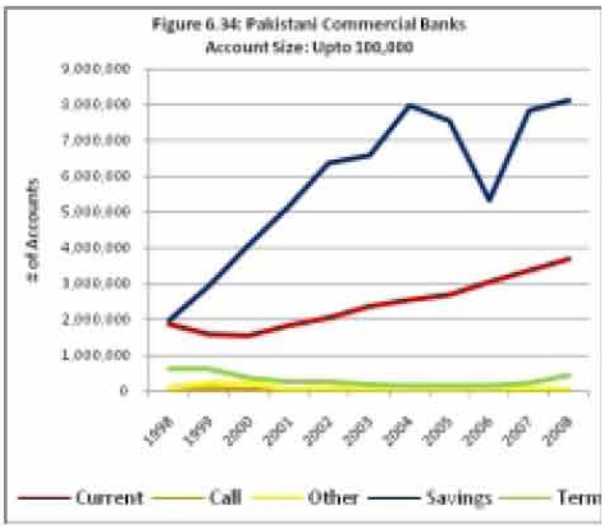


Figure 6.34: Pakistani Commercial Banks
Account Size: Upto 100,000

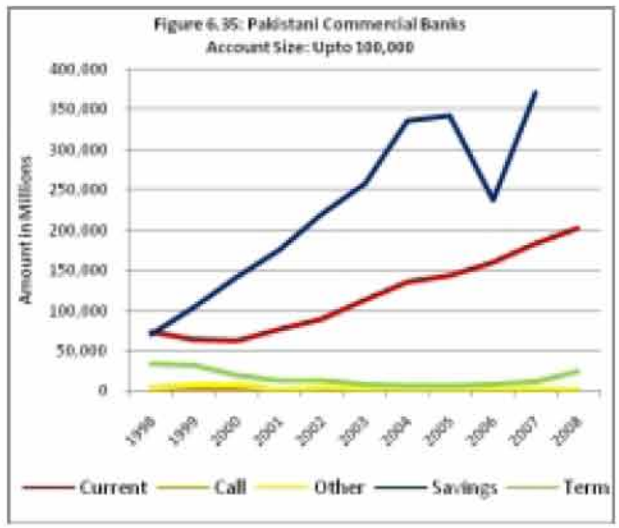


Figure 6.35: Pakistani Commercial Banks
Account Size: Upto 100,000

Figure 6.34 and 6.35 depict the next segment of deposits (from Rs 20,000 to Rs 100,000). In this segment these was a growth in savings accounts, both in terms of numbers and account. However, all that these data show is the effect of inflation. The smallest sized category has become trivial because of the depreciation in the value of money and the smallest deposits should now be re-defined as not being under Rs 20,000 but a higher inflation-adjusted amount that would fall between Rs 20,000 and Rs 100,000. It can be shown that when this adjustment is made, Rs 20,000 in 2001 translates into Rs. 40,000 in 2008 prices. Figures 6.34 and Figure 6.35 therefore become an updated version of the same sized accounts as shown in the previous figures (Figure 6.32-6.33). They show that the small savings deposits (up to Rs 100,000) continued to grow until 2003, then dipped and then recovered.

On the other hand, current accounts grew constantly, both in terms of numbers and in the amount involved. Once again this confirms the liquidity preference of the decade that has been mentioned elsewhere too.

The next segment (Rs 100,000 – Rs 1,000,000) is an important one for both savings and current accounts. Savings accounts increased from 421,522 (1998) to nearly 2 million (2008) and their amount rose from Rs 93,610 million (1998) to Rs 433,855 million (2008). At the same time, current accounts grew from 177,134 to 2.4 million, whilst the amount rose from Rs 35,899 million to Rs 485,732 million (see Figures 6.36 and 6.37)

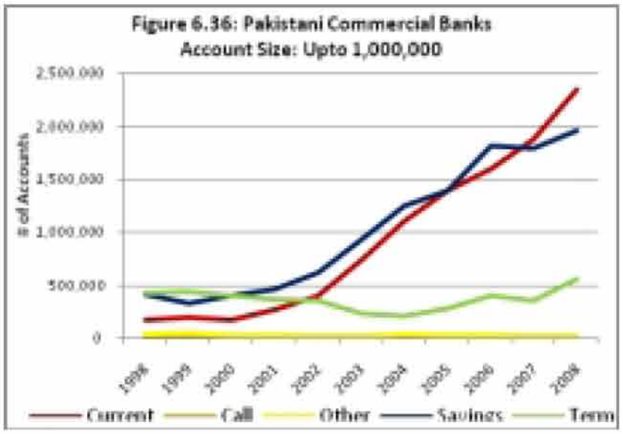


Figure 6.36: Pakistani Commercial Banks Account Size: Upto 1,000,000

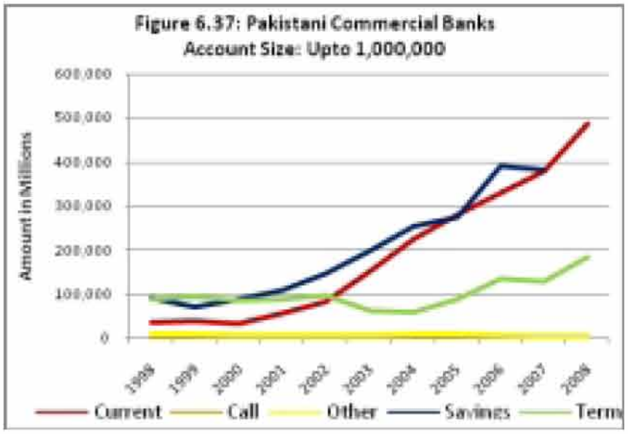


Figure 6.37: Pakistani Commercial Banks Account Size: Upto 1,000,000

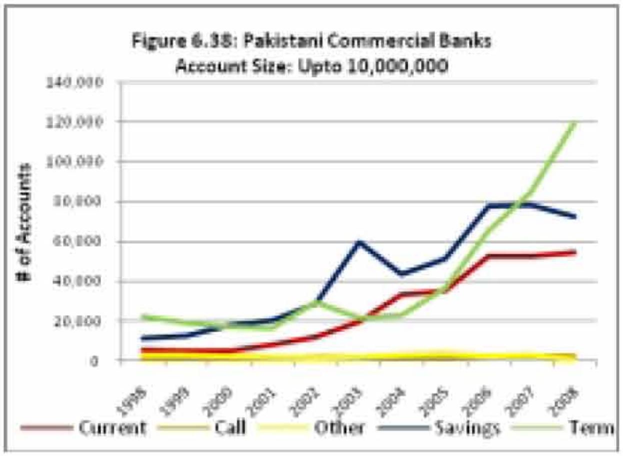


Figure 6.38: Pakistani Commercial Banks Account Size: Upto 10,000,000

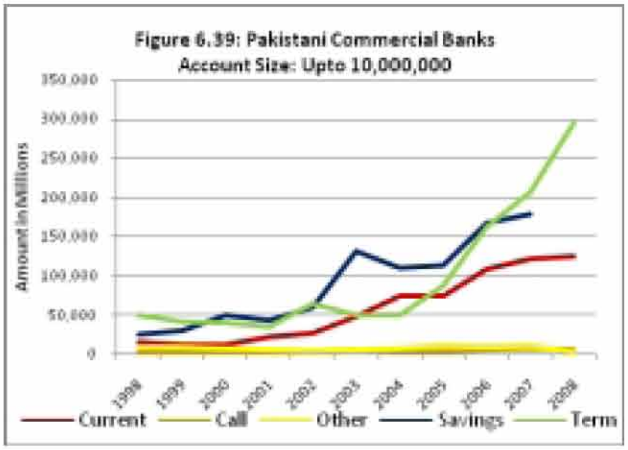
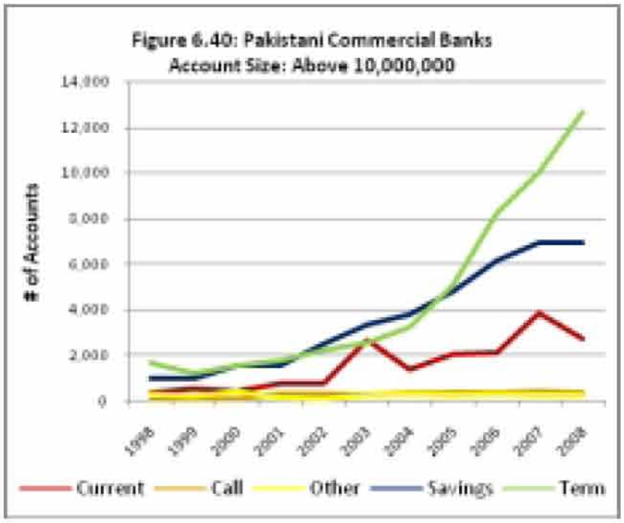
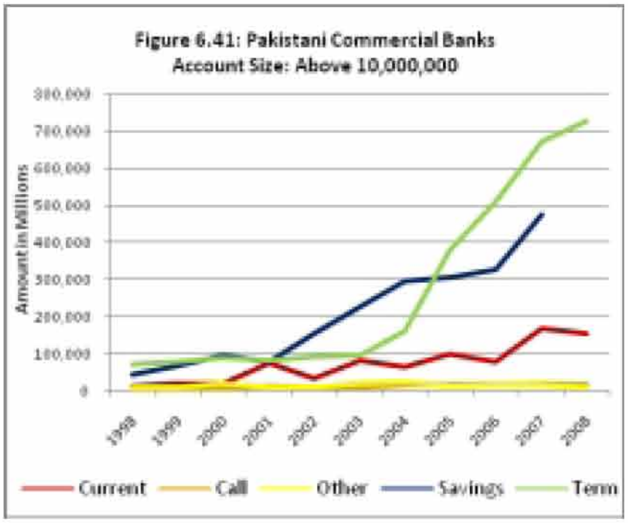


Figure 6.39: Pakistani Commercial Banks Account Size: Upto 10,000,000

The growth profile of large-sized accounts is shown in Figures 6.38 and 6.39. It is surprising that all three types of accounts (current, savings and term) showed a parallel growth.

The largest accounts (those above Rs 10 million) can be viewed as investment accounts. Product substitution takes place here with other investment products. It is therefore not surprising that term deposits should take the lead in this segment, as is borne out by Figures 6.40 & 6.41.





Once small sized deposits (and depositors) are taken out of the data, the remaining accounts (i.e. the larger ones) show an upward trend in growth across all major types of accounts. See Figure 6.36 to 6.39 for deposits ranging from Rs 100,000 to Rs 10 million. The marked trend shown in these figures is an obvious reflection of the fact that Pakistani commercial banks were able to attract the consumer surplus of a rising middle class economy into all its deposit instruments, but the less affluent were diminishing in importance as bank customers. This fact becomes highlighted in Figures 6.40 and 6.41 which confirm the growing importance of the very large (above Rs 10 million) deposits made by a miniscule number of depositors, by way of term deposits. In 1998, the number of such depositors was 1,698. In 2008 it increased to 12,652. The amount of deposits increased from Rs 71,375 million to Rs 728,189 million, implying that the average size of deposits had risen from Rs 42 million to Rs 57.6 million. It is this noticeable expansion, but one that is confined to a very small number of the very rich, that forms the basis of the State Bank's observation (at the beginning of this chapter) about the growth in term deposits. It must be pointed out, however, that this growth trend was neither universal nor restricted to term deposits. Current and savings accounts, of the larger variety, grew as well.

Re-classifying the data

Just as national income accounts need to be re-based every 10 years (or should be) to reflect structural changes (changes in output contribution of different sectors) and differential effects of price changes in the economy[95], the classification of bank accounts --- in accordance with which the State Bank collects and publishes its statistics ---- also needs to be re-visited periodically[96], in order to incorporate inflationary changes and those of structure (contributions of different categories and sizes of account). For purposes of competition analysis it is all the more important to re-define the categories of size of deposits, to make them more meaningful and conform to

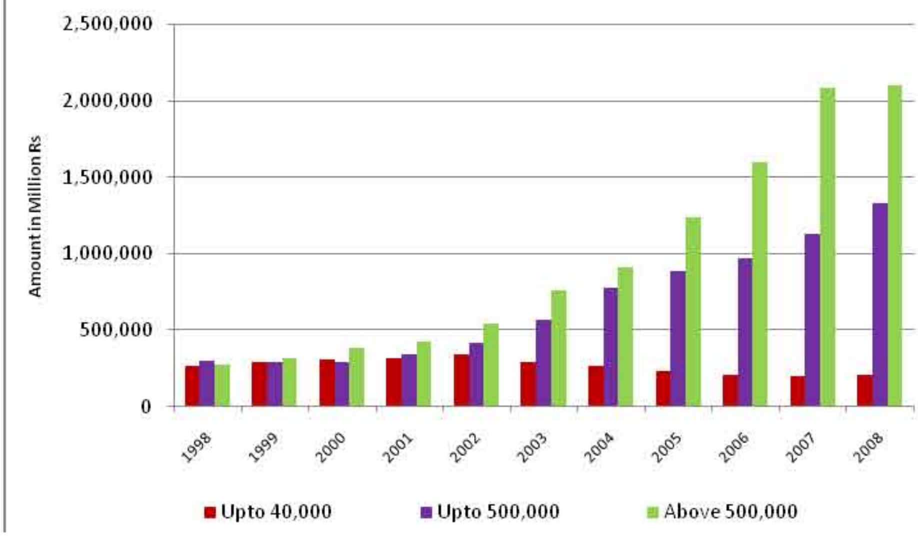
[95] The last re-basing of Pakistan's national accounts was done in 2004. See Ghazanfar (2004), Re-basing of National Accounts, Government of Pakistan, Statistics Division, Islamabad.
[96] The State Bank in fact does so. For its re-classification of categories and other banking sector attributes, see Statistics on Scheduled Banks (June 2008), pp v-vii

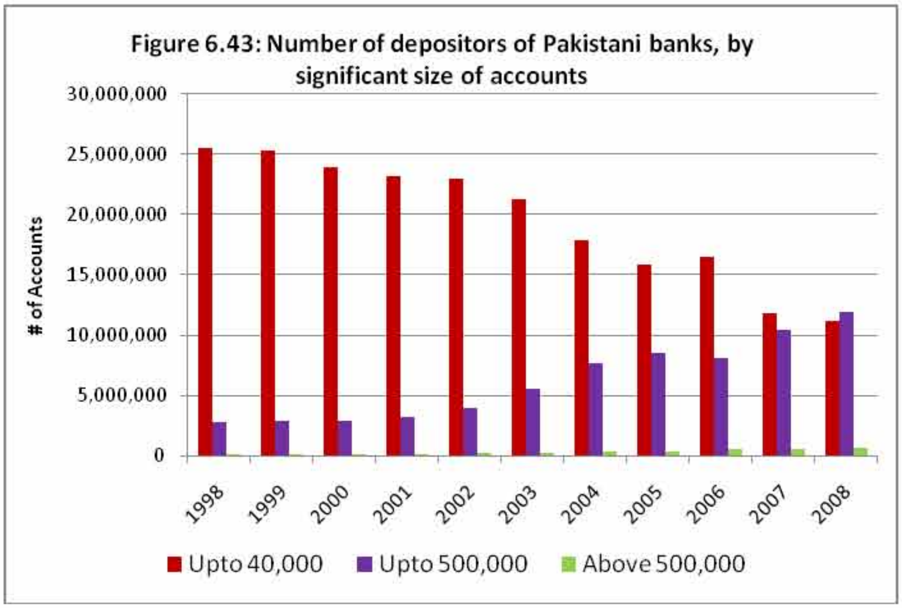
observed behaviour within 'product markets'. This is a central criterion in demand side analysis of markets (see Robinson, 1953, 1956): the relevant market is the one where competition actually takes place.

Accordingly, we now re-classify the sizes of accounts. The State Bank had made available to this author year-wise (1998 – 2008) data pertaining to the 7 categories of deposits and advances, for 5 types of accounts, according to their size distribution. The size distribution (for each year) was recorded in 31 classes, starting from "less than Rs 5,000" to "over Rs 10 million". These data were, for the purpose of the present analysis, re-grouped into the 5 classes shown in Figures 32 – 41.

These segments can now be re-defined to incorporate inflationary changes and to facilitate observation of the competitive activity having taken place. The resultant simplification is depicted in Figures 6.42 and 6.43. These three sizes constitute, to our mind, distinct and separate product market segments.

Figure 6.42: Deposits in Pakistani banks, by significant sizes of accounts





How these market segments have fared, relative to one another, over time (10 years, 1998-2008) is shown in pie-charts in Figure 6.44 below.

Figure 6.44: Concentration of deposits – 1998 vs 2008

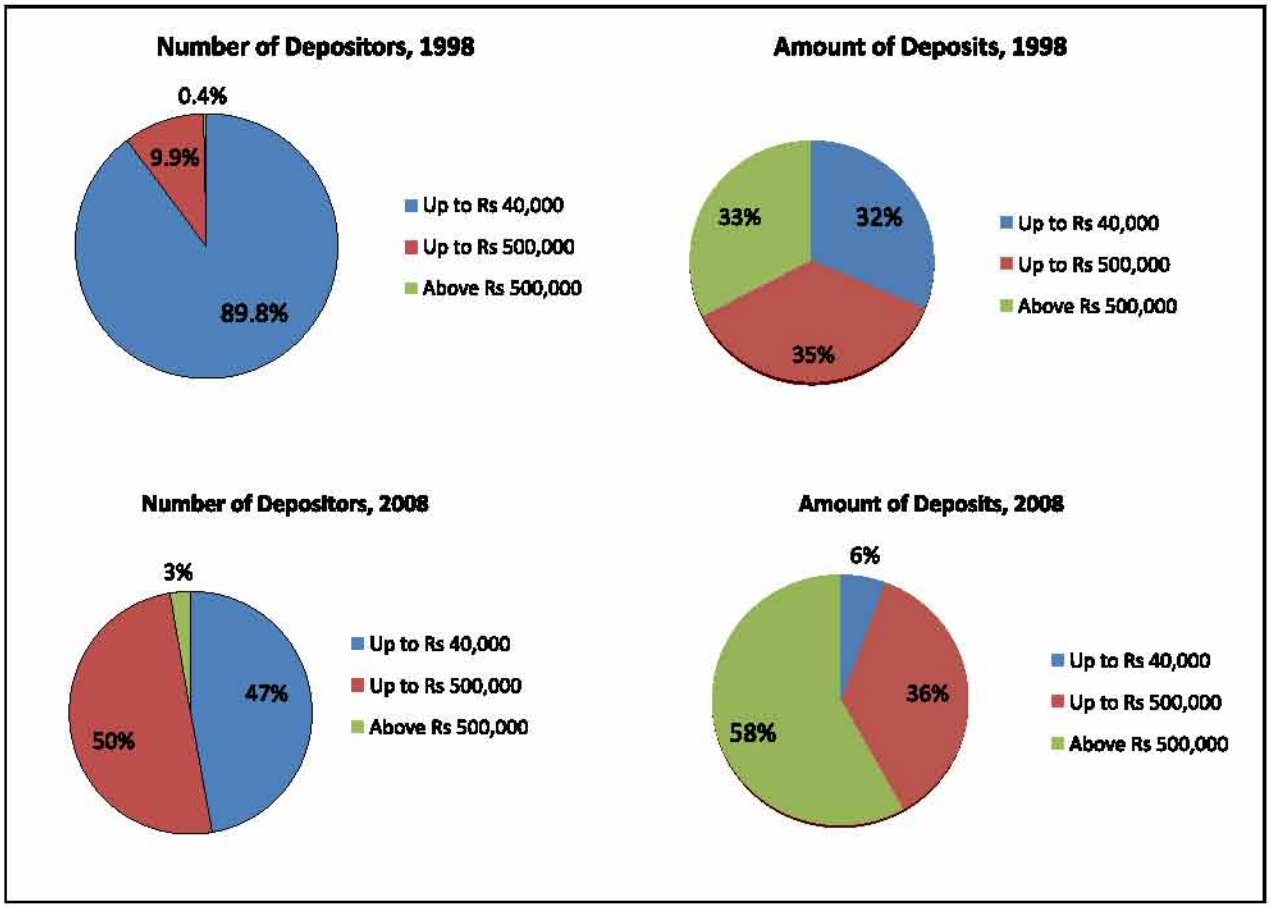


Table 6.9 shows how small-size depositors have dropped out. Their proportion has fallen from 90% (1998) to 47% (2008), while that of the middle class has risen from 10% to 50%. The amounts of deposits held by small depositors were 31% of the total. They are now only 6%. Those of the richer class (above Rs 500,000) have risen from 33% to 58%, as shown in Table 6.10.

Table 6.9: Number of Accounts (percentage of total)

Size of Account	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Up to Rs 40,000	89.8	89.4	88.9	87.4	84.6	78.8	69.3	64.0	65.8	51.9	47.2
Up to Rs 500,000	9.9	10.2	10.7	12.1	14.6	20.3	29.7	34.6	32.2	45.8	50.1
Above Rs 500,000	0.4	0.4	0.4	0.5	0.8	0.9	1.1	1.4	2.0	2.4	2.7
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Table 6.10 : Amount of deposits (percentage of total)

Size of Account	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Up to Rs 40,000	31.7	32.2	31.0	29.5	26.3	18.1	13.7	9.9	7.6	5.8	5.7
Up to Rs 500,000	35.6	32.9	30.1	31.4	32.1	35.1	39.5	37.6	34.9	33.1	36.6
Above Rs 500,000	32.7	34.9	38.9	39.1	41.7	46.8	46.8	52.5	57.5	61.1	57.7
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

The above segmentation of the market indicates the extent to which banking wealth (as reflected in deposits) has gotten re-distributed among economic classes. Whether it has happened as a result of competition, or despite it, or whether it has happened because of the absence of competition or that competition (or the lack of it) has nothing to do with it, raises a number of fundamental questions that we cannot go into within the restricted scope of this inquiry. Nevertheless, the questions are of national importance and need to be addressed.

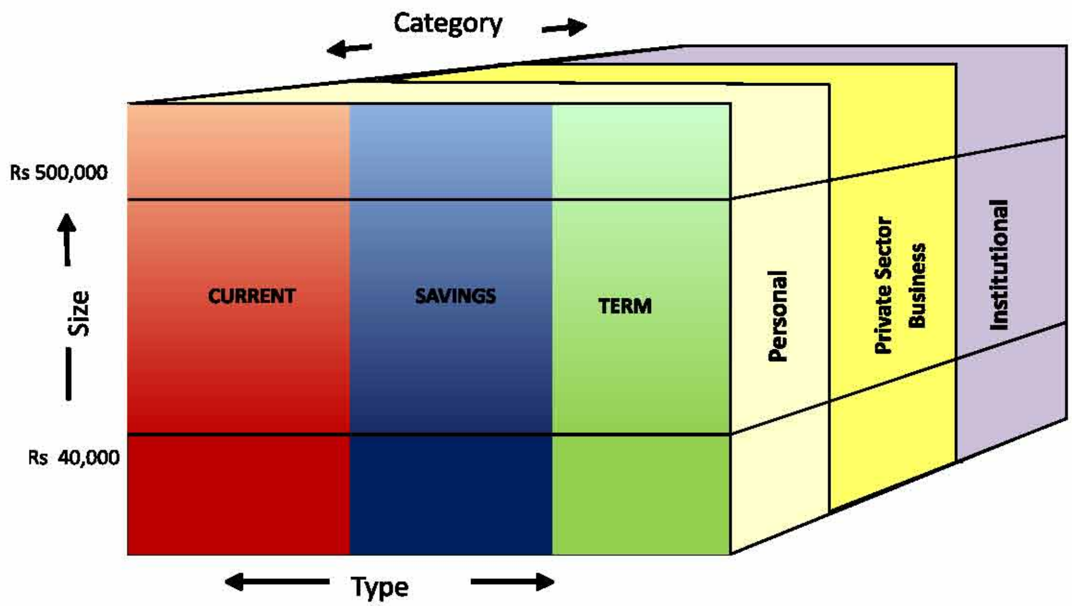
What we do need to do presently, as a consequence of the preceding analysis, is a conceptual (theoretical, if you will) summation of what we mean by 'product markets' -- how we have defined them and how we suggest the Competition Commission of Pakistan must look at them for its own analyses of how competition takes place and how best it can be understood.

VII. RE-DEFINING PRODUCT-MARKETS

In order to observe the dynamics of market evolution, the literature on strategic management provides for the definition of a product-market along three (or more) dimensions corresponding to different customer attributes, needs and specifications. Thus customers can be differentiated according to their income, their habits and preferences, their occupational grouping, and so forth.

Importing this schema to banking customers, we can define them along the following three vectors: (i) income (represented by size of account), (ii) preference or need (represented by type of account) and (iii) occupational grouping, represented by category of account. The relevant product market can, therefore, be re-defined to comprise one of 9 segments obtained from a three-dimensional view of customers (in this case, depositors) along the vectors shown in Figure 6.45

Figure 6.45: Market segments schema of banking sector



If all the banking sector data were to be broken down in terms of these 9 segments, a study of the competition indicators in each segment, from year to year, would enable us to draw meaningful conclusions about the evolution of competition. We can, of course, break down available statistics into two dimensions and have done so by plotting type *versus* size of account, and size of account *versus* category of account. However, further segmentation analysis is not possible because of unavailability of micro-data required for the purpose. Nor would it be meaningful in the absence of other data on determinants of competition. And, data on those determinants or indicators are not available. For instance, Cruickshank was unable to get competition indicators separately for any product market. Consequently, his analysis of competition indices (concentration ratios and Herfindahl indices) was based on an estimation procedure (sample survey), and that too of aggregate markets, not of segments. The South African, Irish, German and other European studies did not look at product markets. The Brazilian study simply estimated the difference between 'corporate' and 'retail' customers in the payment system. No competition study has so far tried or been able to examine the unfolding of competition in specific product markets. We have made a limited attempt at examining this aspect, but clearly full justice cannot be done to it in the present context and with current data limitations.

[97] Interest rate data are of course available, but their application to specific segments, to measure the interest elasticity of demand, is not possible.

Competition indicators

Since product-wise competition indicators are not available, every study has relied upon the statistics available for the entire industry. Concentration ratios and Herfindahl indices are the norm. These have been applied to the banking sector as a whole, in different studies, notably by the State Bank itself, to conclude, albeit with caveats, that competition has increased. The conclusions have an unsatisfactory property, which has been discussed in previous chapters. That is why the present analysis took an altogether different route of looking at the level of competition, through various product markets. Having done so, we could at best point out what was happening in different markets, with possible explanations why. To go into a further measurement of the actual intensity of competition would require a much bigger research project, involving substantial customized statistical data. One could start by looking at the concentration of bank deposits, as shown in Table 6.11.

Table 6.11: Concentration of bank deposits (amount in *Rs billion)*

Year	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Total deposits	1,070	1,092	1,189	1,309	1,500	1,842	2,202	2,613	2,927	3,534	3,791
5 Big Banks	689	744	760	842	943	1,096	1,247	1,365	1,507	1,794	1,953
% Share	64.4	68.1	63.9	64.3	62.8	59.5	56.6	52.3	51.5	50.8	51.5

It is quite obvious that the big five banks have lost their share of deposits. This continual loss of market share raises another basic issue. Under competitive conditions, the loss of market share could not but have translated into a corresponding loss of revenues and profitability of the top five banks. That is almost axiomatic. Yet, the profitability of the big banks did not decrease. It had increased, despite the loss of markets. The natural corollary to this observation is that the assumption of a competitive market has been violated – that the markets are not competitive; otherwise this outcome was not possible. But, this cannot be proven without disposing of the alternative hypothesis.

The alternative hypothesis is that, even though the big five banks have lost their share of deposits, this loss has been more than offset by gains elsewhere. Those could be gains in efficiency (see, for instance, Qayyum and Khan, 2007, *op cit*), lower costs of intermediation, increase in non-interest income, or more effective (more profitable) lending operations. All these possibilities oblige us to turn, in the next chapter, to the other side (that of loans and advances) of the banking equation.

CHAPTER 7

COMPETITION IN CREDIT ALLOCATION

Chapter 6 concluded with the finding that the big banks had lost their share of deposits. This had happened not owing to intensification of competition but an indifference occasioned by plentiful availability of deposits at very cheap rates. Smaller private domestic banks partook of an increasingly greater share of the money that flowed into the banking system after 9/11, after a dramatic increase in remittances from overseas. This resulted not only in larger deposits, but also in much larger loans and advances. The State Bank has also confirmed

> "that there is greater competition in extending loans than in deposit mobilization in Pakistan during recent times. This is particularly so because banks have focused more on asset growth as compared to innovations in liability products in recent years .... taking advantage of low competition in mobilizing deposits."[98]

The State Bank has also noted that the

> "lack of competition in the banking sector allows banks to maintain high spreads and extract above normal profits. This does not bode well not only for the overall efficiency of the banking sector, but also for its long-term sustainability."[99]

High banking spreads result also in inefficient credit allocations. Despite the remarkable increase in the amounts having become available after 9/11 and the resulting decline in interest-rates to the point of becoming negative in real terms, Pakistan's ratio of private-sector credit to GDP remained low.[100] Pakistan had a lot of catching up to do, but was unable to do so even after the sudden upsurge in credit 2001-2003.

This Chapter analyzes this upsurge, the pattern of its allocation and its implications for competition.

I. PROFILE OF BANK ADVANCES

Figure 7.1 is a profile of the increase in banks' advances and the share of the top 5 banks in this increase. In order to facilitate a comparison with the deposit side, Table 7.1 shows that, while the

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[98] "Efficiency of Financial Intermediation: An Analysis of Banking Spreads" in *Financial Stability Review 2006*, pp. 25-26, State Bank of Pakistan.

[99] *Ibid*, p.29

[100] Pakistan's current Private Credit to GDP ratio is only 27.18%. This results in Pakistan being ranked number 46 out of the 52 countries listed in this count in the Financial Development Index 2009. The U.S. has the highest ratio of 202.42%. This index is based on Thorsten Beck, Asli Demirguc-Kunt and Ross Levine (2000), A New Database on Financial Development and Structure, World Bank Economic Review, 14:597 – 605 updated November 2008.

See also IMF's International Financial Statistics for an international comparison, in which the developed countries' bank credits often exceed 100%, as do those of China and Malaysia, but those of developing countries are usually below 40%.

share of the top 5 banks in deposits declined by about 13% between 2001 and 2008, the decline in the share of the same 5 banks in advances was about 9% between 2001 and 2008. Actually this 9% drop had occurred in the very first two years, 2001 – 2003. It seems that the top five banks were not quickly off their mark and lost the initiative to smaller banks. The incremental gains of the smaller banks suggest that competition for loans/advances was stronger at least than that for deposits.

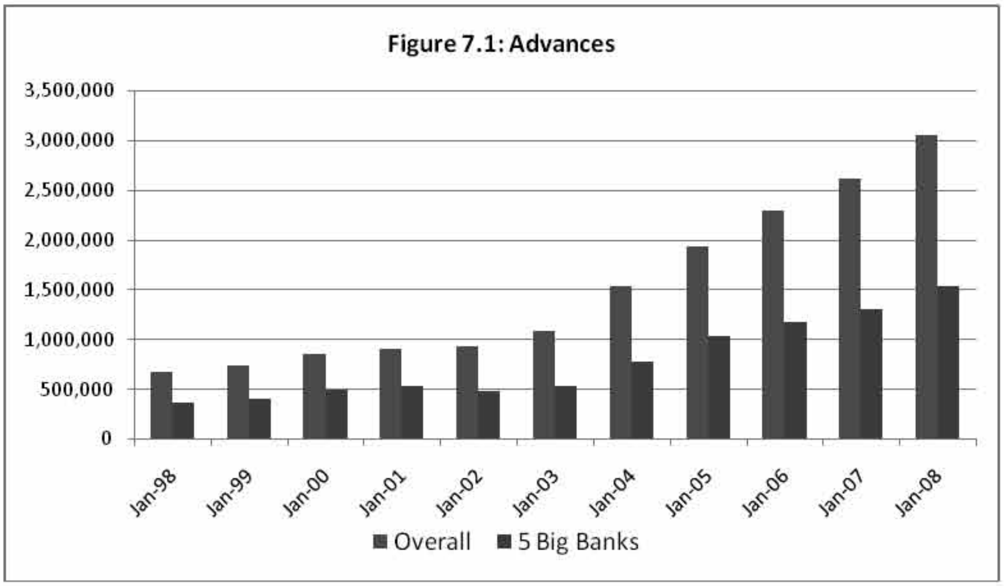


Table 7.1: Share of top 5 banks: advances and deposits

(amount in Rs million)

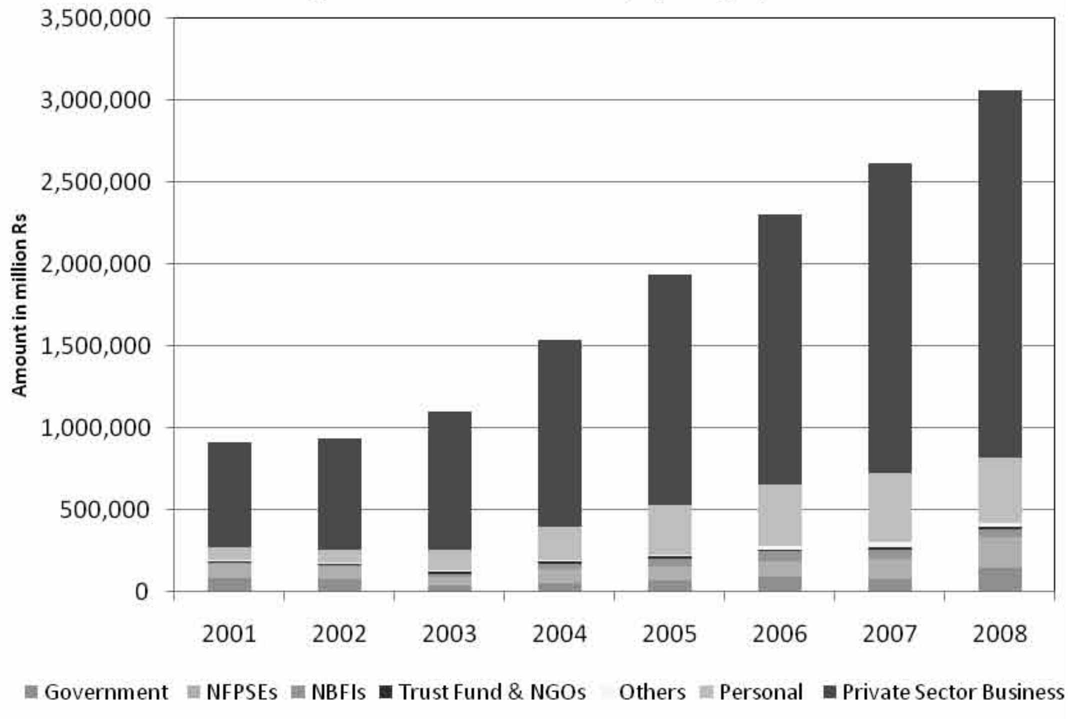
	Advances			Deposits		
Period	**5 Big Banks**	**Overall**	**%**	**5 Big Banks**	**Overall**	**%**
Dec-98	377,597.80	680,234.50	55.51	688,815.10	1,070,304.80	64.36
Dec-99	416,181.20	742,913.30	56.02	743,781.30	1,091,610.80	68.14
Dec-00	497,550.50	862,557.50	57.68	760,239.70	1,189,013.70	63.94
Dec-01	533,276.30	910,037.30	58.6	841,801.20	1,309,264.80	64.3
Dec-02	492,156.80	936,194.70	52.57	942,625.20	1,500,470.40	62.82
Dec-03	544,219.60	1,095,749.00	49.67	1,096,356.30	1,842,142.70	59.52
Dec-04	779,726.40	1,535,891.50	50.77	1,246,762.90	2,201,811.60	56.62
Dec-05	1,035,622.60	1,935,149.50	53.52	1,365,485.60	2,613,464.80	52.25
Dec-06	1,185,126.50	2,300,533.20	51.52	1,507,198.00	2,926,644.70	51.5
Dec-07	1,312,237.60	2,613,204.90	50.22	1,794,022.60	3,534,495.80	50.76
Dec-08	1,535,420.20	3,056,394.00	50.24	1,953,298.20	3,791,489.40	51.52

Table 7.2 shows the year-wise growth in advances made by the banking system to different categories of borrowers.

Table 7.2: Distribution of advances, by category of borrowers (Rs million)

year	Government	NFPSEs	NBFIs	Private Sector Business	Trust Fund & NGOs	Personal	Others	TOTAL	+% Increase
2001	85,082.4	85,998.8	8,413.7	634,476.4	9,419.8	78,367.1	8,278.3	910,036.5	
2002	74,689.2	81,400.1	10,759.7	679,322.6	8,483.1	77,324.0	4,216.0	936,194.7	2.87
2003	37,455.8	53,163.9	21,487.2	835,684.4	14390.9	128,448.9	5,117.1	1,095,748.2	17.04
2004	58,255.7	80,929.8	35,444.3	1,135,797.6	13,029.4	203,725.3	8,710.0	1,535,892.1	40.17
2005	71,123.2	86,429.4	42,959.3	1,404,194.3	15,073.4	302,764.8	12,604.5	1,935,148.9	26.00
2006	93,722.0	96,936.1	55,217.3	1,646,615.4	14,573.7	377,117.8	16,350.6	2,300,532.9	18.88
2007	77,701.3	125,398.8	52,258.6	1,884,923.3	17,180.6	422,806.9	32,935.6	2,613,205.1	13.59
2008	150,460.8	187,001.5	45,733.3	2,240,768.1	13,606.0	396,088.0	22,835.2	3,056,492.9	16.96

Figure 7.2 : Profile of advances, by category



It would be seen that the private sector businesses were by far the largest recipients of bank loans, accounting for 2/3rd of the advances in 2001, with their proportion rising above 70% afterwards.

The government and non-financial public sector enterprises were the next important categories, accounting for 11% each of bank advances in 2001, but their shares went down to 3.8% and 5.5%, respectively, in 2003, and remained low subsequently. By contrast, the shares of personal advances doubled, rising from 8.9% in 2001 to 17% in 2006. Table 7.2 can, therefore, be re-written in its reduced form, as in Table 7.3

Table 7.3: Share of main categories of bank borrowing (per cent)

	2001	2002	2003	2004	2005	2006	2007	2008
Private Sector Business	69.21	72.28	76.02	73.82	72.41	71.46	72.00	73.21
Personal	9.26	8.61	11.99	13.40	15.77	16.51	16.31	13.07
Others	21.53	19.11	11.99	12.78	11.81	12.03	11.68	13.72
Total	100	100	100	100	100	100	100	100

Clearly, the two-categories of borrowers that were the greatest net recipients of the increased bank lending were the corporate sector, followed by households who availed of consumer financing and personal loans. This is shown graphically in Figure 7.2.

The increase in the preponderance of corporate lending shows up also in the doubling of the lending to deposit ratio of the corporate sector. The only other ratio that increased was that of personal lending. This can be seen from the tabulation of the different ratios ('lending to deposit') for each of the 7 categories (of borrowers/depositors), as shown in Table 7.4. Analysis of these ratios provides further evidence of this trend towards a disproportionately enhanced credit apportionment.

This propensity towards re-distribution of credit has given rise to serious concerns. For instance, the State Bank has concluded that:

> "banks need to increase the penetration of bank credit to uniformly meet the needs of the growing economy. The major issue is that bank credit is heavily skewed towards the corporate sector, and even within corporate sector only the textile industry is getting the bulk of credit. Agriculture and SME sectors that contribute immensely in employment need better access to credit, commensurate with their size and contribution to economy. In retrospect, banks are more inclined to serve the corporate / manufacturing sector as it generally does not have problems related to collateral, information and outreach. In terms of returns, the agriculture and SME sectors can probably provide higher interest rates as these sectors currently rely heavily on non-institutional credit which is usually available at exorbitant interest rates (higher than 50 – 100 per cent in some cases). In order to improve penetration in these sectors, banks need to strengthen on their credit assessment and risk management systems to overcome the problems associated with lending to these sectors."[101]

The uneven distribution is also manifest in the size distribution of the clients of the banking system. Table 7.5 shows the number of accounts that received bank credits during this period. The numbers have been classified according to the same sizes that were composed in Chapter 6 for deposits.

[101] "Issues in Sectoral Allocation of Credit", Chapter 5 of *Financial Stability Review 2006*, p. 67

Table 7.4: Lending /deposit ratios of different categories

	2001	2002	2003	2004	2005	2006	2007	2008
Aggregate ratio	0.70	0.63	0.60	0.70	0.74	0.79	0.74	0.81
Government	0.85	0.61	0.24	0.31	0.31	0.34	0.20	0.36
NFPSEs	1.09	1.04	0.50	0.41	0.35	0.48	0.43	0.73
NBFIs	1.05	1.10	0.86	1.29	1.08	1.09	0.53	0.51
Private Sector Business	1.22	1.17	1.33	1.59	1.72	1.86	2.01	2.04
Trust Fund & NGOs	0.57	0.32	0.41	0.24	0.24	0.21	0.21	0.13
Personal	0.17	0.14	0.17	0.22	0.28	0.29	0.27	0.23
Others	0.40	0.11	0.10	0.36	0.36	0.27	0.38	0.36

Table 7.5: Number of bank advances, according to size of accounts (per cent)

	2001	2002	2003	2004	2005	2006	2007	2008
Up to 40,000	39.3	31.8	39.4	41.0	40.8	37.4	23.9	38.3
Up to 500,000	57.3	64.9	57.0	54.7	53.8	57.7	70.8	56.5
Above 500,000	3.4	3.2	3.6	4.3	5.4	4.9	5.3	5.2
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Looking at the amounts of the bank advances (instead of number of accounts) in each size of account makes the concentration even more apparent. See Table 7.6 for this.

Table 7.6: Amount of bank advances, according to size of accounts (per cent)

	2001	2002	2003	2004	2005	2006	2007	2008
Up to 40,000	2.4	1.8	2.5	2.5	2.4	2.2	1.0	1.3
Up to 500,000	14.6	15.1	14.7	13.9	15.3	15.6	15.3	11.9
Above 500,000	83.0	83.1	82.8	83.6	82.3	82.2	83.8	86.8
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

This highly skewed distribution has already rung alarm bells in different quarters, including the State Bank, which has said:

> " On the credit risk front, despite slower growth of 10.8 percent in the loans and advances of the banking sector (lowest in the last five years) during CY07, credit growth in excess of 25.0 percent per annum during CY 03 – 06 continues has been a source of concern, in terms of its implications on the quality of the credit portfolio. Credit concentration stands out as an even bigger concern, as the top 0.5 percent of total loan account holders have a 67.7 percent share in banks' advances, with an average loan size of Rs 68.6 million. Sectoral composition of loans also indicates concentration of credit in the corporate sector, which accounts for 59.0 percent of banks' loan portfolio. Furthermore, loans to the textile sector constitute 18.5 percent of the total loans, indicating another source of concentration risk."[102]

The State Bank has also noted in its 2007 -2008 assessment that, with the strengthening of the capital base of banks, as a consequence of increased MCR and a rise in the capital to (risk-

[102] "Stability of the Banking System", Chapter 3 in *Financial Stability Review, 2007 – 08*, pp. 39 - 40

weighted) asset ratio (CAR), the risks posed to the capital of banks have eased. Banks can gain further comfort from the fact that non-performing loans are diminishing (NPL to capital ratio declining).[103] Under these circumstances, commercial banks could easily afford the 'risk' of greater lending to SMEs and agriculture without water-tight collateral. Ironically, the banks' aversion to this risk, manifest in their seeking shelter behind ample collateral, has added to the riskiness (exposure) of the entire lending operations. This is indeed the moral hazard that the State Bank seems to be pointing towards.

There is a double jeopardy here. The first stems from the fragility imposed on the system, via the lack of diversification in the product portfolio. The second stems from the lack of competition. The failure, on the part of banks, to undertake even a modicum of risk in the assessment and appraisal of clients (when all other indicators point towards a very stable, almost risk-free environment) can point only towards the absence of any competitive pressure. Banks are comfortable in their safe havens of collateralized, concentrated lending. Their concentrated lending, however, poses a greater risk to public welfare.

II. COMPETITION IN PRODUCT MARKETS

The product- market matrix of deposits, shown in Figure 6.45 in Chapter 6, can be re-drawn for the lending side as well. This is done in Figure 7.3.

Given the fact that the loan/deposit ratio for private sector businesses (the largest category) is now 2:1, the class-intervals for sizes of accounts need to be revised upwards. This is necessitated also by the fact that, owing to inflation, micro-financing which used to typically comprise loans of up to Rs 40,000 in value, has now been re-defined as loans of up to Rs 100,000.[104] The average size of consumer loan is now around Rs 200,000[105] falling squarely in the range from Rs 100,000 – Rs 500,000[106], although this might also have to be revised upward.

Accordingly, five sizes of accounts are shown in Figure 7.3: (i) up to Rs 100,000, conforming to the present definition of microfinance, (ii) up to Rs 500,000, which is the limit for unsecured credit (iii) up to Rs. 1 million, (iv) up to Rs. Rs 10 million, and (v) above Rs 10 million. The shares of these segments, in terms of amounts of loan advances, are shown in Table 7.7.

[103] Ibid, p. 39

[104] (SBP's SMED-11 Circular dated 27/06/06)

[105] see "Perspectives on Consumer Finance in Pakistan", Chapter 5 of *Financial Stability Review 2007-2008*, p 90

[106] Rs 500,000 is also the maximum limit of an unsecured personal loan and is therefore a natural boundary between secured and unsecured credit markets.